

Rates surged in October on increased odds of a Republican victory, now recalibrating as markets assess the implications on inflation, deficit spending, and economic growth. Municipals were caught in the crossfire, trading nearly one-for-one with rates, and underperforming on a duration adjusted basis. Sustained volatility is on the horizon, potentially leading to some of the most compelling entry points in recent times.

Policy uncertainty is driving issuers to accelerate financing, shaping a demand narrative that prioritizes capturing opportunities over reducing risk. A steady stream of positive news surrounding municipals underscores their robust value proposition, supported by attractive taxable-equivalent yields and the defensive benefits of infrastructure assets. Demand is further bolstered by record cash reserves in money markets, modest street inventories, elevated equity valuations, and the Fed's transition to easier monetary policy.

Although municipals are entering a seasonally favorable period, broader concerns are unlikely to dissipate quickly. Rallies should be contained with intermittent liquidity challenges. As markets search for clarity, a turning point is likely before year-end amid the uncertainty. In this environment, timing is essential, making a disciplined, dollar-cost averaging strategy the most prudent approach.

The policy narrative around tariffs and taxation is likely to blur the line between reality and negotiation tactics. If deficit constraints fail to influence policy among fiscal conservatives, rates may reach a tipping point that would constrain growth, like when 10s touched 5% last year. With infrastructure at the forefront for economic expansion, a shift of supply into the taxable muni market is likely at some point. This shift would widen spreads, generate broader demand, and enhance the technical backdrop for tax-exempt munis.

Additional tailwinds for municipals may emerge sooner from potential SALT deduction relief and the sunset of TCJA individual tax cut provisions driven by the deficit and the 2025 budget resolution. Furthermore, any forthcoming tax reform is likely to target lower-income brackets—demographics less inclined to invest in munis. Amid the uncertainties of tax reform, major states and some cities are raising rates, boosting demand for muni bonds.

We're on the brink of a transformative era, with rising odds of an unprecedented level of private sector expertise, poised to drive innovation and reshape the economy. With persistent inflation and an already burdensome tax system, the demand for strategic public-private-partnerships is likely to intensify, even with a divided government. These partnerships could redefine state-level economies and the credit landscape, unlocking new opportunities in the muni market and reshaping the path forward for economic growth.

About

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