Municipal Market Quarterly Review

First Quarter 2025

Municipal Market Review

The S&P Municipal Index (Municipal Index) returned -0.24% in the first quarter, bringing the trailing 12-month total return to 1.76% (**Figure 1**). Prices were pressured as investors raised cash ahead of tax season in concert with higher-than-expected levels of municipal bond issuance.

Municipal yields were mixed across the yield curve. Short-term yields declined, while long-term yields increased, leading to a steeper yield curve as measured by the spread between 2- and 30-year rates (**Figure 2, page 2**). The shift in municipal term structure indicated an increased risk premium for interest rates. The U.S. Treasury (UST) curve also steepened, albeit to a lesser degree (**Figure 3, page 2**). Shorter-dated bonds outperformed longer-dated bonds due to their lower interest rate sensitivity, or duration, amid the shift in interest rates.

Relative to taxable fixed income sectors, the Municipal Index underperformed the Bloomberg UST Index by 302 basis points (bps) in

Figure 1. Fixed Income Returns and Statistics
As of 3/31/2025

S&P Municipal Bond Indices	Q4 2024 Return	12-Month Return	Yield to Worst	Duration
Main	-0.24%	1.76%	3.90%	6.1
Intermediate	0.19%	1.53%	3.63%	4.9
Short-Intermediate	0.77%	2.82%	3.25%	3.1
Short	0.98%	3.57%	3.05%	1.7
General Obligation	-0.28%	1.35%	3.65%	5.8
Revenue	-0.22%	1.99%	4.10%	6.5
Taxable	2.90%	4.81%	4.95%	7.7
Bloomberg Indices				
U.S. Treasury	2.78%	4.88%	4.60%	6.0
U.S. Aggregate	2.92%	4.51%	4.11%	5.9
U.S. Corporate	2.31%	4.90%	5.15%	6.8

Sources: S&P Dow Jones Indices LLC, Bloomberg L.P., PNC

KEY THEMES

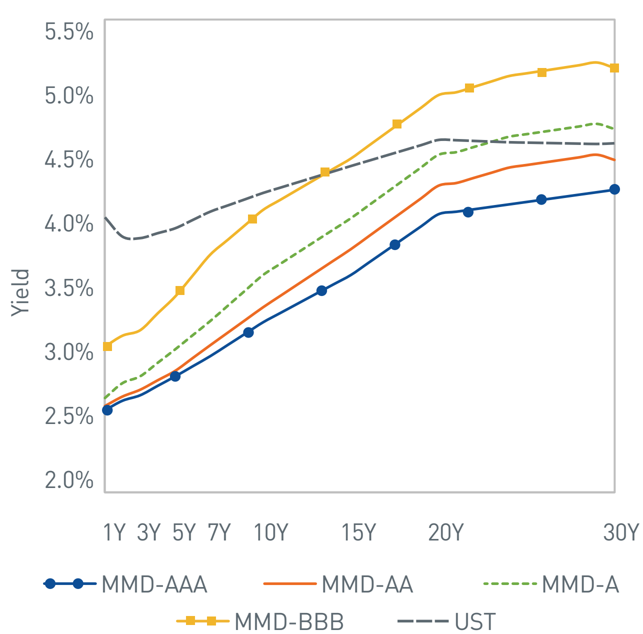
- The Municipal Index returned -0.24% in the first quarter and underperformed comparable taxable sectors by more than 2.5%.
- The municipal yield curve steepened as long-term yields climbed and short-term yields fell, indicating an increased risk premium for interest rates.
- Municipal valuations improved versus USTs on a maturity-matched basis; intermediate- and long-term Municipal-to-Treasury (MT) ratios are near one-year highs.
- A-rated and BBB-rated municipals outperformed as credit spreads were little changed. We expect spreads to be flat to wider for the remainder of 2025.
- We believe municipal yields offer a compelling option for tax-sensitive investors relative to taxable alternatives.

Figure 2. Quarter-over-Quarter Yield Curve Change (bps) (12/31/2024 – 3/31/2025)

	Market Spot Rates				
Maturity	**AAA**	**AA**	**A**	**BBB**	**UST**
1 Year	-25	-25	-25	-25	-12
2 Year	-14	-14	-14	-14	-35
3 Year	-9	-9	-9	-9	-40
5 Year	-1	-1	-1	-1	-43
7 Year	11	11	11	11	-41
10 Year	20	20	20	20	-37
15 Year	34	34	34	34	-31
20 Year	44	44	44	44	-26
30 Year	34	34	34	34	-21

Sources: Refinitive, S&P Dow Jones Indices, Bloomberg L.P., PNC

Figure 3. Municipal Market and UST Yield Curves As of 3/31/2025



Sources: Refinitive, S&P Dow Jones Indices, Bloomberg L.P., PNC

the first quarter as UST yields shifted broadly lower. Municipals also underperformed the Bloomberg U.S. Aggregate and Bloomberg U.S. Corporate indices by 316 bps and 254 bps, respectively, similarly driven by a divergence in long-term rates. Among quality cohorts, A-rated and BBB-rated bonds outperformed, benefiting from higher yields as credit spreads were little changed.

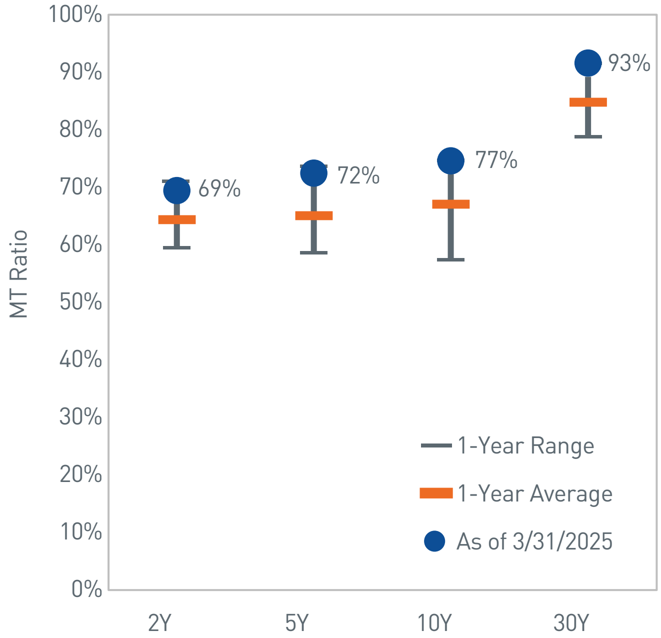
From a technical perspective, investor demand for municipals remained positive in the first quarter. Municipal mutual funds experienced net inflows of $5.3 billion during the quarter, after attracting $29.8 billion in 2024. On the supply side, municipal bond issuance totaled $119 billion for the quarter, representing a 20% increase year over year (y/y) and the highest level of first quarter issuance over the past decade. Only 6% of all municipal bonds issued in the first quarter were taxable, a 1% increase compared to the 5% in 2024.

Tax-exempt Municipal Valuations

Municipal valuations improved relative to USTs across the yield curve. The sharpest changes for MT ratios were at the middle and long end of the yield curve. The 10- and 30-year MT ratios both improved by over 10%. The 5-year MT ratio improved by 7%, while the 2-year MT ratio improved by less than 3%. The 2-, 5-, 10- and 30-year MT ratios are now above their respective 1-year averages and are much closer to their 1-year highs than 1-year lows (**Figure 4, page 3**).

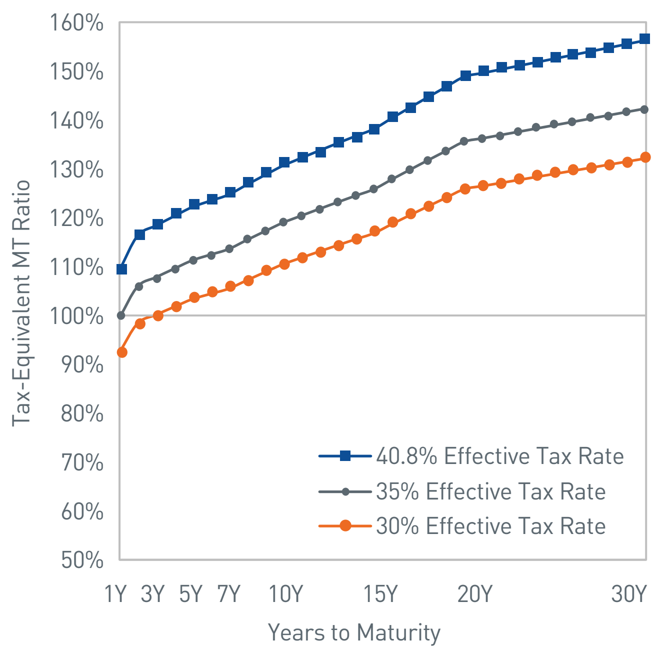
The shift in yields has made tax-exempt municipal bonds more attractive on a tax-equivalent basis versus taxable alternatives. Assuming an estimated federal tax rate of 40.8% (37% maximum federal income tax level and 3.8% Medicare tax that may apply to some taxpayers), the tax-equivalent yield of a 10-year AAA-rated municipal bond now offers 131% of the 4.22% yield offered by the 10-year UST, up from 113% at the end of last quarter. For investors with an effective tax rate of 40.8%, tax-equivalent MT ratios are now above 100% across the yield curve, with more advantage in long-term bonds. Similarly, tax-equivalent MT ratios for investors with a tax rate of 35% are above 100% for nearly all tenors (**Figure 5, page 3**).

Figure 4. MT Yield Ratios
As of 3/31/2025



Sources: Refinitive, S&P Dow Jones Indices, Bloomberg L.P., PNC

Figure 5. Tax Equivalent MT Yield Ratios
As of 3/31/2025



Sources: Refinitive, S&P Dow Jones Indices, Bloomberg L.P., PNC

Taxable Municipals Outperform Tax-exempt

The S&P Taxable Municipal Bond Index (Taxable Municipals) returned 2.90% in the first quarter, outperforming tax-exempt municipals by 314 bps. Taxable municipals also outperformed the Bloomberg U.S. Corporate Index by 59 bps, mostly due to higher index-level duration, or interest rate sensitivity. A-rated taxable municipal bond yields are largely in line with A-rated corporates across the yield curve. We believe supply-side technicals remain supportive of valuations given the landscape of competitive yields and our expectation for increased, but palatable, taxable municipal issuance in 2025.

Municipal Credit Review

For the entirety of first quarter 2025, rate movement was muted, but plagued by intraperiod volatility. Nonetheless, the credit pricing side of the market was active. Credit spreads generally widened during the period as investors digested the impacts of the January wildfires and acute policy shifts at the federal level. AA spreads, which ended 2024 at historically tight levels, were most impacted, with A-rated and BBB-rated bonds following to a lesser degree. As investment grade corporate pricing tends to lead municipals, investors should expect continued degradation in credit spread pricing.

Fundamental credit quality may be facing a new reality in 2025, following relative serenity in the prior year. Newly introduced federal policy initiatives caused reverberations in many sectors of the municipal market. The Hospital sector will potentially have to endure significant changes to Medicaid reimbursement rates, which would have a deleterious impact on margins. Proposed cuts to federal research funding could impact operations and funded programs. Likewise, the Higher Education sector could feel even greater effects in the form of research grant reductions and a newly proposed tax on endowment gains. The California wildfires also directly impacted fundamental credit quality, as observed by a two-notch downgrade to the Los Angeles Department of Water and Power from AA- to A.

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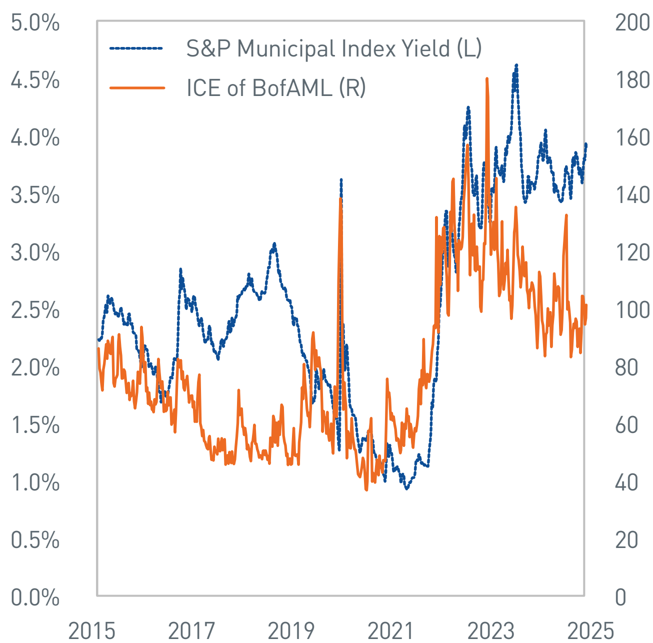
Figure 6. S&P Municipal Bond Index Yield & Rate Volatility
As of 3/31/2025



Sources: Bloomberg L.P., PNC

At the national level, Moody's Investor Services reaffirmed their Aaa rating of U.S. government debt, but reiterated their negative outlook, citing debt affordability and political polarization as the primary drivers. Given that Moody's first assigned a negative outlook in November 2023, we expect a resolution on their outlook for the U.S. government rating in 2025 as customarily, credit outlooks are intended to be resolved within 12 to 18 months. Both Standard & Poor's and Fitch ratings have already downgraded U.S. government debt to AA+. It should be noted for municipal investors that the weakening credit conditions surrounding the U.S. government have the potential to permanently impact relative valuations. Weakening credit quality of the U.S. sovereign can be observed in the market today via rating agency actions and movements in credit default swap pricing. All of these factors could place downward pressure on the equilibrium point of MT ratios, the traditional measure of cross market relative value.

Looking Ahead

The combination of investors raising cash ahead of tax season and higher-than-expected municipal bond issuance in the first quarter has improved relative valuations and higher absolute yields, offering an attractive entry point for tax-sensitive investors, in our view. Additionally, 5-, 10- and 30-year MT ratios are within 1% of their 1-year highs, and the Municipal Index yield is now in the 95th percentile of weekly observations over the past 10 years (**Figure 6**).

Fiscal policy remains top of mind amid the pending impact of tariffs and budgeting negotiations in Congress. While the current House of Representatives' budget does not specify cuts to Medicaid, their directive to reduce Energy and Commerce Committee spending by $880 billion over the next ten years suggests the program will be impacted. Decreases in Medicaid reimbursement would likely increase uninsured care and weigh on not-for-profit hospital revenues and margins. States may increase support to offset the impact of federal cuts, which would likely weigh on state budgets. The states most impacted in this scenario include California, New York, Texas, Pennsylvania and Ohio.

Worth monitoring in 2025 and beyond, discussions around substantive changes to the tax shelter offered by most municipal bonds have increased. We believe the value and relevance of the municipal bond tax exemption could fall under greater scrutiny, which has helped to drive record levels of issuance in early 2025. Additionally, both political parties have expressed interest in amending and/or repealing the State and Local Tax (SALT) cap, which would have a dramatic impact on municipal bond pricing.

While spreads were little changed for the quarter, current levels reflect the improvement in financial health for municipalities since the COVID-19 pandemic. State and Local tax collections increased in 2024, growing by 4.5% y/y, an improvement from small declines in 2023. While spread compression will always enhance returns for municipal bondholders, historically, tight credit spreads leave little margin for any deterioration from the current fundamental baseline. We believe the remainder of 2025 is likely to bring flat to wider credit pricing, with income being the primary driver of returns.

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