

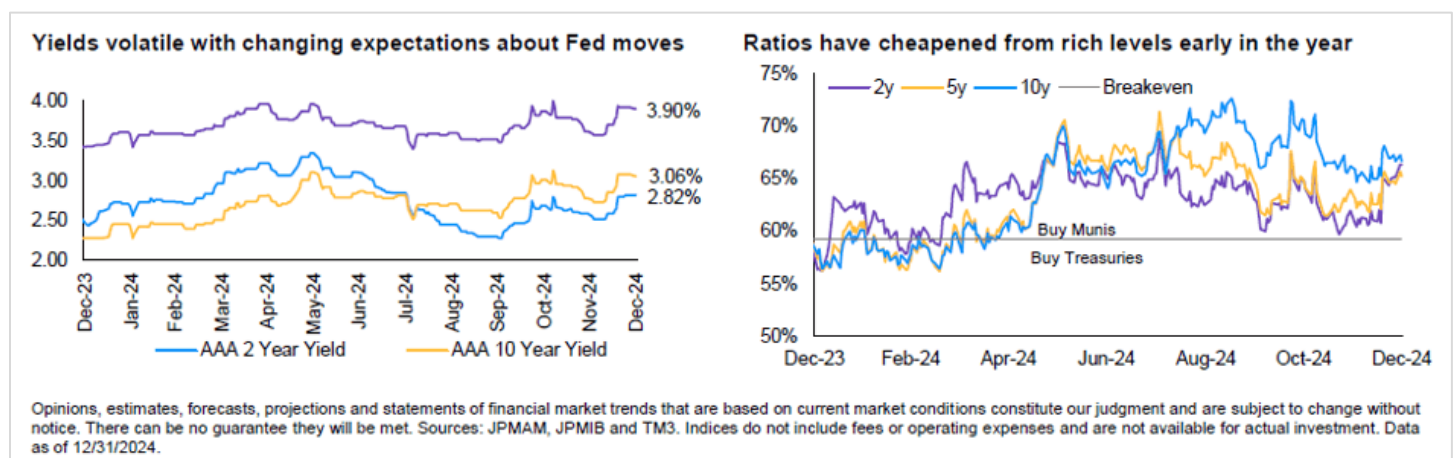
Note: This is an update to “Muni Rich, (After-Tax) Yield Poor,” originally published by Freedom Investment Management in May 2024.

Last May, we published a piece pointing towards the rich levels municipal bonds were trading at relative to taxable equivalents such as U.S. Treasuries, especially on an after-tax basis. With tax season coming upon us amidst an uncertain outlook for federal tax policy with the new administration, tax-sensitive investors now face more reasonable valuations offered by the federally tax-exempt municipal bond market.

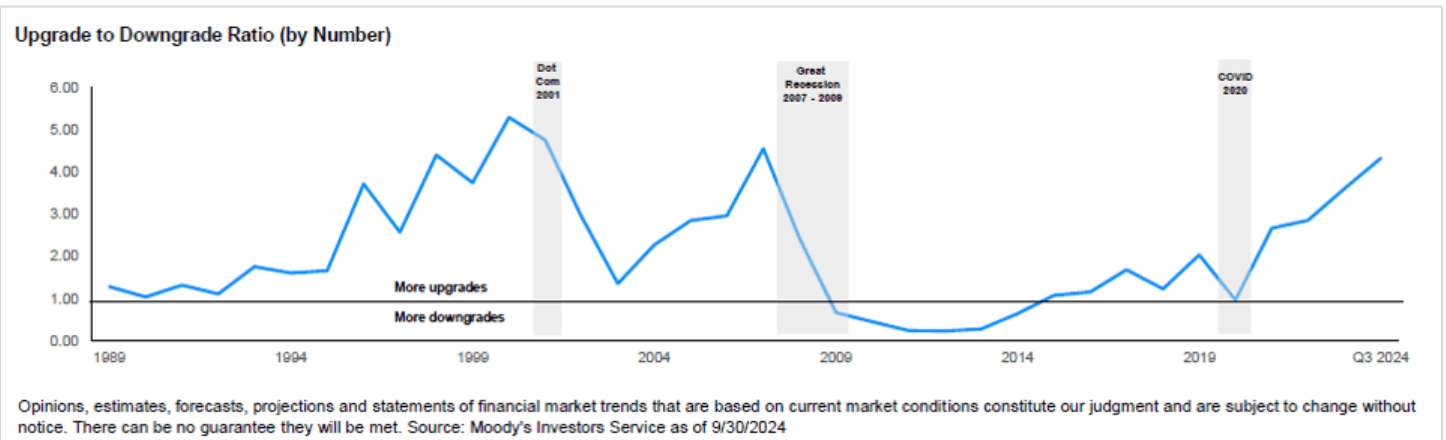
Last spring, Freedom Investment Management had an opportunity to meet with JPMorgan Asset Management for an in-depth discussion on the tax-exempt fixed income landscape. Back then, we noted how a strong economy and fiscal support from the federal government made for a more conducive environment for taking additional credit risk, especially with tax-exempt state and local issuers, but warned about elevated valuations driven by strong retail flows (individuals and advisor SMAs). As yield ratios to U.S. Treasuries have improved since last spring, the relative value offered by municipal bonds appears more reasonable, as the Federal Reserve embarks on a rate cut campaign expected over the next few years.

Uncertainty Over Future Federal Tax Policy Leads to Some Cheapening

- Following the November election, the Trump Administration has made renewal of the 2017 Tax Cuts and Jobs Act a high priority. Some of the Act’s provisions such as the SALT deductions cap, lower corporate tax rates, the elimination of tax-exempt refunding deals helped increase demand and reduce tax-exempt supply, supporting richer federal tax-exempt bond valuations.
- However, both Congress and the Administration are seeking revenue offsets for the projected loss of revenue from renewal of the 2017 tax legislation. Some of the more impactful measures being explored are the elimination of nonprofit status for hospitals, tax preferences for non-municipal private activity bonds, and the interest earned on municipal bonds. Analysts assign a low probability given the lack of bipartisan appeal for these measures.
- From a credit fundamentals standpoint, the ratings upgrade/downgrade ratio continues to rise and is approaching multi-decade level highs reflecting the strong fiscal backdrop for state and local issuers.



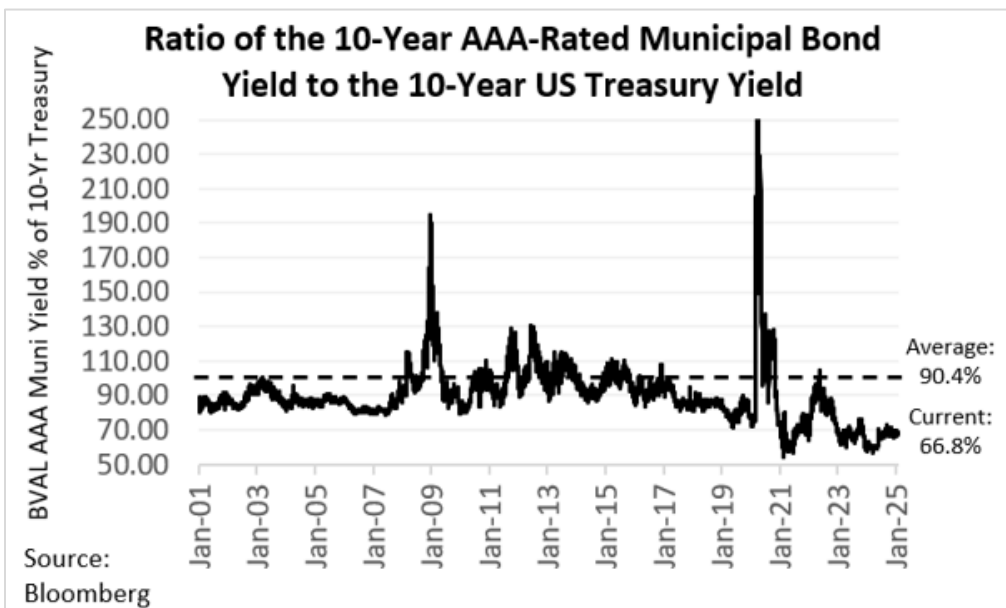
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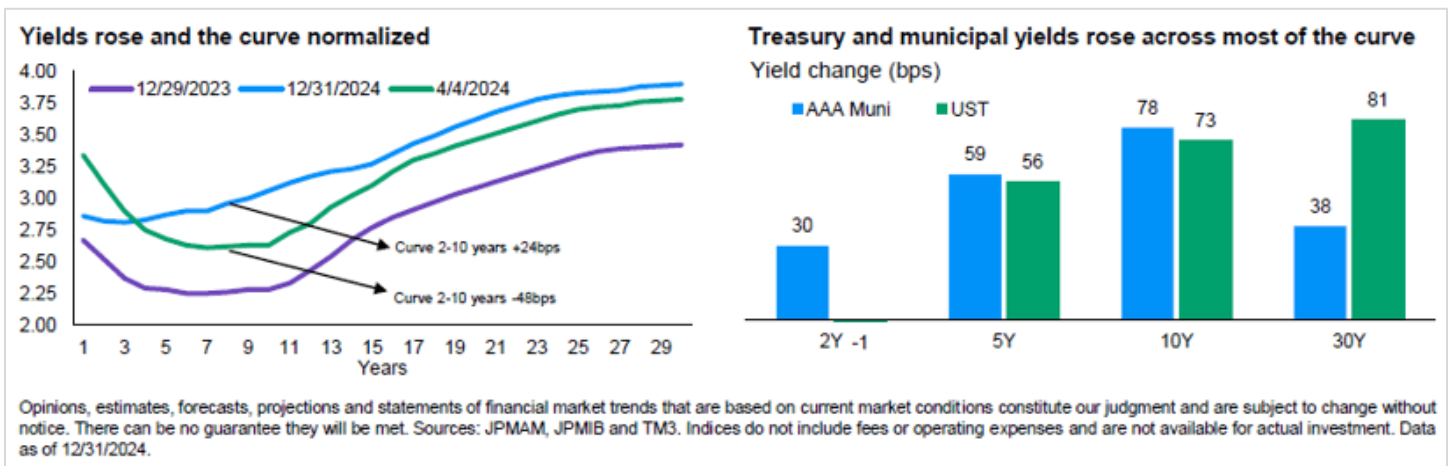
Top-Rated Municipal Bonds Trade Near Historically Rich Levels versus US Treasuries but Now More Attractive on a Tax-Equivalent Basis

- As of 2/3/2025, the BofA 10-Year AAA-Muni yield sits at 3.04% yield, below the 4.55% 10-Year U.S. Treasury yield. The yield ratio (black line in chart below) has improved from last spring, rising from just below 60% to 67% but remains below the long-term average of 91%.
- On a tax-equivalent basis, using a 37% federal income tax bracket, the AAA-rated municipal yield is 4.82%. The muni tax-equivalent yield is now above a comparable U.S. Treasury yield, unlike last Spring when the tax-equivalent yield was below.
- The post-pandemic period has introduced a new regime of greater appetite for safe after-tax investments as investors remain willing to receive comparable income from municipal bonds versus U.S. Treasuries on a tax-equivalent basis.



In 2024, Rates on Intermediate Maturities (7-10 Year) Rose by a Greater Amount Versus the Rise in Rates for Both Short- and Long Maturities

- At the end of the 2024, the AAA-rated municipal bond curve had steepened from the beginning of the year as U.S. interest rates rose across the board.
- After yielding well below short- and long maturities, the intermediate part of the curve (and most popular with retail and financial advisors) experienced the sharpest rise in yields across the curve (blue bars in right chart below).
- We warned last spring that the Intermediate part of the curve looked historically rich as intermediate maturities were heavily favored by tax-sensitive investors who were less inclined to purchase maturities beyond 10 years. Some of this richness corrected itself with the broader steepening of the yield curve (blue line in left chart below).



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Be More Targeted in Your Municipal Bond Allocation

Fixed income remains attractive on an absolute inflation-adjusted basis, even municipal bonds on a tax-equivalent basis, especially if the U.S. economy experiences a soft landing of slow and steady growth. Advisors should be more deliberate in how they allocate client investments in the municipal bond market. Consider:

- Managed model offerings (mutual funds/ETFs), such as 3D Fixed Income-Tax Sensitive ETF Model and EQIS Municipal Fixed Income ETF.
- Laddered bond model portfolios such as EQIS 7 Year Muni ETF Ladder and the Invesco BulletShare Municipal Bond portfolios.
- Models from American Funds, BlackRock, First Trust, PIMCO, and VanEck.
- Dynamic/tactical models such as Clark Navigator Tax-Free Fixed Income Core and Ocean Park Municipal Bond.
- Replacing municipal bond allocation with a taxable fixed income allocation, such as investing in U.S. Treasuries that are as attractive on a tax-equivalent basis. Advisors can pair a government money market fund with the EQIS Long Term Treasury ETF Model to target the desired level of interest rate risk while earning attractive yields.

As always, come to us if we can guide you or assist you in any way. Reach out to your Consultant at consulting@freedomadvisors.com.



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Except as otherwise specifically stated, all information is as of February 4, 2025.