Outlook on Municipal Bonds: Seeking Opportunity Amid Volatility

A historic sell-off enhances value, with high yields, strong fundamentals, and ample reserves mitigating policy risks.

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Municipal bond investors may feel uneasy about recent volatility and legislative changes. The historic sell-off in April drove negative performance, while proposals to slash Medicaid spending have heightened concerns about states and healthcare institutions. Risks also include cuts to education funding and the potential elimination of municipal bonds' tax-exempt status.

Nonetheless, we view municipal bonds as a compelling opportunity for investors who prioritize risk management, monitor policy developments, and employ strategic security and sector selection. Our long-term bullish outlook stems from historically attractive municipal valuations and strong credit fundamentals. These factors position municipals to deliver attractive, tax-efficient returns over the secular horizon, even under scenarios more challenging than our baseline view.

MANAGING VOLATILITY AND SEEKING COMPELLING OPPORTUNITIES

As early April's global market volatility spilled over into the tax-exempt asset class, benchmark municipal yields rated AAA jumped 85–100 basis points (bps) over a three-day period – one of the largest moves in municipal market history.[1] Longer-dated municipals sold off to levels that indicate value, with 30-year municipals rated AA trading in line with 30-year Treasuries.[1] This was driven by a perfect storm as reinvestment capital dipped, creating a weak technical environment, and the market experienced the worst week of outflows since 2022.[2] Excess selling from the retail buyer base, likely driven by heightened volatility and efforts to raise liquidity for tax payments, exacerbated muni market liquidity to levels not seen since 2020. These episodes, when technicals temporarily dominate fundamentals, have become more frequent and are expected to persist, creating opportunities for managers who construct portfolios with this dynamic in mind.

Since the sell-off, absolute valuations have become exceptionally attractive for tax-aware investors. The Bloomberg Municipal Bond Index yield to worst reached 4.29% (7.24% on a taxable-equivalent basis[3]) on 11 April, a level exceeded on only 24 trading days over the past 15 years; it offered 238–296 bps in excess yield over other high-quality taxable fixed income indices on a tax-equivalent basis.[4]

Figure 1: Relative to the past decade, municipal bond yields rank in the 99th percentile

Source: Bloomberg as of 11 April 2025

Past performance is not a guarantee or a reliable indicator of future results.

Relative valuations make a case for a measured approach to lower-quality credit, where price discovery has been limited despite recent volatility and increased probabilities of recession, keeping spreads at compressed levels. As of 11 April, the spread between the Bloomberg High Yield Municipal Bond Index and the Bloomberg Municipal Bond Index is 170 bps, which is 54 bps below its five-year average and near multi-year tights.[4] Although select opportunities offer compelling value, we are focused on building resilience within municipal portfolios.

We see ample opportunities, particularly at the long end and in housing:

- **Thirty-year munis** rated AA yielded 4.86% (8.21% on a taxable-equivalent basis[3]) as of 11 April, offering a 334-bps taxable-equivalent spread over 30-year Treasuries.[1] The tax-exempt municipal curve remains upward sloping, with yields on 30-year munis rated AAA 98 bps above 10-year yields – compared to 38 bps on the U.S. Treasury yield curve.[1] With institutions having stepped away from the long end of the curve due to lower corporate tax rates and fund flows remaining under pressure, this dynamic will likely persist. PIMCO aims to capitalize on this through active yield curve management, enhancing carry and roll-down.
- **Tax-exempt mortgage pass-throughs (MPTs)**, composed of housing loans from state and local housing agencies, are among our highest-conviction ideas. Purchases by banks – traditionally, the largest buyers – have declined due to lower tax rates diminishing their appeal as well as reduced appetite for longer-duration securities. Another advantage: MPTs are excluded from most municipal benchmarks, and their complexity reduces demand from traditional muni managers. Rated AAA, they have an effectively explicit government guarantee given Fannie Mae and Freddie Mac's entry into conservatorship in 2008. With recent yields of 4.5%–5.0%, they rival credits rated BBB.[4]
- **Tax-exempt multifamily housing loans are attractive**, especially those on properties offering below-market rents that are senior in the capital structure and have low loan-to-value ratios. Many properties enjoy strong demand and high occupancy, even in challenging economic conditions. These housing-related loans offer a significant yield advantage over broader investment grade and high yield indices.

POLICY IMPLICATIONS

While debate continues over the tax exemption of municipal bonds, and over Medicaid cuts, we believe the outcomes will be less severe than current proposals. Ultimately, we expect most sectors of the municipal bond market to demonstrate resilience, supported by strong fundamentals and flexible budgets.

Will muni bonds lose their tax-exempt status?

We believe it's highly unlikely. Though repeal could save the federal government $250 billion over 10 years,[5] it would cost municipalities nearly $1 trillion.[6] For over a century, municipal bonds have retained their tax-exempt status, enabling lower-cost funding for capital projects and garnering bipartisan support. While private activity bonds and debt for higher education and healthcare are frequent targets, we expect these securities to stay tax-exempt. If future issuance becomes taxable, existing debt will likely be grandfathered in, boosting valuations for outstanding debt as the market shrinks.

Will cuts to Medicaid damage municipal budgets?

Federal transfers account for over a third of state revenues,[7] with Medicaid as the largest component.[8] We believe states, which share the costs of Medicaid with the federal government, will remain resilient. Although the House Republicans' proposal to slash $880 billion over 10 years would represent significant savings for the federal government, we believe that enacting cuts of this magnitude would be challenging. If cuts are made, states will have discretion to modify their programs, making even severe reductions manageable.

What about healthcare systems?

Cuts could hurt margins for not-for-profit healthcare providers. Major systems with structural advantages to address margin challenges will likely be able to manage lower reimbursements without significant stress. However, financially weaker systems may struggle.

Will funding cuts lead to severe local government credit stress?

Local funding, primarily targeted to K-12 education, is expected to persist despite efforts by the administration to dismantle the U.S. Department of Education. However, uncertainty looms: Certain cities may face targeted reductions, and proposed cuts could give rise to significant legal challenges. We believe that local governments are well-equipped to effectively manage these pressures, while localities will continue to benefit from a large dispersion between assessed property valuations and current market values. House price appreciation has been significant, and with roughly 73% of local tax revenues coming from property taxes, this should drive positive momentum for property tax collections as assessed values catch up.

Will funding cuts for education and research harm schools?

Federal education policy, potential cuts to research funding, and the possibility of additional endowment taxation will present headwinds for the sector. Although major institutions with strong brands, stable or rising enrollment, and robust public and private support are well-positioned, weaker segments, especially smaller private universities, will remain severely pressured.

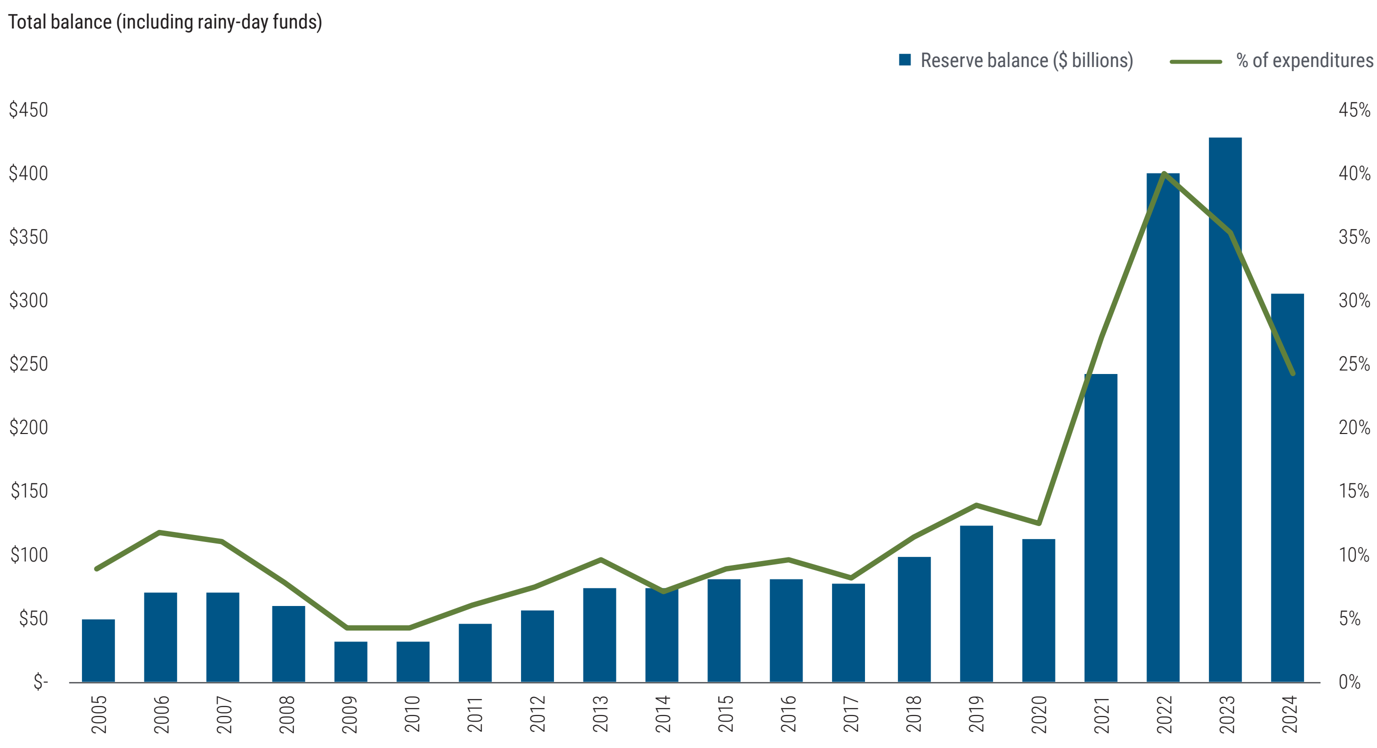
STRONG FUNDAMENTALS: RESERVES, REVENUES, AND LEVERAGE

Credit fundamentals for state and local municipalities remain robust, supported by substantial reserves, stable revenue streams, and declining leverage. Over the past year, tax collections have surpassed pre-pandemic levels, with 2024 collections rising 32.3% versus 2019.[9] Total state balances, including rainy-day funds, are nearing record highs, accounting for 24% of expenditures in fiscal year 2024 – well above the 10-year pre-pandemic average of 8.9% and the 20-year low of 4.6% during the financial crisis (see Figure 2). This sustained fiscal strength reinforces our outlook for a stable credit environment and has driven positive ratings momentum, with the fourth quarter of 2024 marking the 16th consecutive quarter in which upgrades outpaced downgrades.[10]

Despite an overall favorable picture, we anticipate greater dispersion in the coming year, making active sector and security selection an important potential source of better risk-adjusted returns.

We see weakness emerging as some governments deplete pandemic-era federal relief funds, while others face potential budget deficits necessitating spending cuts or revenue enhancements. For example, S&P Global Ratings downgraded a major Midwestern city's general obligation bonds from BBB+ to BBB in January due to the 2025 budget's failure to address a structural imbalance. We also remain cautious on charter schools, which experienced record distress last year, and continuing care retirement communities, where 8% of the sector has been in default in recent years.

Figure 2: State reserves remain robust



Source: Pew as of 30 September 2024. **For illustrative purposes only. Figure is not indicative of the past or future results of any PIMCO product or strategy. There is no assurance that the stated results will be achieved.**

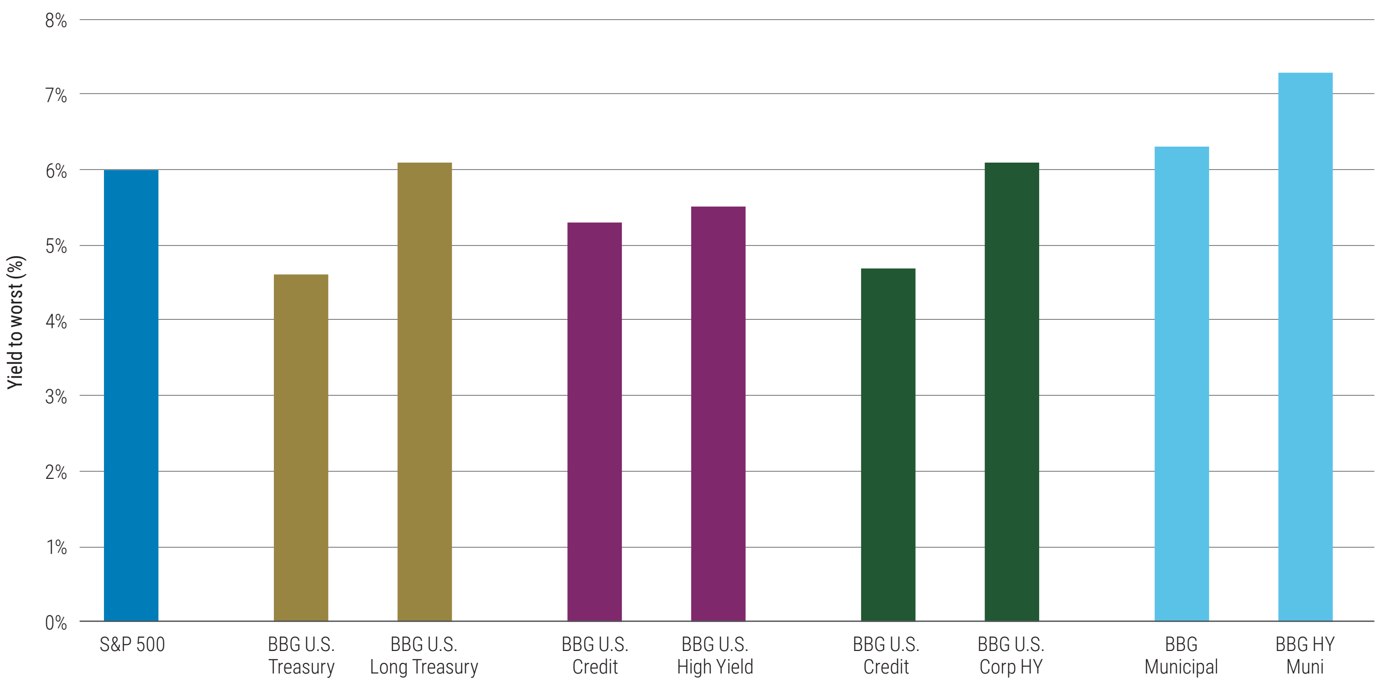
For indices and asset class models, return estimates (arithmetic) are based on the product of risk factor exposures and projected risk factor premia that rely on fair value models and qualitative inputs from senior PIMCO investment professionals. Returns for the BBG Muni and the BBG HY Muni are reported on a tax-equivalent basis assuming a 40.8% marginal tax rate (37% federal and 3.8% Medicare investment tax).

INVESTMENT TAKEAWAYS: A COMPELLING LONG-TERM OUTLOOK FOR MUNIS

Current yields, strong fundamentals and historical resilience create a potentially attractive long-term return outlook for municipal bonds. PIMCO's five-year capital market assumptions (see figure 3) suggest that municipals could be among the highest-performing public market asset classes for tax-aware investors.

Despite concerns over potential federal spending cuts and legislative changes, we believe that the muni bond market remains attractive and that excess volatility creates more opportunities for active managers. Effectively navigating this landscape requires institutional discipline and a keen focus on policy developments and strategic security selection.

Figure 3: Five-year estimated return



Source: PIMCO as of December 2024. **For illustrative purposes only. Figure is not indicative of the past or future results of any PIMCO product or strategy. There is no assurance that the stated results will be achieved.**

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ENDNOTES

1 TM3 MMD Interactive Data as of 11 April 2025

2 Lipper and J.P. Morgan as of 9 April 2025

3 Taxable-equivalent yield calculation assumes a 37% federal income tax and a 3.8% Medicare investment tax. The yield to worst is the yield resulting from the most adverse set of circumstances from the investor's point of view; the lowest of all possible yields.

4 Bloomberg as of 11 April 2025

5 U.S. House Committee on Ways and Means as of 17 January 2025

6 Government Finance Officers Association as of 31 January 2025

7 U.S. Census Bureau's Census of Governments as of 31 December 2018

8 National Association of State Budget Officers as of 31 December 2024

9 U.S. Census Bureau as of 31 December 2024

10 Moody's as of 31 December 2024

Past performance is not a guarantee or a reliable indicator of future results.

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The Bloomberg U.S. Investment Grade Credit Index is an unmanaged index comprised of publicly issued U.S. corporate and specified non-U.S. debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered.

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