1Q 2025

Investment Highlights

Western Asset
A Franklin Templeton Company

US Municipal Bond

Key Takeaways

- *The municipal bond market posted negative returns during the quarter as rate volatility increased.*
- *Technicals weakened amid elevated supply and softer demand conditions.*
- *Municipal credit fundamentals remained favorable, underscored by strong tax collections. However, the increased potential for recession could challenge peaking credit quality.*

Market Review

The investment-grade municipal market posted negative returns in the first quarter, lagging taxable fixed-income asset classes. Proposed trade and foreign policy changes from the new US administration created uncertainty and volatility in financial markets, with divergence in fixed-income returns—strong returns from US government bonds and many emerging market (EM) government bonds, and negative returns from Japanese and eurozone government bonds. Spread sectors provided positive returns but generally underperformed government bonds. The unpredictability of the proposed policy changes drove a sharp correction in US stocks, and the US dollar weakened.

US economic data, such as retail sales, durable goods orders and the unemployment rate continued to indicate a resilient economy. However, uncertainty surrounding tariffs and other policy changes negatively affected business and consumer sentiment. US Treasuries (USTs) rallied as slower growth prospects increased the likelihood of Federal Reserve (Fed) rate cuts, while the yield curve steepened due to tariff-related inflation and US fiscal policy concerns.

Municipal fundamentals remained resilient in the first quarter. The Census released state and local revenue collection estimates which signaled that municipal credit conditions remained well supported by elevated tax collections. Calendar-year 2024 collections increased 4.5% to $2.1 trillion year-over-year (YoY), marking a record high level according to the Census data. Individual income tax collections increased 4.9% YoY, corporate income tax collections declined 0.4% YoY and sales tax collections increased 1.5% YoY. Property tax collections also recorded a strong trend higher, growing 7.7% YoY.

Performance Scorecard

We thought that …	Therefore, we …	And the results …	
Uncertainty regarding US government policy would remain elevated. Central banks would ease policy further with headline inflation close to target and as global growth downshifted. We still believed that duration could serve as a valuable diversification strategy and risk-off hedge.	Maintained a long-duration position versus the benchmark.	Duration positioning had a negative impact on performance as municipal yields moved higher.	–
Revenue-backed municipal sectors would offer better risk-adjusted value versus their general obligation counterparts.	Maintained an overweight to revenue-backed sectors, including transportation, lease-backed and industrial-backed sectors.	Exposure to higher-beta revenue-backed securities contributed to performance during the quarter.	+
Municipal credit conditions would remain favorable over the medium term due to supportive tax collections and cash balances.	Maintained an overweight to lower-investment-grade and high-yield securities.	The overweight to high-yield securities detracted from relative performance due to lower US growth expectations and ongoing policy uncertainty.	–

Investment Outlook

With the rebound of short-term inflation pressures, extended rate volatility may occur, and the increased potential for recession could challenge peaking credit quality. Despite these concerns, Western Asset remains constructive on municipal fundamentals and risk-adjusted returns. We expect that a strong labor market and consumer spending should support tax collections and municipal credit conditions over the medium term. We also anticipate direct revenue sources will play a more critical role in state and local budgets, particularly if federal spending reductions extend more broadly to municipal credit.

Data Sources: Thompson Reuters MMD, Bloomberg, Lipper, Barclays and St. Louis Fed.

Important Information

Past performance is no guarantee of future results. Please note that an investor cannot invest directly in an index. Unmanaged index returns do not reflect any fees, expenses or sales charges.

Fixed income securities involve interest rate, credit, inflation and reinvestment risks, and possible loss of principal. As interest rates rise, the value of fixed income securities falls. High-yield bonds are subject to greater price volatility, illiquidity and possibility of default. Certain investors may be subject to the Federal Alternative Minimum Tax (AMT), and state and local taxes may apply. Capital gains, if any, are fully taxable.

U.S. Treasuries (USTs) are direct debt obligations issued and backed by the "full faith and credit" of the U.S. government. The U.S. government guarantees the principal and interest payments on U.S. Treasuries when the securities are held to maturity. Unlike U.S. Treasury securities, debt securities issued by the federal agencies and instrumentalities and related investments may or may not be backed by the full faith and credit of the U.S. government. Even when the U.S. government guarantees principal and interest payments on securities, this guarantee does not apply to losses resulting from declines in the market value of these securities.

Credit quality is a measure of a bond issuer's ability to repay interest and principal in a timely manner. The credit ratings are provided by Standard and Poor's, Moody's Investors Service and/or Fitch Ratings, Ltd. and typically range from AAA (highest) to D (lowest), or an equivalent and/or similar rating. Investment-grade bonds are those rated Aaa, Aa, A and Baa by Moody's Investors Service and AAA, AA, A and BBB by Standard & Poor's Ratings Service, or that have an equivalent rating by a nationally recognized statistical rating organization or are determined be of equivalent quality.

Franklin Resources, Inc., its specialized investment managers, and its employees are not in the business of providing tax or legal advice to taxpayers. These materials and any tax-related statements are not intended or written to be used, and cannot be used or relied upon, by any such taxpayer for the purpose of avoiding tax penalties or complying with any applicable tax laws or regulations. Tax-related statements, if any, may have been written in connection with the promotion or marketing of the transaction(s) or matter(s) addressed by these materials, to the extent allowed by applicable law. Any such taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

The Bloomberg Municipal Bond Index is a flagship measure of the USD-denominated tax exempt bond market over 1 year to maturity. The index includes four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and prerefunded bonds. Securities must be rated investment grade (Baa3/BBB-/BBB- or higher).

The Bloomberg Municipal Taxable Bonds Index is a flagship measure of the USD-denominated taxable municipal bond market over 1 year to maturity. Securities must be rated investment grade (Baa3/BBB-/BBB- or higher).

The Bloomberg Municipal High Yield Bond Index is a flagship measure of the non-investment-grade and nonrated USD-denominated tax exempt bond market. Included in the index are securities from all 50 US States and four other qualifying regions (Washington DC, Puerto Rico, Guam, and the Virgin Islands). The index includes state and local general obligation bonds and revenue bonds. High-yield (Ba1/BB+/BB+ or below) and non-rated issues are eligible. Defaulted securities are not index eligible.

Any information, statement or opinion set forth herein is general in nature, is not directed to or based on the financial situation or needs of any particular investor, and does not constitute, and should not be construed as, investment advice, a forecast of future events, a guarantee of future results, or a recommendation with respect to any particular security or investment strategy or type of retirement account. Investors seeking financial advice regarding the appropriateness of investing in any securities or investment strategies should consult their financial professional. Views are current as of the date of this publication and subject to change. The information is based on current market conditions, which will fluctuate and may be superseded by subsequent market events.

INVESTMENT PRODUCTS: NOT FDIC INSURED • NO BANK GUARANTEE • MAY LOSE VALUE