
S&P: Tracking Munis in Uncertain Markets

As uncertainties around tariffs, inflation and interest rates continue to make headlines, how are yield seekers viewing munis? S&P DJI's Jennifer Schnabl and Vanguard's David Sharp discuss key performance drivers of munis in challenging markets.

[TRANSCRIPT]

How have munis fared over the past 12-18 months and what's driving this performance?

Jennifer Schnabl:

When I think about 2024, it was a year largely driven by interest rate volatility. We began the market, as we remember, early 2024, the market was expecting six interest rate cuts by the Fed. Within a few months, that shifted wildly, where at one point, the market then only expected one rate cut for the entirety of the year. And when it ended up happening, as we know, the Fed finally did cut rates for the first time in over four years in September of 2024, followed by two more rate cuts to close out the year.

And what this meant was interest rates, Treasury yields, fixed income yields across the board really, swung pretty wildly with the shift in sentiment, and municipal bond yields certainly went along with that ride in interest rate volatility.

And just to put some numbers to it, our intermediate muni yields, so 0 to 20 year in maturity, this is as measured by our S&P Intermediate Term National AMT-Free Municipal Bond Index, those yields began the year at 2.9%, ended up being a low for the year. By May, they hit a high of 3.68% when the market peeled back its rate cut expectations. By October, they fell again to the low of 2.9%. This was after the Fed cut rates in September. And then they spent the remainder of the year drifting higher, closing the year out higher than where they began at 3.34%. So, those swings were not normal, certainly not in the year prior and in the many years prior.

But what's more telling is that, despite the interest rate volatility in the yields, and despite the move higher in yields throughout the year, the municipal bond market finished 2024 with positive returns, and the main driver of this was those elevated yield levels providing an income return high enough to not only drive performance but serve as a buffer to the broader market volatility.

How do munis stack up in today's yield landscape?

Jennifer Schnabl:

Municipal bond yields began 2025 at some of the highest levels since 2011. I think most fixed income asset classes currently have yields that are at historical highs, and this is an environment we really haven't seen in more than a decade, where the majority of a return generated in a fixed income asset class, munis in particular, can largely be driven by the income associated with the yield offered.

The second thing I'd mention is, with the uncertainty with the changing regulatory landscape, of the changing fiscal policy, I think tariffs, a new regulatory regime, immigration policies, those tend to be associated with inflationary sentiment as well as mixed or uncertain economic impact on U.S. growth, but they do tend to point to, and I think it's general market consensus, that perhaps a higher-for-longer framework for interest rates is about to ensue. If that were to come to fruition, what it would mean for muni bond yields is it would just support these elevated yields that are currently in the market right now and allow for that yield or income capture that market practitioners can participate in for a little bit longer.

The third thing is the data shows that there's still a significant amount of cash on the sidelines or in the front end of the curve. Should front-end yields decrease and the curves steepen, I think that it would be logical to assume that that cash would move further out the curve into longer-dated assets where higher yields could be captured.

What are the headwinds and tailwinds for munis in 2025?

David Sharp:

Jennifer spoke to a lot of really important points there on what some of those tailwinds could look like. Most specifically, what we'd like to note is over the last couple of years, yields are back, and the taxable equivalent yield within munis is quite compelling.

Last year, it ended around, or at the end of February, it ended around 6% on taxable for the intermediate part of the curve. That's really attractive compared to taxable bonds in the aggregate. Even corporate bonds in the intermediate part of the curve can't return yields quite like that. So, that's going to be attractive to the right investor, and that will add some tailwinds behind this product.

The other thing is it's certainly the fundamentals, a lot of, again, what Jennifer mentioned, are really good and look really good in munis right now. A lot of the rainy-day funds at some of the municipalities are still very strong after a few years being able to add to those savings, those buffers. That's good for, even in a credit cycle that might change a little bit, that's good for munis. And that fundamental is really is going to resonate for a lot of investors in that space.

The headwinds are really some of the uncertainty with just economic policy. What is that going to, what is the impact of tariffs? Some of the administration's policies could be inflationary, the way that they hit the market, and that could lead to changes in the way the Fed behaves and thinks about lowering rates and adding supply to the monetary policy.

So, those headwinds, it's more around just the uncertainty that some clients have, that they want to be in really safe investments, like U.S. Treasuries or cash on the sidelines that they're still sitting in with those higher yields, they still remain to be a bit of a headwind to the muni landscape.

How is the role of passive strategies changing for munis?

David Sharp:

When we look at passive, it hasn't got quite the adoption in the muni space that we've seen in other parts of the market historically, but we're seeing that tide start to shift. When we look at the end of last year, about 13% of all assets in funds, and ETFs specifically, were in passive. But 27% of the flows last year went into passive, so it was really outkicking its weight, showing that there is a greater adoption of passive investing in munis. And a big driver of that frankly is ETFs. Just using ETFs more, the tax efficiency that the ETF provides, the trading flexibility it provides, it works really well in model portfolios, which are a growing area of business for many advisors. So, having the ETF in that package, that's those ETFs, there's active ETFs in that space, but passive is where the big assets lie. Our broad market muni product is over USD 30 billion. There are some really large funds that sit on the passive side to get that inclusion in models because the models like to have that stability and consistency that a passive index provides.

Closing:

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