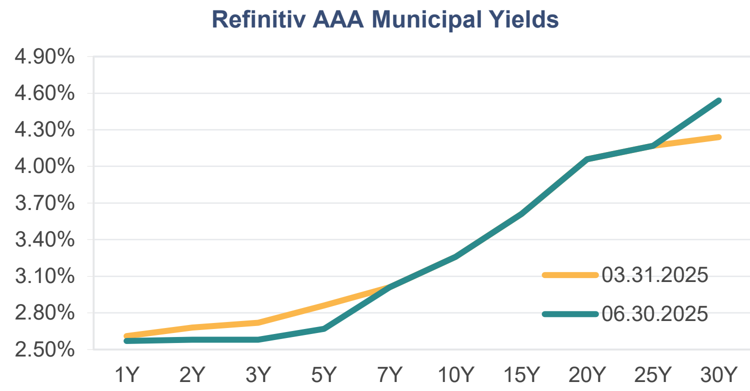
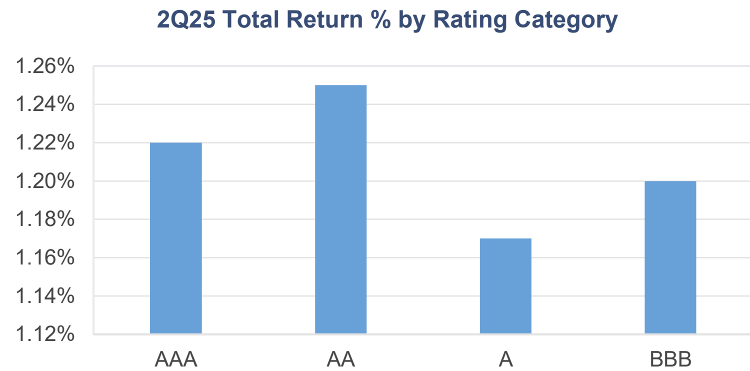
Municipal Fixed Income Commentary

2nd Quarter 2025

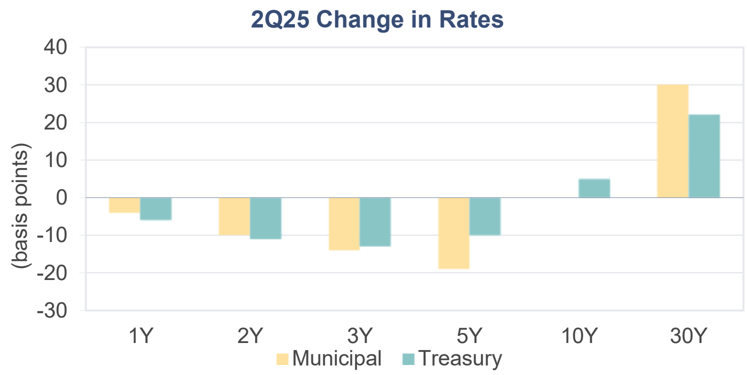
While exempt from taxes, municipal bonds were not exempt from elevated volatility in the second quarter. Markets grappled with a rapidly-shifting U.S. tariff policy and a surge in new issuance, both of which exerted sharp upward pressure on municipal yields. In early April, the Trump administration's "Liberation Day" tariff announcement shattered consensus expectations for growth and inflation, triggering dislocations in the U.S. Treasury market and propelling municipal yields over 70 bps higher. As the quarter progressed and tariff implementations were postponed, technical conditions improved. Declining Treasury yields helped support a recovery in the municipal market, particularly in the front end of the yield curve. This rebound helped the market retrace earlier losses and finish the quarter with a positive return. The ICE BofA 1-10Y U.S. Municipal Securities Index reflected this bifurcated performance. From April 1-9, the index returned -2.02% and underperformed duration-matched Treasuries by 1.95% before recovering over the balance of the quarter to produce a total return of 1.22% and an excess return just nine bps less than duration-matched Treasuries for the quarter.

The municipal primary market saw record-setting activity in the second quarter with approximately $158B in new issuance, marking the largest second quarter on record and representing a 15% increase year-over-year, driven by rising infrastructure costs and the continued depletion of pandemic-era stimulus reserves. Elevated primary supply was amplified by steady pressure in the secondary market with bid-wanted activity averaging $1.5B in par value per day, though offset somewhat by the reinvestment implied by approximately $111B in quarterly redemptions and nine consecutive weeks of positive mutual fund flows to end the quarter. The weak technical backdrop and volatility early in the quarter drove municipal-to-Treasury ratios to their highest levels since 2022, peaking at 88% in the 5-year ratio and 89% in the 10-year, before retracing to end the quarter at 70% and 77%, respectively. The shape of the municipal yield curve reflected these dynamics as well: the 2-year to 10-year spread differential initially flattened by 18 bps amid heavy issuance, tax-related selling, and tariff-driven volatility. However, as the quarter progressed, attractive valuations and absolute yields drew stronger investor demand, contributing to a 28-bp steepening in the spread differential to finish at 68 bps.





Municipal credit returns were broadly positive during the quarter, with modest differentiation across rating categories. Within the 1-10Y index, AA-rated bonds led with a total return of 1.25%, followed closely by AAAs at 1.22%, BBBs at 1.20%, and single-As at 1.17%. Revenue-backed sectors such as toll roads, airports, and leases outperformed, supported by resilient credit fundamentals and steady demand. In contrast, education and hospital bonds lagged amid ongoing secular pressures tied to enrollment and labor costs.



BPS = basis points. Data is as of 06.30.2025. Textual data source: Bloomberg L.P. Chart data sources: Bloomberg L.P.; U.S. Treasury; Refinitiv. Charts are for illustrative purposes only. Yields are subject to market conditions and are therefore expected to fluctuate. The views expressed represent opinions of Sterling Capital Management. Any type of investing involves risk and there are no guarantees that these methods will be successful. This information must be read in conjunction with the important disclosures and definitions on page 3.

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Among individual issuers, lower-quality credits such as the New York Metropolitan Transportation Authority (MTA) and the State of Illinois saw OAS widening of 14 bps and 11 bps, respectively, compared to seven bps of widening for the broader index, highlighting the risk-off tone during the quarter. The prepaid gas and electric sector also modestly underperformed the index as its OAS widened by 16 bps. Still, the sector continued to offer compelling value, with solid credit quality and higher yields providing a cushion in a volatile environment.

Credit fundamentals remained broadly sound, though sector-specific strains remained. Moody’s continued to report positive ratings momentum with upgrades outpacing downgrades in the first quarter, underscoring the municipal market’s resilience to ongoing geopolitical uncertainty. Reinforcing this trend, U.S. Census Bureau seasonally adjusted tax revenue data showed a 5.8% year-over-year increase in total tax collected, while the NASBO Spring Fiscal Survey of States noted many U.S. states exceeded their original revenue estimates in 2025. Furthermore, states such as Alaska and Rhode Island were upgraded by Moody’s to Aa2 and Fitch to AA+, respectively, as each state demonstrated improved fiscal discipline. Not all sectors shared in strength, however. Moody's issued negative sector revisions on public ports and airports, citing concerns of softening economic growth and its potential impact on travel and trade volumes, though they also highlighted the strong liquidity, low leverage, and strong debt service coverage present in both sectors. Transportation Security Administration (TSA) data showed average daily passenger throughput of 2.58MM, with total quarterly volume down just 0.85% year-over-year.

Our View

Amid the Federal Reserve’s effort to support the labor market while remaining cautious about the inflationary implications of tariffs, we expect real growth to moderate to 1.5% in 2025, unemployment to rise to 4.5%, and core PCE inflation to run at 2.9%. With growth and inflation data continuing to send mixed signals, we anticipate further steepening in the yield curve as the market shifts its focus from inflation concerns to broader macro risks, including trade policy dynamics and their downstream impact on employment.

Within this context, we are positioned neutral on duration and remain bulleted to benefit from ongoing curve steepening. We remain constructive on cyclical sectors such as airports and ports, supported by strong balance sheets, despite our expectation of a slowing economy and continued policy uncertainty. We also look to take advantage of any headline-driven volatility to add more risk exposure selectively, focusing on stable-to-improving names in the context of still-supportive economic fundamentals. While we anticipate the continuation of a robust issuance environment, we believe investor demand will remain strong. Just as experienced in the second quarter, we view a sustained rise in yields as a likely catalyst for renewed demand, particularly from long-term investors seeking tax-exempt income at more attractive entry points.

OAS = option-adjusted spread. PCE = personal consumption expenditures. Data is as of 06.30.2025. Textual data sources: Bloomberg L.P.; U.S. Census Bureau; National Association of State Budget Officers (NASBO). Yields are subject to market conditions and are therefore expected to fluctuate. The views expressed represent opinions of Sterling Capital Management. Any type of investing involves risk and there are no guarantees that these methods will be successful. This information must be read in conjunction with the important disclosures and definitions on page 3.

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The volatility of an index varies greatly. All indices are unmanaged and investments cannot be made directly in an index.

The **ICE BofA 1-10Y Municipal Securities Index** is a subset of the ICE BofA U.S. Municipal Securities Index including all securities with a remaining term to final maturity less than 10 years.

Refinitiv Municipal Market Monitor (MMD) AAA benchmark: The Municipal Market Monitor has been delivering the municipal market's MMD AAA benchmark for over 30 years and is integrated into the most comprehensive source of critical municipal market information.

Technical Terms:

The **core Personal Consumption Expenditure (core PCE) Index** is a measure of prices that people living in the U.S., or those buying on their behalf, pay for goods and services.

The **"Liberation Day"** plan included a 10% tariff on all imports as well as reciprocal tariffs for 60 nations including 34% on China, 32% on Taiwan, 46% on Vietnam, 20% on the European Union, 25% on Canada, and 25% on Mexico.

Bid wanted: An announcement by an investor who holds a security, commodity, or currency. It indicates that they are looking to sell the product, and are ready to entertain price bids for it. Interested parties may thus respond with bids.

General obligation bonds (GOs) are municipal bonds which provide a way for state and local governments to raise money for projects that may not generate a revenue stream directly.

Industrial development revenue bonds (qualified small issue bonds or IDRBs) are securities issued by a local government agency for the purpose of acquiring or constructing capital facilities for use by private business and industry.

The **National Association of State Budget Officers Spring (NASBO)** has been in existence for nearly 80 years and is a professional membership organization for budget and finance officers. The survey referenced is a semi-annual report gathered from all 50 state budget offices. Spring survey referenced: https://www.nasbo.org/reports-data/fiscal-survey-of-states