GW&K INVESTMENT MANAGEMENT

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# THE CASE FOR MUNIS: STAYING THE COURSE IN A HISTORIC FIXED INCOME SLUMP

## Key Takeaways:

While recent fixed income returns have been disappointing, there are several reasons to be optimistic about the asset class:

- Interest rates are above long-term averages, improving future return potential.
- Higher yields assist in offsetting potential price volatility.
- Fixed income has historically provided downside protection during stock market corrections.

## Recent Bond Returns Have Been the Worst in History

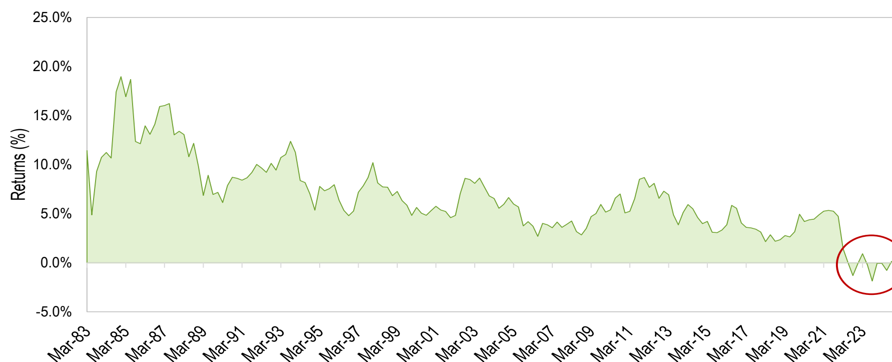
Over the past three years, fixed-income investors have experienced the worst bond market in history. Meanwhile, equities have performed exceptionally well, drawing even more attention to these meager returns. During this period, municipal bonds recorded their first-ever negative return (**Figure 1**), whereas the S&P 500 returned 8.94% per year. These vastly different results have investors questioning why they own bonds at all.

### FIGURE 1

### Three Years of Turmoil: The Muni Market's Toughest Stretch Yet

**THREE-YEAR ROLLING RETURNS: BLOOMBERG 10-YEAR MUNICIPAL BOND INDEX**

*January 1, 1980 – December 31, 2024*




Sources: FactSet, Bloomberg, GW&K. Three-year rolling returns are annualized, based on quarterly returns. The tax-equivalent yield to worst was calculated using the highest federal income tax bracket (37.0%) plus the health care surtax (3.8%) for a combined federal tax rate of 40.8%. The Bloomberg 10-Year Municipal Bond Index is comprised of investment grade national municipal bond issues with a maturity range of 8–12 years. Indexes are not subject to fees and expenses typically associated with managed accounts or investment funds. Investments cannot be made directly in an index. GW&K assumes no responsibility for the accuracy of the data provided by outside sources. This represents the views and opinions of GW&K Investment Management and does not constitute investment advice, nor should it be considered predictive of any future market performance. Data is from what we believe to be reliable sources, but it cannot be guaranteed. Opinions expressed are subject to change. Past performance is no guarantee of future results.

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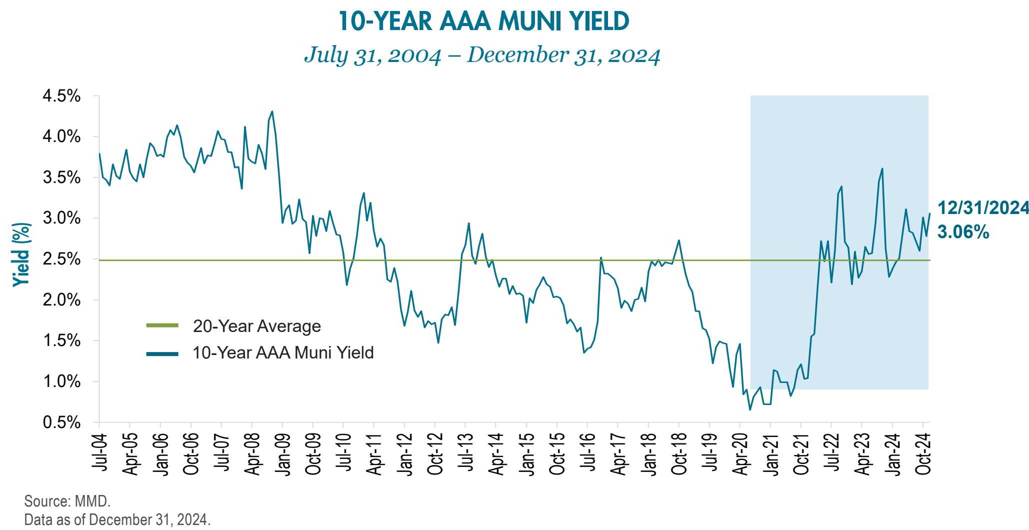
## How Did We Get Here?

Beginning during the Global Financial Crisis of 2007 – 2009, the US Federal Reserve (Fed) engineered a period of zero rates to combat deflation that lasted for over a decade. However, over the last three years, inflation emerged from its deep sleep and interest rates spiked. As a result, the 10-Year AAA muni rate rose nearly 300 basis points from its all-time low of 0.68% in early 2021 (**Figure 2**). The historically low initial yield meant that the losses inflicted on bond investors were even more extreme than prior periods of rising rates when there was more "coupon cushion."

### FIGURE 2

### A Rapid Rise Has Put Current Rate Levels Above 20-Year Averages




Source: MMD.
Data as of December 31, 2024.

## The Good News

With a new and improved yield, the prospects for returns moving forward have increased significantly. And these higher yields also provide a buffer against future increases in rates, unlike the period investors just experienced. Bond market participants are now presented with favorable upside relative to downside risk. **Figure 3** illustrates this dynamic by showing returns in rising/declining rate scenarios.

### FIGURE 3

### Prepared for What's Next — Higher Yields Provide Some Rate Buffer

| | Decline 100 (bps) | Decline 50 (bps) | No Change | Increase 50 (bps) | Increase 100 (bps) |
|---|---|---|---|---|---|
| **Index Price Return** | 5.77% | 2.89% | 0.00% | -2.89% | -5.77% |
| **Yield to Worst** | 2.53% | 3.03% | 3.53% | 4.03% | 4.53% |
| **Total Return** | **8.30%** | **5.92%** | **3.53%** | **1.15%** | **-1.24%** |

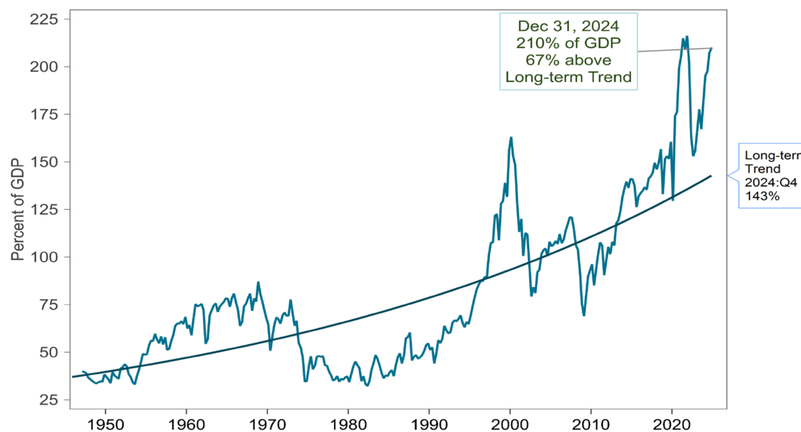
Source: Municipal Market Data. Reflects yield to worst of 3.53% and option adjusted duration of 5.77 for the Bloomberg 10-Year Municipal Bond Index as of 12/31/2024. Returns are over a 12-month period.
Interest rate moves occur over the first 12 months of the analysis. Calculations do not account for any spread widening or tightening that may occur and it does not take into account the potential benefits of active management on a portfolio. Additionally, the calculations do not take into account the deduction of advisory fees and other expenses or other potentially material economic or market factors that could impact investment performance. No portion of this illustration, including potential impact to the performance resulting from events described, is guaranteed. The interest rate scenarios provided are intended to present a variety of potential market moves but are not meant to be predictive.

## Don't Forget Why You Own Bonds

While simply generating income is a fair objective, given the possibility for future volatility in risk markets, a potentially even more important reason to own bonds is for portfolio protection. Fixed income serves as the sleep-well-at-night portion of your investment allocation, acting as a hedge if and when the stock market corrects. **Figure 4** examines the current high valuations of the stock market and **Figure 5** shows the performance of municipal bonds during equity corrections.

### FIGURE 4

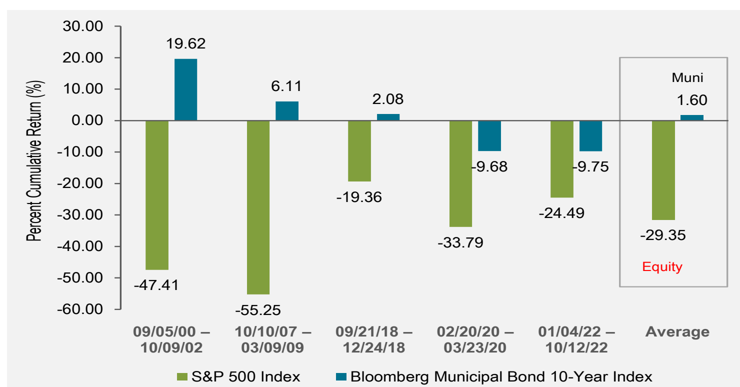
### US Stock Market Value to GDP (%)




Source: GW&K Investment Management, BEA, Federal Reserve, and Macrobond.
Data as of December 31, 2024.

### FIGURE 5

### Municipal Bond Returns During Equity Market Corrections




Source: FactSet. Equity downturns prior to 2002 represent month end periods only due to Index data availability.
Data as of December 31, 2024.

## Rough Patches Don't Last — But Diversification Always Matters

With today's higher rates, fixed income provides reliable income, reduces portfolio volatility, and enhances risk-adjusted returns. Instead of abandoning bonds for a crowded equity market, investors should view fixed income as a crucial component of a well- balanced portfolio offering diversification, capital preservation, and income generation — especially in these times of uncertainty.

**DISCLOSURES:**

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