CIO expect volatility to be higher, especially in the first half of the year, driven by potential volatility in long treasury yields and increased policy uncertainties. (UBS)

Opportunities to extend interest rate exposure are beginning to emerge

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Investment grade (IG) tax-exempt munis ended 2024 with a tepid 1.1% total return owing to a combination of record issuance and higher treasury rates. Taxable munis fared a little better, with a total return of 1.6% and their performance hindered since the election owing to rising treasury yields and their long duration.

In contrast, high yield (HY) munis had another strong year with a 6.3% total return, their performance fueled by tighter spreads amid a resilient economy and higher carry.

Looking ahead, we expect a stronger performance from **IG munis**. However, we also expect volatility to be higher, especially in the first half of the year, driven by potential volatility in long treasury yields and increased policy uncertainties (see blog titled "*MAGA v DOGE*" published 5 January 2025). **Taxable muni** yields are attractive, but they are more exposed than IG munis to potential treasury rate volatility given their longer duration. **HY munis** have richened relative to IG munis after two years of strong performance, so we don't see compelling value, except perhaps for short-dated maturities.

The AAA tax-exempt curve de-inverted prior to the election. Yields have continued to rise post-election (although less so than treasuries) and are now at one-year highs. We expect yields across the curve to be lower by the end of 2025, but that decline would likely not occur in a straight line, as we expect more volatility in the first half of the year. That said, higher muni index yield to duration ratio provides some buffer against negative total returns. The 2-year-10-year steepened in

2024 and we expect it to steepen further in 2025. In contrast, the 10-year-30-year flattened, and we expect it to remain range bound in 2025. It is unlikely to significantly flatten further given expected strong supply.

There was record issuance in 2024. Supply dipped in December but has come back strongly in January. Muni funds have seen net outflows since December, but we expect strong net inflows in 2025, balancing demand and supply

Economic and Treasury rates outlook

GDP growth appears to have been just a bit below 3% in 2024, led by robust consumer spending. The labor market remains healthy, with solid job growth, real wages rising, and unemployment flat in 2H24. December 2024 job growth exceeded expectations. Core PCE inflation, a key metric for the Fed, was 2.8% in November, the highest reading since April. These data give the Fed little reason to consider cutting rates in the near term. However, the latest CPI report shows inflation cooling more than expected month on month. We expect slower growth in 2025, near the 2% trend, and softer data could open the door to an additional 50bps of cuts starting in June. Overly aggressive policy action on tariffs or immigration could create upward pressure on inflation and downward pressure on growth. However, thin majorities in the House and Senate and differing policy priorities within the Republican party may moderate actual legislative outcomes.

The Treasury market has sold off significantly on more hawkish Fed expectations in 2025. Ten-year yields have entered our buy zone of 4.75-5.00%. With hawkish sentiment, rising term premium, and real yields putting upward pressure on nominals, *we believe opportunities to extend interest rate exposure are beginning to emerge*. We continue to believe that 10-year yields will trend toward 4% by year-end, but it will not be a straight path down and we do not discount seeing 5% yields before then—at least not sustainably.

Although 30-year muni-Treasury ratios are rich relative to their three-year average, we believe that is more of a function of elevated treasury rates at the long end. Absolute yields on long tenor munis are attractive, especially on a tax-equivalent basis, for investors in the highest tax brackets in the high tax states. Credit spreads on BBB and HY are tight. However, given, our expectation of continued economic growth (albeit slower), we do not expect significant spread widening.

California wildfires

The wildfires in Los Angeles have caused unprecedented destruction and suffering. Bonds spreads of issuers in the region have widened and there could be more volatility ahead, as it remains an evolving situation. While it is difficult to assess the precise impact on various credits, we note that default risk for most affected credits remains low, although some face increased credit downgrade risks. We are particularly cautious on lease revenue bonds and Certificates of Obligation (COPs) issued by local governments and school districts, as debt service on these bonds are subject to appropriation. Utility credits also face risks as they may incur financial liabilities per the state's Inverse Condemnation doctrine. For more color on specific credits that CIO covers, please refer to our *publication "Impact of California wildfires on munis"* published on 15 January 2025. The impact on the broader muni market seems to be limited at this time. However, this tragic event has brought the climate crisis front and center, especially in regions prone to extreme weather events, such as Southern California. Investors will need to pay closer attention to these risks going forward.

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