Stay invested and remain nimble in 2025

BlackRock

Our 2025 outlook for municipal bonds

BlackRock's municipal (muni) bond experts share their market outlook and the actions you can take to raise your portfolio's potential in 2025.

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2025 – Positive economic growth – policy questions

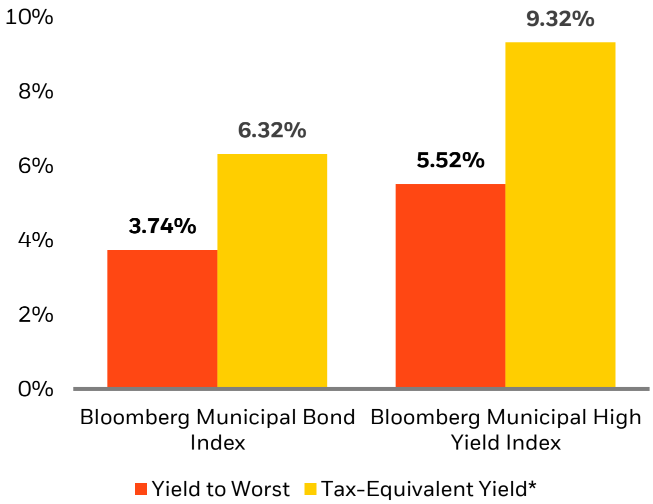
Given the uncertainty around forthcoming policies of the incoming administration, we forecast higher levels of volatility in 2025. An emphasis on deregulation may quickly catalyze economic growth, and although new tariffs could be a marginal drag and moderately increase inflation, we believe those new tariff threats will be more of a bargaining chip rather than a de facto policy.

We anticipate the Federal Reserve (Fed) will gradually slow the pace of rate cuts as the year progresses. Cuts should end by mid-year, as stalled progress toward the Fed's 2% inflation goal, amid continued economic strength, will not warrant substantial further easing. We do not, however, expect to see a transition back to rate hikes in 2025. The Treasury yield curve will likely steepen, with front-end rates falling in cadence with an active Fed early in the year, and long-end rates staying rangebound to modestly higher amid fiscal deficit concerns and increased term premiums.

Firm demand and robust supply

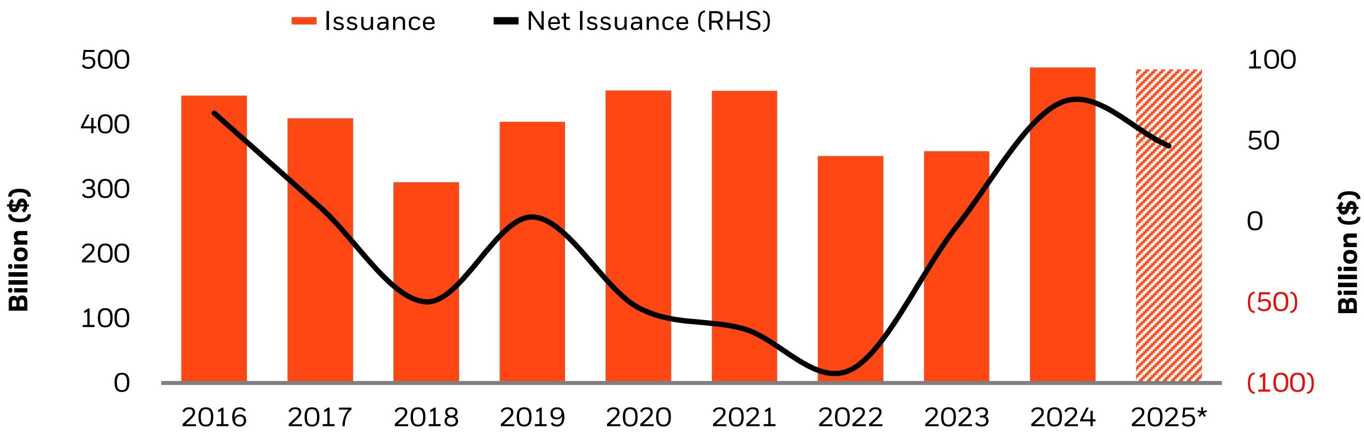
We anticipate muni demand will remain firm as retail investors, who are yield-focused and valuation-agnostic, capitalize on attractive absolute yields. Only a small portion of the $166 billion in mutual fund outflows seen in 2022–2023 has been recaptured, and significant cash is on the sidelines awaiting better opportunities. Any additional rate cuts by the Fed would also bring in incremental cash. We do, however, acknowledge that tax policy changes could disrupt our demand forecast. For example, any increase or removal of the state and local tax deduction cap could reduce the need for tax shelter in high-tax states, decreasing state-specific demand. Lowering the corporate tax rate could incrementally decrease demand from institutions. Also, reversing the AMT provision to pre-Tax Cut and Jobs Act thresholds and phase-outs could limit demand for AMT bonds on the margin.

Attractive yields should sustain continued demand in 2025



Source: Bloomberg Indices, BlackRock, as of 12/31/24.
*Tax-adjusted at the top individual tax rate of 40.8%

Deferred maintenance and higher costs expected to keep issuance robust



Source: SourceMedia, Siebert, BlackRock, as of 12/31/24. *BlackRock forecast

We expect issuance will remain robust, driven by the ongoing need to address deferred maintenance and higher costs due to elevated inflation. The large number of bond proposals on the ballot in November (especially in California and Texas) also serves as a strong indicator of healthy new money supply for the coming year. We foresee approximately $485 billion in new issuance (within a range of $460–$510 billion)—on par with 2024 but slightly lower than the median street projection of $500 billion. Issuance should outpace reinvestment income from maturities, calls, and coupons, resulting in net positive supply of ~$47 billion. For now, we forecast a typical seasonal distribution of supply, but tax policy uncertainties could impact issuance patterns, including a pull-forward in perceived vulnerable sectors to front-run any potential new legislation.

Fiscal policy and tax reform

We anticipate that the asset class will face criticism as lawmakers look for avenues for savings while negotiating a broad tax package. However, we believe that the elimination of the muni tax exemption is extremely unlikely. The exemption is estimated to cost the government just $37 billion per year, a small proportion of the overall deficit, while removing it would place added stress on states and local governments and make them more reliant on federal aid. In addition, the tax exemption generally has bipartisan support, benefiting both Democrats and Republicans. Nonetheless, we do see potential targets that could ultimately be sacrificed, including private activity bonds, not-for-profit entities, and private universities.

Stay nimble with a barbell yield curve strategy

We expect a year focused on income with potential for modest price performance, combining for a mid-to-upper single-digit total return for investment-grade munis, dependent on how fiscal and monetary policy evolves. Given tight spreads and rich valuations, we believe that munis will be tethered to the broader rates market, and the prospect for material outperformance relative to duration-matched Treasuries will be limited. In today's elevated rate environment, muni high yield offers a higher risk-return profile.

Market timing will be increasingly difficult, so getting and staying invested will be key. We prefer a barbell yield curve strategy to combine the benefits of monetary policy easing in the front end with attractive yield further out on the curve. We anticipate taking advantage of concessions in the new issue market, using seasonality to benefit from periods of favorable supply-and-demand dynamics, and deploying cash balances into periods of weakness or potential dislocations spurred by tax policy discussions. We expect short-term rates to remain volatile but ultimately decline, so adding some leverage into portfolios could prove to be a favorable strategy. We think coupons will account for a large proportion of total returns, with sectors providing outsized carry opportunities, such as the housing sector, having the potential to outperform. Lower-rated, investment-grade credits could also provide the opportunity for attractive yield pickup amid a still solid fundamental backdrop.

Credit views for 2025

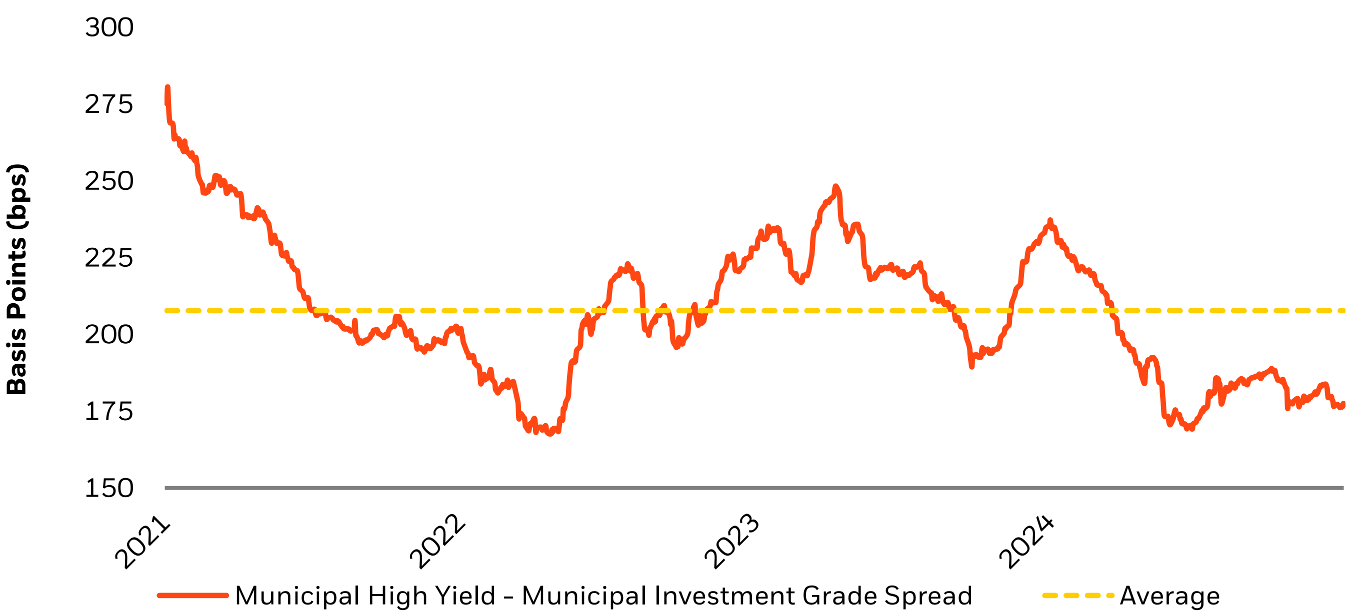
Positive economic outlook supportive of municipal fundamentals. Most municipal issuers are stable as tax receipts and spending have normalized since the COVID era. With reserves at record highs, debt service burdens near 50-year lows, and pension funding levels dramatically improving, states are well positioned to weather an economic slowdown or significant targeted changes to federal spending or tax policy. Local governments and suburban school districts that primarily rely on property tax revenues typically fare well during a slowdown. However, affordability is becoming a concern as the rapid appreciation of home values drives property taxes and homeowner insurance costs higher. Large cities have adjusted to declining commercial real estate values, but changes to federal legal immigration policy will create near-term budgetary pressure.

We view changes in federal tax and spending policy as the largest risk to the sector since federal funds represent, on average, 35% of state budgets. States with higher poverty rates and limited own-source revenue rely more on federal aid, making it difficult to enact dramatic across-the-board cuts to large non-discretionary programs such as Medicaid.

Lean toward revenue sectors. We continue to favor revenue-sector issuers over state and local governments since they are typically lower-rated and offer additional yield. Most municipal revenue sector borrowers are highly defensive, as they are monopolistic providers of essential services that can raise user fees to cover operations. In the investment-grade sector, we prefer single-A and triple-B bonds. We also favor prepaid gas and housing bonds that offer attractive yields, high quality, and good liquidity.

Positive fundamentals for high yield. Credit concerns have been muted in the high yield sector due to the robustness of the economy. Puerto Rico's tax collections are outperforming the board's fiscal plan; occupancy in retirement communities is rising to pre-pandemic levels; and strong demographics buoy land-secured and charter school bonds in the sunbelt and mountain regions. Tobacco bonds continue to face headwinds from consumption declines. However, supply has diminished, and careful security selection offers plenty of opportunities for total return and income. Defaults remain episodic and concentrated in healthcare and industrial development bonds. In 2025, a modest uptick in defaults is anticipated. Technicals were extremely favorable in 2024, with demand for high yield bonds exceeding supply by seven times. We expect this demand to persist, with after-tax yields surpassing 9%. Unlike in 2024, we do not anticipate a further contraction in credit spreads; however, we believe the additional carry will drive performance in 2025.

Credit spreads remain tight versus recent history



Source: Bloomberg Indices, BlackRock, as of 12/31/24.

BlackRock's muni advantage

BlackRock's size and scale can mean greater access to inventory and tighter trading spreads.*

An award-winning team

In the fragmented muni market, you need experts to comb through thousands of issuers to identify opportunities and manage risk. BlackRock's 58 muni investment professionals† are led by a team with over 20 years of industry experience on average.

Technology that sees opportunities & risks

Our experts leverage Aladdin®, BlackRock's risk management technology, to identify risks and drivers of performance in the market. By digging deeper, Aladdin® empowers our experts to manage risk and seek the right opportunities.

* BlackRock as of 12/31/2024. † BlackRock as of 12/31/2024. Personnel includes Patrick Haskell, CIO of Municipal Fixed Income.

Investment involves risk. *The two main risks related to fixed income investing are interest rate risk and credit risk. Typically, when interest rates rise, there is a corresponding decline in the market value of bonds. Credit risk refers to the possibility that the issuer of the bond will not be able to make principal and interest payments. There may be less information available on the financial condition of issuers of municipal securities than for public corporations. The market for municipal bonds may be less liquid than for taxable bonds. A portion of the income from tax-exempt bonds may be taxable. Some investors may be subject to Alternative Minimum Tax (AMT). Capital gains distributions, if any, are taxable.* ***Index performance is shown for illustrative purposes only. You cannot invest directly in an index. Past performance is no guarantee of future results.***

Prepared by BlackRock Investments, LLC, member FINRA.

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