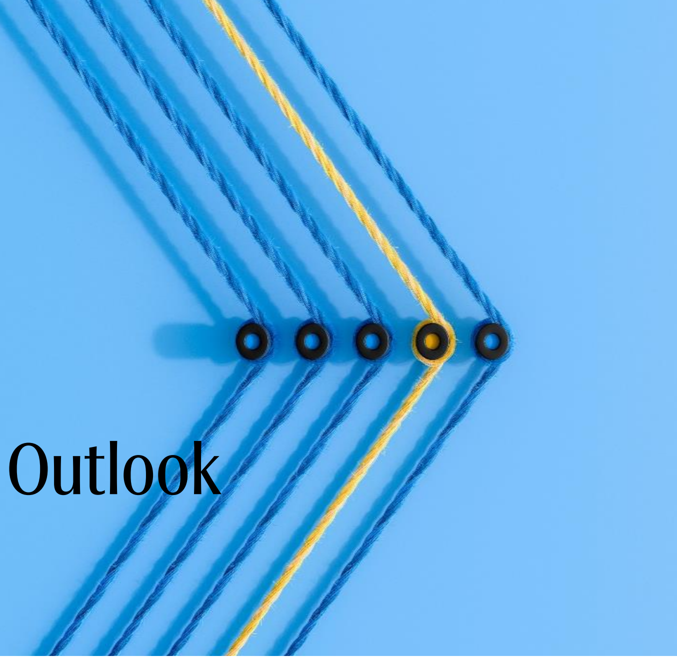
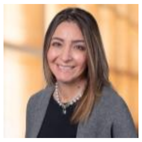


MUNICIPAL FIXED INCOME

# Municipal Quarterly Review and Outlook 1Q 2025


**Scott Diamond**
Co-Head of Municipal Fixed Income



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## Promising Start Derailed by March's Madness

Municipal bonds began 2025 on a strong note, with declining Treasury yields and consistent investor inflows driving robust demand that effectively absorbed the substantial volume of new bond issues. However, this positive trend reversed sharply in March. A combination of negative factors—outflows, high new issuance, positive net supply, tax-related selling, and increased news regarding the tax exemption—created a challenging market environment for municipal bonds.

January and February had positive returns; however, March delivered the muni market's worst monthly return in almost 18 months. For the quarter, the Bloomberg Muni Bond Index returned -0.22%. The Bloomberg Municipal High Yield and Taxable Indices returned 0.82% and 2.99%, respectively, for Q1'25.

The 10-year Treasury yield peaked at 4.80% in mid-January and then generally fell due to lower inflation expectations, tariff concerns, mixed labor market data, and weaker consumer confidence — munis followed suit.

Munis largely underperformed Treasuries as benchmark muni yields fell in short-term maturities but moved higher in longer-term ones. The yield-to-worst on the Bloomberg 3yr Index ended the quarter 12bps lower at 3.06%. The Bloomberg 1-10 Index closed at 3.34%, 2bps lower, and the Bloomberg Muni Agg Index rose 11bps, reaching 3.85%.

"During the past quarter, concerns about credit fundamentals took a backseat to municipal technicals and broader rate volatility. With credit spreads largely unchanged, and market volatility increasing – there is no reason to believe this changes during the near term."

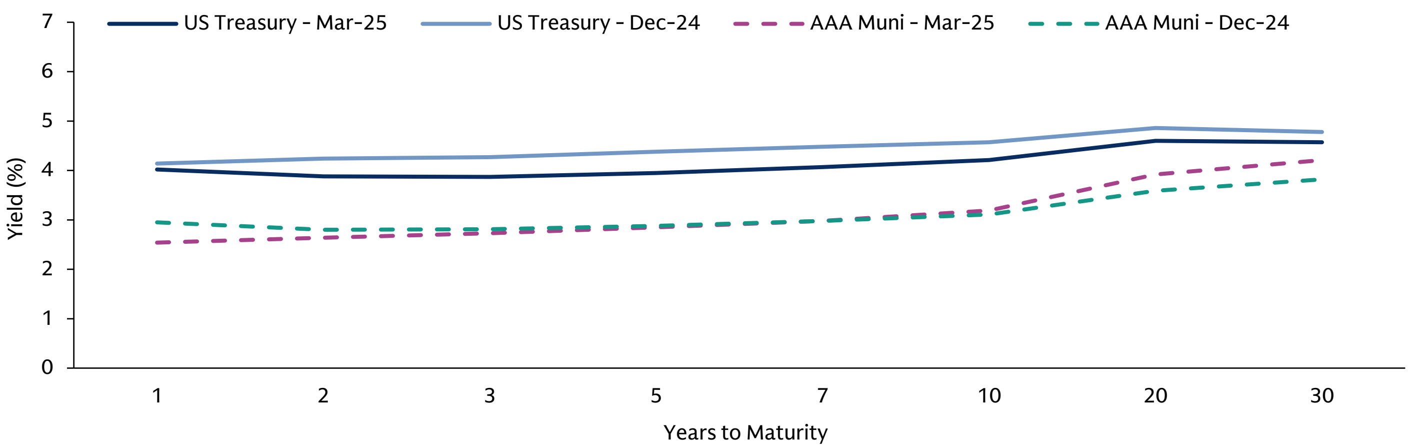
**Ed Paulinski,** Portfolio Manager, Head of Municipal Separately Managed Accounts

# Market Review

## Primary Market: Record Pace to Start the Year

While new municipal bond issuance tends to start off slow each year, the record-breaking issuance volume of 2024 carried over into 2025, resulting in higher issuance levels at the start of the year. Municipal bond issuance in January, February, and March 2025 surpassed the corresponding months' issuance in 2024. Overall volumes were 15% higher than Q1'24, but slightly below the pace of the last quarter of 2024.

**Q1 2025 Treasury vs Municipal Yield Shifts**

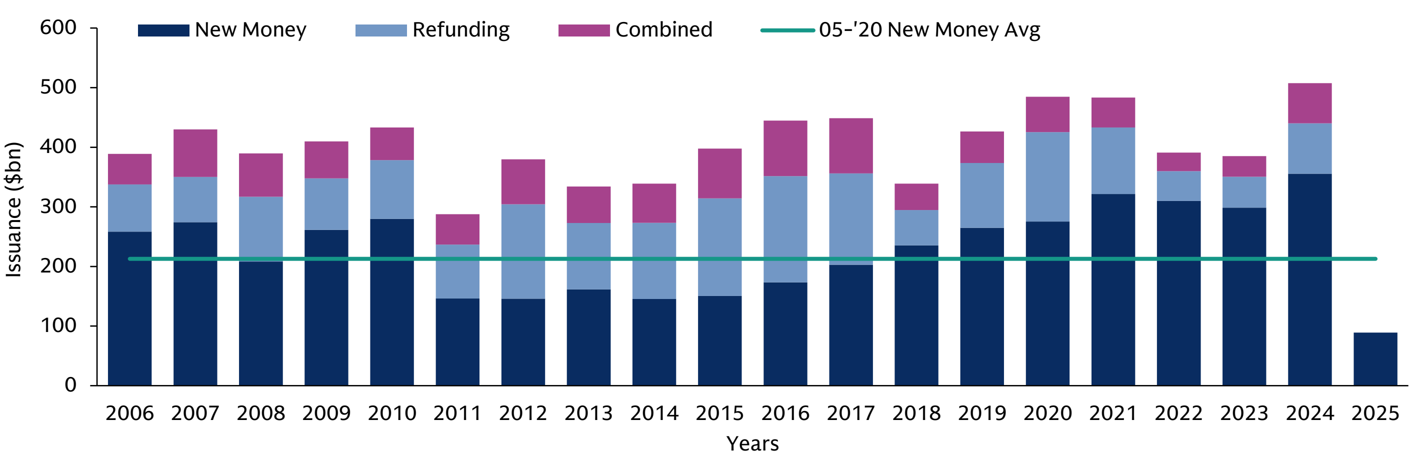



Source: Bloomberg, BVAL Muni. As of March 31, 2025.

The start of the year saw numerous deals for new projects, while refinancing activity was less prevalent. The transportation sector experienced significant activity with airports, passenger rail, and toll road issuers bringing substantial deals to the market. Other sectors that saw increased activity included healthcare, education, and utilities.

The increased issuance could be partially attributed to anxieties surrounding potential limitations or the complete elimination of tax-exempt borrowing capabilities for all or parts of the municipal market. Throughout the quarter, there has been heightened attention and media coverage regarding this scenario, particularly in the context of discussions about its potential inclusion in future tax legislation.

**Municipal Issuance**

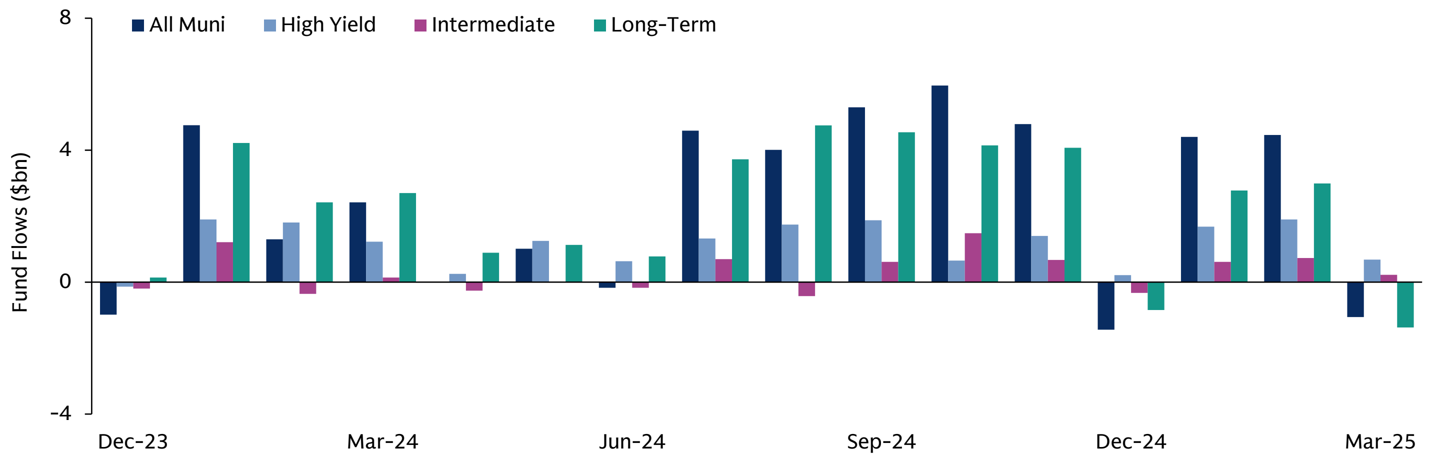



Source: Bloomberg, Bond Buyer. As of March 31, 2025.

## Demand: Consistently Positive Inflows, Then an Abrupt Shift to Outflows

Municipal mutual funds experienced positive flows for all but one week during January and February. Funds received nearly $10 billion in inflows by late February. By the second week of March, the direction changed as funds experienced outflows for the rest of the quarter, continuing into the next quarter with a three-week outflow streak. This sudden change may have been influenced by macroeconomic uncertainty, tax season, and/or news regarding the tax-exempt status of municipal bonds. In aggregate, Q1'25 amounted to $10 billion of inflows, similar to Q1'24's level of inflows. Long-Term and High Yield Funds garnered a disproportionate share of the inflows.

**Municipal Fund Flows**



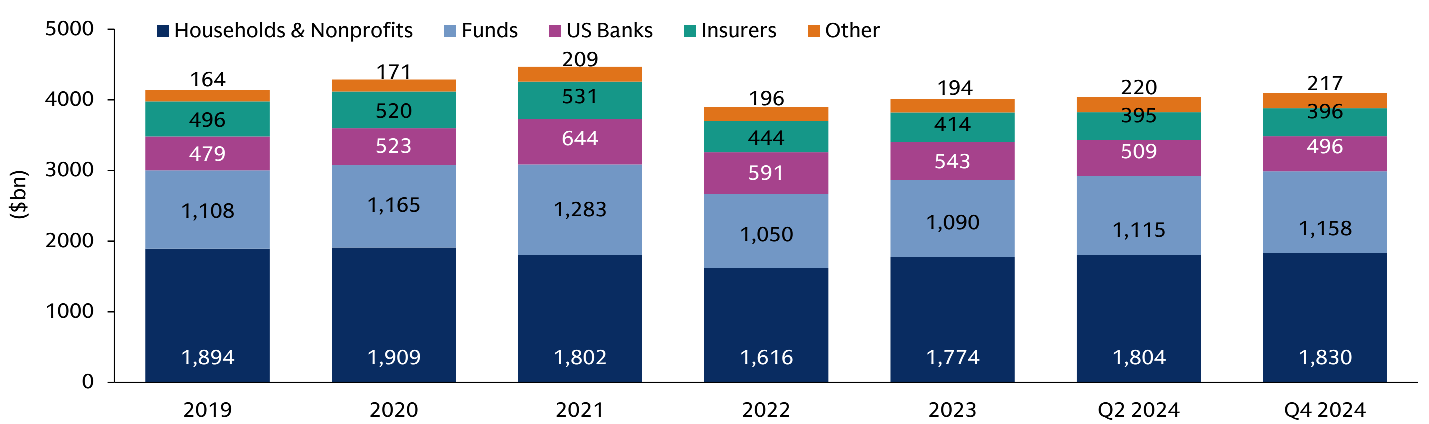

Source: Lipper. As of March 31, 2025.

## Valuation and Yield Changes: Underperformance Across the Curve

In the initial two months of the quarter, yields on triple-A tax-exempt municipal bonds steadily declined, reflecting the trend observed in Treasury securities. In January, yields decreased by an average of 10bps, with municipal bonds outperforming U.S. Treasuries. In February, yields fell by an average of 14bps, with municipal bonds lagging the yield move in Treasuries. In March, muni yields rose by 21bps, while Treasury yields generally fell. Municipal fund outflows, substantial supply, and tax season selling pressure caused a major shift in relative yield changes.

Triple-A tax-exempt muni yields fell 16bps and 3bps in 2 and 5-year tenors but rose 8bps and 39bps in 10 and 30-year tenors. Treasuries dropped 36/43/36/21bps at the same maturity points. Muni/UST ratios were higher across the curve, with 2yr and 5yr ratios increasing to 68% and 72%, while the 10yr and 30yr ratios increased to 76% and 92%, respectively.

**Municipal Holdings by Investor Type**



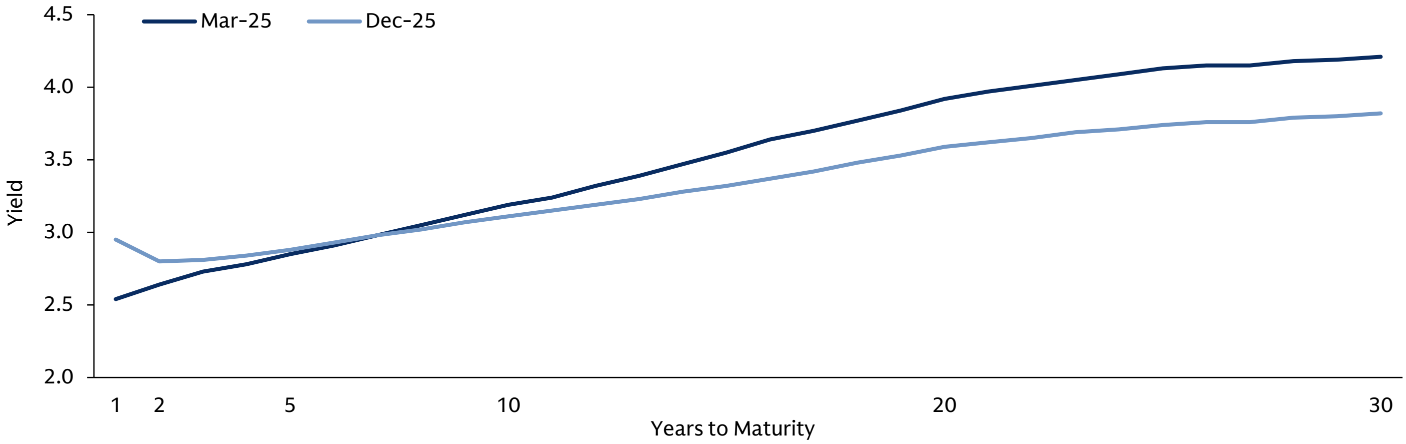

Source: Federal Reserve Board Flow of Funds data, BofA Merrill Lynch Global Research. As of 4Q24, latest available.

## Yield Curve: Steepens as Long Maturities Underperform

Maturities of 10 years and longer exhibited the weakest relative performance during the first quarter. Notably, the 30-year segment of the municipal yield curve experienced significant underperformance, with its yield rising by 39bps, while the shortest maturities recorded a decrease in yields by nearly 30bps.

The difference between 2- and 30-year tax-exempt muni yields increased by 55bps, ending the quarter with a slope of 157bps. The middle curve (5 to 10-year maturities) steepened by 11bps, finishing with a slope of 34bps.

**Municipal Yield Curve**




Source: BVAL Muni. As of March 31, 2025.

## Investment Grade Index Returns & Spreads: Slightly Negative with Some Bright Spots

The Bloomberg Municipal Bond Index returned -0.22% during Q1'25. The 1-10 Year Blend Index posted a total return of 0.70%, while the 3-year Index returned 1.01%.

Within investment grade credit, the 'BBB' segment of the municipal index recorded the highest relative returns at 0.13%, whereas the 'AAA' segment showed the weakest performance with a return of -0.34%. From a yield curve perspective, the 1-year Index achieved the best performance with a return of 1.05%, while the 22+ year Index experienced the lowest return at -1.46%.

BBB-AAA credit spreads tightened by 3bps to end the quarter at 86bps. BBB-AAA credit spreads have averaged 119bps over the last 10 years but have also reached levels as low as 54bps.

## High Yield Municipals: Outperformance Continues as Spreads Tighten

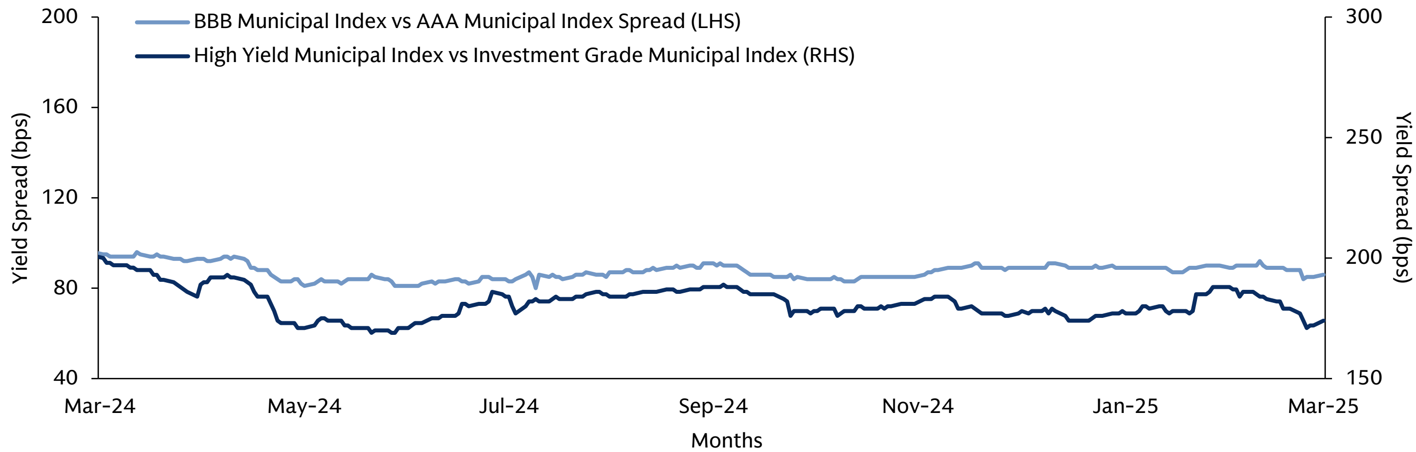
The high yield municipal market, represented by the Bloomberg Municipal High Yield Index, posted a return of 0.82% over the quarter, outperforming the investment grade index by 104bps — the seventh consecutive quarter it has outperformed IG.

Within high yield municipals, transportation and hospital credits were the best performers — posting total returns of 1.56% to 1.45% for Q1'25. Education and water/sewer sector credits were relative underperformers, returning -0.13% and 0.20% respectively for the quarter.

Within the HY municipal index, the 2-4 year maturity area of the curve outperformed — returning 1.65%, while the 20 year and long index underperformed returning 0.49% and 0.63% respectively for the quarter.

High yield spreads decreased by 4bps on the quarter and ended March at 174bps — close to the lowest level in more than three years. High yield credit spreads have averaged 273bps over the last ten years but also reached levels as low as 168bps in 2022.

**Municipal Index Spreads**




Source: BVAL Muni. As of March 31, 2025.

While some sector-wide challenges have begun to take shape, we continue to believe that the majority of distressed situations will remain one-off in nature given the idiosyncratic nature of municipal credit. Underlying credit quality remains solid across a number of sub-sectors and obligors, providing for a strong fundamental base for this portion of the market. Demand continued its positive trend over the quarter as well, as high yield funds saw inflows of $4.9 billion, a disproportionately positive amount given the relatively smaller size of the asset class.

## Taxable Municipal Market: Strong Returns as Treasuries Rally

The taxable municipal market, as represented by the Bloomberg Taxable Muni Index, posted a total return of 2.99% during Q1'25, outperforming the tax-exempt investment grade index by 323bps Positive returns were driven mainly by a decrease in Treasury yields during the quarter.

Credit spreads widened by 13bp as the difference between the Bloomberg Taxable Municipal Index and the 10-year Treasury ended the quarter at 77bp — still within reach of the tightest spreads the market has seen in its history. Taxable muni issuance was 17% higher than over the same quarter in 2024.

| | Returns (%) | | Statistics (as of March 2025) | | | Statistics (as of December 2024) | | |
|---|---|---|---|---|---|---|---|---|
| | **1Q25** | **4Q24** | **OAD (yrs)** | **YTW (%)** | **TEY (%)** | **OAD (yrs)** | **YTW (%)** | **TEY (%)** |
| Municipal 3yr | 1.01 | -0.42 | 2.39 | 3.06 | 5.17 | 2.47 | 3.18 | 5.37 |
| Municipal Managed Money 1-5 | 0.84 | -0.66 | 2.74 | 2.84 | 4.80 | 2.78 | 2.93 | 4.95 |
| Municipal Managed Money 1-10 | 0.48 | -1.35 | 4.57 | 3.02 | 5.11 | 4.62 | 3.01 | 5.08 |
| Municipal 1-10yr Blend | 0.70 | -0.95 | 4.02 | 3.34 | 5.64 | 4.03 | 3.36 | 5.67 |
| Municipal Aggregate | -0.22 | -1.22 | 6.40 | 3.85 | 6.50 | 6.29 | 3.74 | 6.32 |
| Municipal High Yield | 0.82 | -1.08 | 10.07 | 5.59 | 9.43 | 10.21 | 5.52 | 9.32 |
| Taxable Municipal Index | 2.99 | -3.57 | 8.37 | 4.98 | N/A | 8.57 | 5.21 | N/A |

Source: Bloomberg, Goldman Sachs Asset Management, Barclays. As of March 31, 2025.
OAD: "Option adjusted duration" is a measure of the sensitivity of a bond's price to interest rate changes, assuming that the expected cash flows of the bond may change with interest rates. YTW: "Yield to worst" is calculated by making worst-case scenario assumptions (excluding issuer default) on the bond by calculating the returns that would be received if provisions, including prepayment, call, put, and sinking fund, are used by the issuer. YTW may be the same as YTM, but never higher. YTW does not represent the performance yield for the Fund. TEY: "Taxable equivalent yield" is the return that is required on a taxable investment to make it equal to the return on a tax-exempt investment. Past performance does not predict future returns and does not guarantee future results, which may vary. Goldman Sachs does not provide accounting, tax or legal advice. Please see additional disclosures at the end of this document. Past correlations are not indicative of future correlations, which may vary. Returns less than 12 months are cumulative, not annualized.

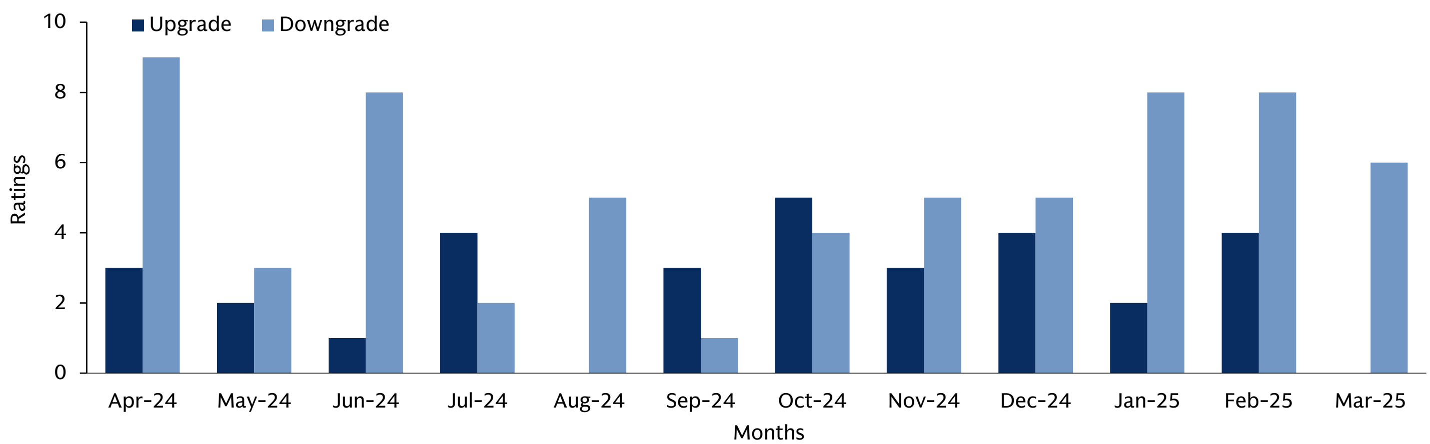
# Municipal Credit Update

## Federal Policies and Impact on Higher Education

The new administration has moved quickly to propose a wide range of policy changes, creating uncertainty regarding their impact on municipal credit. While we maintain confidence in the fundamental strength of municipal credits, we are closely monitoring the situation. The anticipated program cuts, particularly those affecting FEMA and Medicaid, will initially affect states due to their budgetary ties. However, the scale and popularity of these programs suggest a lengthy and complex implementation process. Concurrently, we are assessing the potential effects of tariffs on states and municipalities. Despite these potential challenges, states currently enjoy a strong financial position, with historically high reserves and manageable debt levels.

The recent focus on universities stems from potential reductions in research funding, student loan program adjustments, and increased endowment taxes. A proposed cap on National Institutes of Health (NIH) indirect cost funding for research is a significant concern, particularly for research-focused institutions. However, the most affected institutions are typically large universities with strong demand and substantial endowments, potentially mitigating the overall impact. We are already observing reductions in program expenses to adapt to these changes. Changes to Medicaid funding could also impact universities with large academic medical centers. Reflecting these concerns, Moody's downgraded the sector outlook to Negative in March, making universities one of the few sectors experiencing more downgrades than upgrades in the past year (see graph).

**University Rating Changes (Moody's and S&P)**




Source: Moody's and S&P As of March 31, 2025.

Disruptions in the administration of federal financial aid can lead to significant financial challenges within the sector. Additionally, any expansion of the endowment tax may also contribute to such strains. The endowment tax currently affects 56 universities, requiring them to pay 1.4% of their net interest income. These institutions have the largest endowments relative to enrollment, and a higher tax should not pose credit concerns.

Changes to immigration policies and potential reductions in international student visas present further operational and enrollment challenges, especially for institutions with strong STEM programs. Increased scrutiny and enforcement against university Diversity, Equity, and Inclusion (DEI) programs creates the risk of funding cuts for non-compliance.

## Los Angeles Wildfires and California

The year began with large wildfires in Los Angeles, which are expected to cause $25-40bn in insured damages (please see our January piece on the wildfires for more information). Following the clean-up and reconstruction efforts, Los Angeles has slightly adjusted its revenue projections downward. This adjustment accounts for the recovery process and uncertainties surrounding federal policies. The city did not provide estimated revenue impacts from the January wildfires but mentioned that aid from the federal administration (FEMA) and potential economic stimulus from recovery efforts could help offset the losses. Some costs may be short-term, with some of the recovery expenses reimbursed by FEMA.

Taking a broader view of California's financial situation, the state has benefited from higher-than-expected revenues due to a robust stock market. In January, Governor Newsom proposed the FY26 budget, revising General Fund revenues up by 6% to $223 billion for the current fiscal year. Additionally, California's cash receipts for FY25 through February have aligned positively with the newly proposed budget, while expenditures remain favorable at 2% lower than projected.

## New York City and State

New York City under Mayor Adams has a history of conservative budgeting, and FY6/30/25 continues that record. The city budgeted for 0% revenue increases for the fiscal year, and as of Jan'25 the city's total revenues are now projected to be up 4% y/y, where both tax revenues and state and federal aid are all better than originally budgeted. The most recent projections show that sales taxes are projected to be up 3.7% y/y from FY24, PITs up 11% y/y and Property taxes up 4% y/y. The total tax collections in NYC are projected to end the Fiscal year at $78.36 billion, up 5.6% y/y. The latest budget update indicates that the city will not make any debt service prepayments or contributions to the formal General Reserve. These prepayments typically serve as an informal reserve fund. Without either of these deposits, the city's reserves will effectively decline. However, budgeted General Fund cash is projected to remain stable at $10 billion.

The State of New York began the 2025-2026 fiscal year on April 1 without an enacted budget; reports indicate that budget negotiations are ongoing in Albany. The Governor's budget proposal includes spending down some of the state's cash reserves and conservatively budgeting for 2% revenue growth. The most recent update indicates that the State's FY25 revenues are trending ahead of budget, with revenues estimated to end the fiscal year up 6.6% over FY24, which is approximately 4% better than budget.

# Notable Mentions and Market Movers

| | |
|---|---|
| January | • Wildfires cause widespread damage in Los Angeles<br>• Non-Farm payrolls much higher-than-expected<br>• CPI readings below consensus<br>• The FOMC left the target range for the federal funds rate unchanged |
| February | • CPI readings above consensus<br>• Non-farm payrolls below expectations, earlier months revised higher<br>• FOMC minutes note 'careful' approach amid high uncertainty |
| March | • Tariffs on foreign goods moves forward<br>• Core CPI comes in below expectations<br>• FOMC holds rates steady, but increases inflation expectations while decreasing growth projections<br>• Tax season takes hold in muni market |

# Municipal Market Outlook

**Supply/Demand**

We expect primary market supply to maintain its record pace from last year as the need for costly infrastructure spending continues across most municipal sectors. At current yield levels, refinancing activity of previously issued debt also has the potential to rise. Issuer concerns about losing their ability to borrow in the tax-exempt markets may cause front-loading of issuance before tax legislation is passed. Given our constructive and income-focused view on muni returns in 2025, we believe aggregate demand for municipals will be positive. If yields stay elevated, we believe all investment vehicles will benefit as investors look to take advantage of the tax-free income available.

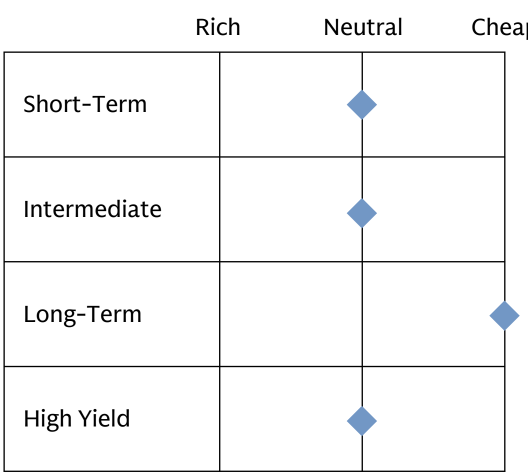
**Valuations**

Short and Intermediate valuations are currently fair to attractive based on recent history. With this past quarter's underperformance, the longest maturities seem most attractive from a curve perspective. Strong demand, improved levels of re-investment capital, and normalized credit fundamentals should lead municipals to outperform in the near-term. However, tax policy uncertainty may put a ceiling on the outperformance potential.

**Credit/Spreads**

We are currently experiencing a typical municipal credit cycle characterized by reduced federal support and increased budgetary pressure, which may result in negative headlines. Despite these challenges, investment-grade municipal issuers remain stable due to healthy reserve balances. We are diligently observing the effects of federal policy and potential tariffs on specific issuers as well as entire sectors. Given the diverse high yield municipal opportunity set, careful credit selectivity will be crucial for portfolio outperformance.

**Relative Value Indicators**



**RISK CONSIDERATIONS**

Municipal Securities are subject to credit/default risk, interest rate risk and certain additional risks.

High-yield, lower-rated securities involve greater price volatility and present greater credit risks than higher-rated fixed income securities.

Investments in fixed-income securities are subject to credit and interest rate risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond's price. Credit risk is the risk that an issuer will default on payments of interest and principal. All fixed income investments may be worth less than their original cost upon redemption or maturity.

Income from municipal securities is generally free from federal taxes and state taxes for residents of the issuing state. While the interest income is tax-free, capital gains, if any, will be subject to taxes. Income for some investors may be subject to the federal Alternative Minimum Tax (AMT).

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Indices are unmanaged. The figures for the index reflect the reinvestment of all income or dividends, as applicable, but do not reflect the deduction of any fees or expenses which would reduce returns. Investors cannot invest directly in indices.

The indices reference herein have been selected because they are well known, easily recognized by investors, and reflect those indices that the Investment Manager believes, in part based on industry practice, provide a suitable benchmark against which to evaluate the investment or broader market described herein.

Municipal 3 yr: Bloomberg Municipal 3 Year Index

The Bloomberg Municipal Bond Index is a rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market. To be included in the index, bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be investment-grade. They must have an outstanding par value of at least $7 million and be issued as part of a transaction of at least $75 million. The bonds must be fixed rate, have a dated-date after December 31, 1990, and must be at least one year from their maturity date. Remarketed issues, municipal bonds, bonds with floating rates, and derivatives, are excluded from the benchmark. This index is the 3 Year (2-4) component of the Municipal Bond index.

Municipal 1-10yr Blend: Bloomberg Municipal 1-10 Yr Blend Index

The Bloomberg Municipal Bond 1-10 Year Blend Index is a market value-weighted index which covers the short and intermediate components of the Bloomberg Municipal Bond Index, an unmanaged, market value-weighted index which covers the U.S. investment-grade tax-exempt bond market. The Bloomberg Municipal Bond 1-10 Year Blend Index tracks tax-exempt municipal General Obligation, Revenue, Insured, and Prerefunded bonds with a minimum $5 million par amount outstanding, issued as part of a transaction of at least $50 million, and with a remaining maturity from 1 up to (but not including) 12 years. The index includes reinvestment of income.

Municipal Aggregate: Bloomberg Aggregate Municipal Index

The Bloomberg Municipal Bond Index is a rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market. To be included in the index, bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be investment-grade. They must have an outstanding par value of at least $7 million and be issued as part of a transaction of at least $75 million. The bonds must be fixed rate, have a dated-date after December 31, 1990, and must be at least one year from their maturity date. Remarketed issues, taxable municipal bonds, bonds with floating rates, and derivatives, are excluded from the benchmark.

Municipal High Yield: Bloomberg High Yield Municipal Index

The Bloomberg Municipal High Yield Bond Index is an unmanaged index made up of bonds that are non-investment grade, unrated, or rated below Ba1 by Moody's Investors Service with a remaining maturity of at least one year. The Index figures do not include any deduction for fees, expenses or taxes. It is not possible to invest directly in an unmanaged index.

Taxable Municipal: Bloomberg Taxable Municipal Index

The Bloomberg Taxable Municipal Bond Index is a rules-based, market-value-weighted index engineered for the long-term taxable bond market. To be included in the index, bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies if all three rate the bond: Moody's, S&P, Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be investment-grade. They must have an outstanding par value of at least $7 million and be issued as part of a transaction of at least $75 million. The bonds must be fixed rate and must be at least one year from their maturity date. Remarketed issues (unless converted to fixed rate), bonds with floating rates, and derivatives, are excluded from the benchmark.

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