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CHIEF INVESTMENT OFFICE

Fixed Income Spotlight

Volatility Provides Potential Opportunity in Munis

April 2025

All data, projections and opinions are as of the date of this report; and subject to change.

SUMMARY

- Munis have significantly underperformed U.S. Treasury securities so far this year due to a combination of technical and fundamental factors.
- As a result, muni valuations versus Treasury bonds have cheapened significantly, with some muni-to-Treasury (M-T) yield ratios reaching their highest levels since 2022.
- We see some of the technical and fundamental pressures as temporary and believe muni valuations could be poised to rally later this year.

View the CIO Viewpoint ▶ View the CIO Asset Allocation Guidelines ▶

ASSET CLASS WEIGHTINGS

Asset Class	Underweight		Neutral	Overweight	
Global Fixed Income		●			
U.S. Governments		●			
U.S. Mortgages		●			
U.S. Corporates		●			
International Fixed Income			●		
High Yield			●		
U.S. Investment-grade Tax Exempt		●			
U.S. High Yield Tax Exempt		●			

These Chief Investment Office (CIO) views relate to fully-diversified, multi-asset class portfolio and use the asset class breakdown of the CIO "High Tax/Balanced" Allocation. Source: Global Wealth & Investment Management Investment Strategy Committee as of April 1, 2025.

FIXED INCOME U.S. RATES FORECAST

(% end of period)	Spot	2Q25	3Q25	4Q25
Fed Funds Range	4.33	4.25–4.50	4.25–4.50	4.25–4.50
2-Year T-Note	3.82	4.00	4.00	4.00
5-Year T-Note	4.08	4.10	4.15	4.20
10-Year T-Note	4.48	4.30	4.40	4.50
30-Year T-Bond	4.95	4.70	4.75	4.80

Source: BofA Global Research U.S. Rates Research; April 11, 2025; spot price as of that date. Note: Federal funds rate forecasts are model expectations; other values are for market rates. The forecasts in the table above are the baseline view from BofA Global Research team. The Global Wealth & Investment Management (GWIM) Investment Strategy Committee (ISC) may make adjustments to this view over the course of the year and can express upside/downside to these forecasts. **There can be no assurance that the forecasts will be achieved. Economic or financial forecasts are inherently limited and should not be relied on as indicators of future investment outcomes.**

FIXED INCOME AT A GLANCE

Rates Markets	31-Mar	Last Month	Change
Fed Funds rate	4.38%	4.38%	+0 bps
3-month Treasury Bills	4.30%	4.30%	+0 bps
U.S. 2-year Note	3.89%	3.99%	-11 bps
U.S. 5-year Note	3.95%	4.02%	-7 bps
U.S. 10-year Note	4.21%	4.21%	-0 bps
U.S. 30-year Note	4.57%	4.49%	+8 bps
FF / 10s Curve	-17 bps	-17 bps	-0 bps
2s / 10s Curve	+32 bps	+22 bps	+10 bps
German 10-year	2.74%	2.41%	+33 bps
UK 10-year	4.68%	4.48%	+19 bps
Japanese 10-year	1.49%	1.37%	+11 bps

Credit Markets	31-Mar	Last Month	Change
U.S. Investment Grade (Spread)	+94 bps	+87 bps	+7 bps
U.S. High Yield (Spread)	+347 bps	+280 bps	+67 bps
U.S. High Yield (Yield)	7.73%	7.15%	+58 bps
Emerging Markets (U.S.$, Spread)	+236 bps	+221 bps	+15 bps
10-year AAA Municipal	3.20%	2.88%	+33 bps
10-year Muni / Treasury Ratio	76.1%	68.4%	+7.8%

Index Returns	1-month	12 months	Year-to-Date
U.S. Treasury	0.2%	0.0%	2.9%
U.S. MBS	0.0%	0.0%	3.1%
U.S. ABS	0.2%	0.0%	1.5%
U.S. CMBS	0.1%	0.0%	2.3%
U.S. Corporate	-0.3%	0.0%	2.3%
U.S. High Yield	-1.0%	0.0%	1.0%
U.S. Leveraged Loans	-0.3%	0.0%	0.5%
U.S. Municipals	-1.7%	0.0%	-0.2%
U.S. Municipal High Yield	-1.2%	0.0%	0.8%

Bps refers to basis points. Source: Bloomberg. Data as of March 2025 and subject to change. **Past performance is no guarantee of future results. Please refer to the end of the document for asset class proxies and index definitions.**

Municipal bonds significantly underperformed U.S. Treasury securities in Q1 (See Fixed Income at a Glance above), and they have continued to underperform so far in April. Year-to-date through April 8, the Bloomberg Municipal Bond Index was down -2.02% versus a 2.63% gain in the Bloomberg U.S. Treasury Index. We attribute this underperformance to a combination of technical and fundamental factors. Technical factors include strong new issue supply, a seasonal lull in muni redemptions, and sales by some retail investors to fund Tax Day liabilities. Fundamental factors are a flight-to-quality which began in late February and accelerated after April 2 due to tariff-related economic growth and inflation concerns, as well as, uncertainty about future federal aid to municipal issuers and the future tax treatment of municipal bonds.

The above factors caused the municipal yield curve to twist steeper in Q1, whereas the Treasury yield curve bull-flattened (Exhibit 1). So far in April, munis yields have continued to rise more than Treasury yields. As a result, muni valuations, as measured by AAA muni-to-Treasury (M-T) yield ratios, have cheapened materially. From December 31, 2024 to April 8, 2025, the 5-year AAA M-T ratio rose from 65% to 81%, the 10-year AAA M-T ratio rose from 67% to 83%, and the 30-year AAA M-T ratio rose from 81% to 96%.

With a seasonal increase in redemptions expected from May to August, the end of pre-Tax Day selling after April 15, potentially stabilizing market and economic conditions, and greater certainty to be gained with regards to future federal funding and tax policies, we believe muni valuations could be poised to rally later this year.

Supply. Since 2023, muni supply has increased markedly due to economic resilience, lower interest rates, significant infrastructure needs, and depleted pandemic stimulus funds. 2024 was a record year for tax-exempt issuance, totaling $487 billion (39% higher than 2023), and Q1 2025 issuance was 17% higher than Q1 2024 (Exhibit 2). We believe tax-exempt issuance will continue to track higher than last year, especially from private activity bond issuers, who could be at risk of losing their access to the tax-exempt market after this year, as Congress considers ways to pay for extending expiring provisions in the 2017 Tax Cuts and Jobs Act (TCJA) (see Uncertainty of Future Tax Treatment of Municipal Bonds, next page).

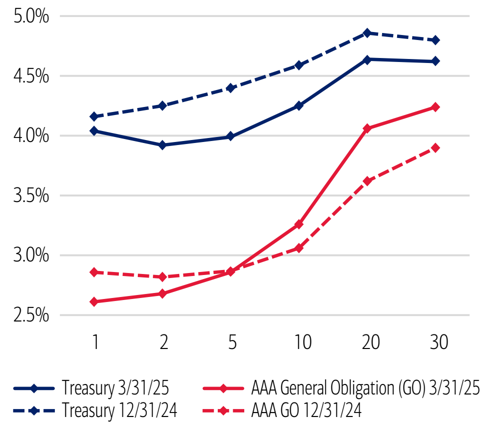
Redemptions. Issuer redemptions on municipal debt tend to be seasonal. March and April have disproportionately low redemptions, while the June to August period has disproportionately high redemptions (Exhibit 3). We believe the lull in redemptions in March, which reduced reinvestment demand, could explain some of the muni underperformance during Q1, and the expected higher redemptions in the summer months could pressure muni valuations richer.

Pre-Tax Day Selling. Some municipal investors tend to sell their muni holdings in March and early April to fund their income tax liabilities. This "Tax Day effect" is inconsistent from year to year, but we believe it has been especially strong this year due to stronger-than-usual capital gains realized by investors in 2024. This technical pressure should ease once such selling ends after April 15.

Flight to Quality. Most risk assets suffered a flight to quality beginning in late February due to concerns about economic growth and inflation, causing the S&P 500 Equity Index to correct by over 10% in just three weeks. After the announcement of tariff levels on April 2, the sell-off in risk assets accelerated. Munis tend to perform well during flights to quality, although not as well as Treasury securities. However, the underperformance in munis was more significant this time, given the combination of concerns related to tariffs, federal fiscal policy, and seasonal technical weakness.

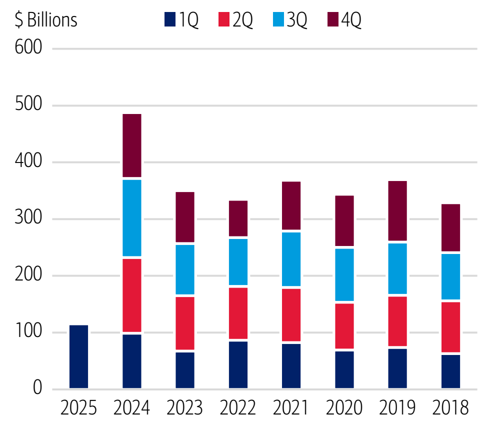
Uncertainty about Federal Aid. We are following discussions in Washington, D.C. with regard to potential reductions in federal spending that could affect municipal credit quality. States and local governments receive over $1 trillion a year from the

Exhibit 1: Muni and Treasury Yield Curves.



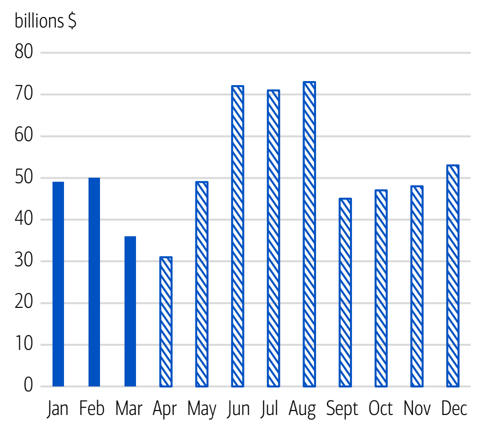
Source: LSEG, as of March 31, 2025.

Exhibit 2: Tax Exempt Municipal Issuance.



Source: Bloomberg, as of March 31, 2025.

Exhibit 3: 2025 Principal and Coupon Redemptions.



Source: Bofa Global Research, LSEG Data, Bloomberg, as of March 31, 2025. January-March data are actual, April-December are forecasts.

federal government, and the money going to states accounts for over one-third of state revenues. Recipients of federal transfers include Medicaid, the Children's Health Insurance Program, K-12 education, the Federal Highway Administration and the Supplemental Nutrition Assistance Program (SNAP). This means that federal spending cuts could affect the credit quality of states, hospitals, school districts, higher education and transportation issuers. We would also note that cuts in federal jobs would likely have a disproportionately negative effect on local governments in the Virginia, Maryland and Washington, D.C. areas. Therefore, the discussions going on in Washington, D.C. could be partly responsible for some of this year's muni underperformance. However, our base-case expectation is that any actual changes to federal funding levels will ultimately be manageable for the vast majority of municipal issuers, and, as that outcome becomes clearer, it should have a richening effect on muni valuations.

Uncertainty about Future Tax Treatment of Municipal Bonds. The market has also begun questioning whether the municipal bond tax exemption is at risk, which may have had a dampening effect on demand. In January, the U.S. House of Representatives Ways and Means Committee released a list of possible options to pay for extending current tax rates. Eliminating the municipal bond tax exemption is on that list, with the 10-year cost of the exemption estimated at $250 billion for states and local governments and $114 billion for private activity and other municipal bond issuers. State and local government officials have been lobbying members of Congress to remind them that the municipal bond tax exemption is an essential tool for the country to maintain and modernize its infrastructure. In fact, the Government Finance Officers Association estimates that eliminating the exemption would increase borrowing costs to municipal issuers by $833 billion over 10 years, far more than the savings to the federal government. We believe the municipal tax exemption will ultimately remain largely intact, although it is possible that Congress may consider disallowing tax-exempt financings for issuers from certain subsectors, e.g., private activity bonds. We are aware of speculation that Congress could choose to cap the value of the muni tax exemption at a level below the top marginal tax rate, which would affect the value of future and outstanding tax-exempt bonds. While we cannot completely rule out this possibility, it is not our base case expectation. We believe any changes to the municipal bond tax exemption would be on a prospective basis, with the tax exemption on existing bonds "grandfathered," as in the last two times there were changes to the muni tax exemption in 1986 and 2017. In fact, any legislation that reduces tax-exempt issuance should eventually cause valuations of outstanding muni bonds to richen due to their increased scarcity value.

Conclusion. With a potential stabilization in market and economic conditions, greater certainty to be gained with regards to federal spending and tax policy, and seasonally stronger technical conditions, we believe muni valuations could be poised to rally later this year.

Asset Class Proxies and Index Definitions

Securities indexes assume reinvestment of all distributions and interest payments. Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index. Indexes are all based in dollars.

S&P 500 Equity Index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the index focuses on the large-cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market.

U.S. Financials/U.S. Industrials/AA-Credit/BBB-Credit/A-Credit/ICE BofA U.S. Corporate Index tracks the performance of U.S. dollar denominated investment grade corporate debt publicly issued in the US domestic market.

U.S. Municipals/Bloomberg Muni Bond Index measures the performance of the Bloomberg U.S. Municipal bond market, which covers the USD- denominated Long-Term tax-exempt bond market with four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds.

U.S. High Yield/BB-Credit/B-Credit/CCC-Credit/Bloomberg U.S. Corporate High Yield Index: The Bloomberg U.S. Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.

U.S. Municipal High Yield/Bloomberg High Yield Municipal Index is a benchmark that covers the high yield portion of the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds.

Emerging Market/Bloomberg Emerging Market USD Index is a flagship hard currency Emerging Markets debt benchmark that includes USD-denominated debt from sovereign, quasi sovereign, and corporate EM issuers.

Cash/U.S. Treasury/Bloomberg U.S. Treasury Index Total Return measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. Treasury bills are excluded by the maturity constraint, but are part of a separate Short Treasury Index. STRIPS are excluded from the index because their inclusion would result in double-counting.

U.S. Mortgage-backed Securities (MBS)/ABS/Bloomberg U.S. Mortgage-backed Securities Index is the U.S. MBS component of the U.S. Aggregate index. The MBS Index covers the mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

U.S. Corporates/Bloomberg U.S. Corporate Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes U.S. dollar-denominated securities publicly issued by U.S. and non-U.S. industrial, utility and financial issuers. The U.S. Corporate Index is a component of the U.S. Credit and U.S. Aggregate Indices.

Bloomberg Capital Asset-Backed Securities (ABS) Index is composed of debt securities backed by credit card, auto and home equity loans that are rated investment grade or higher by Moody's.

Bloomberg U.S. Commercial Mortgage Backed Securities (CMBS) Index is the Bloomberg Non-Agency Investment Grade CMBS: BBB Total Return Index Unhedged.

Muni High Yield/Bloomberg Muni High Yield Index is a market-value-weighted index that tracks the performance of the U.S. dollar-denominated, tax-exempt, non-investment grade municipal bonds issued by U.S. states, the District of Columbia, U.S. territories, and local governments or agencies.

ICE BofA Investment-grade Index tracks the performance of U.S. dollar-denominated, investment grade (IG), asset-backed securities publicly issued in the U.S. domestic market.

ICE BofA High Yield tracks the performance of U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market.

ICE BofA U.S. Corporate Index tracks the performance of U.S. dollar denominated investment grade and sub-investment grade corporate debt publicly issued in the U.S. domestic market.

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