Parametric

Municipal Bond Market Insight | December 2025

Reasons to be Cheerful

Key takeaways

- » Robust new issue supply continues and will set a new record this year.
- » Muni yields remain attractive despite positive mild year-to-date (YTD) total returns.
- » The steepness of the muni curve continues to invite investors to extend.
- » There have been numerous opportunities to harvest tax losses during this positive year.

General market update

Volatility and uncertainty have been hallmarks of the 2025 bond market, and the latter was clearly on display in late October and throughout November. The longest US government shutdown on record also added a layer of unwanted opacity to frustrate market pundits and possibly even the Fed.

Meanwhile, artificial intelligence remains all the rage, and equity markets continue to climb a wall of worry regarding rising valuations. Munis added to prior months' gains during November, while enjoying a continued uneven multi-month pattern of new-issue supply weeks.

However, the Bloomberg Municipal Bond Index increase of 0.23% fell well short of its taxable counterparts, as the Bloomberg US Treasury Index and the Bloomberg US Corporate Index posted gains of 0.62% and 0.65%, respectively. With a total return of 4.15% YTD, there may be too much ground to cover and not enough time for munis to catch up to Treasurys' 6.67% and corporates' 7.79% by year-end.

Supply

Robust new issue supply has been an enduring theme throughout the year, and November's volume didn't disappoint. With approximately $38.5 billion entering the primary market, the heavy slate of bonds was enough to eclipse last year's torrid pace and ensure that 2025 sets a new record. According to *The Bond Buyer*, Texas, California and New York have been leading the way YTD, each issuing more than twice the amount of fourth place Florida. That said, it's worth noting that despite the record-setting YTD issuance, much of it is concentrated in just a few states, which means spot shortages have emerged sporadically in other states.

Looking ahead to 2026, we expect municipal supply to remain elevated compared with long-term averages as issuers continue to fund deferred infrastructure projects and opportunistically refinance higher-cost debt when market windows open.

Figure 1: Fixed income returns as of November 28, 2025

	MTD return	YTD return
Bloomberg Muni Index	0.23%	4.15%
Bloomberg US Treasury Index	0.62%	6.67%
Bloomberg US Aggregate Index	0.62%	7.46%
Bloomberg US Corporate Index	0.65%	7.99%

Source: Bloomberg, 11/28/2025. For illustrative purposes only. It is not possible to invest directly in an index.

Past performance is no guarantee of future results.

Figure 2: AAA municipal yields as of November 28, 2025

Year	Current	MTD change	YTD change
2-year	2.44%	-2 bps	-38 bps
5-year	2.38%	3 bps	-46 bps
10-year	2.75%	2 bps	-31 bps
30-year	4.16%	1 bp	26 bps

Source: Thomson Reuters Municipal Market Data, 11/28/2025. For illustrative purposes only and is not meant to depict the performance of a specific investment. Not a recommendation to buy or sell any security.

Past performance is no guarantee of future results.

Figure 3: US Treasury yields as of November 28, 2025

Year	Current	MTD change	YTD change
2-year	3.49%	-12 bps	76 bps
5-year	3.6%	-11 bps	-80 bps
10-year	4.02%	-8 bps	-56 bps
30-year	4.67%	0 bps	-12 bps

Source: Bloomberg, 11/28/2025. For illustrative purposes only and is not meant to depict the performance of a specific investment. Not a recommendation to buy or sell any security.

Past performance is no guarantee of future results.

Importantly, the saw-toothed pattern of heavy and light weeks continues, providing ample supply for incoming cash. But we expect issuance to dwindle into the year-end holidays, which should set the stage for additional muni performance to tighten the gap versus Treasurys and corporate bonds.

On the demand side, long-term YTD inflows are more than double that of short-term, and investment-grade funds have attracted more than three times as many assets as high-yield funds. With muni supply potentially slowing into year end, these fund flows may have a greater impact on pricing. Our weekly fixed income insights routinely highlight the latest fund flows.

Market opportunity

We almost always cheer an underdog triumph, but sometimes an exciting effort falls short of a win. For the first half of the year, total muni returns were flat to slightly negative, and the asset class materially lagged other high-quality fixed income. Although tax-exempts sharply outperformed Treasurys and corporate bonds in both September and October, they underperformed again in November. With just weeks left on the calendar, it would take an unlikely Herculean outperformance for munis to "win the year" on a relative basis, despite an already-respectable 4% total return, but that performance doesn't highlight the opportunity remaining for forward-looking investors.

We see reasons for bondholders to be cheerful—silver linings, if you will. With this year's price action shaping up to produce a low- to mid-single-digit positive total return, as we forecast in January's fixed income outlook, the majority of individual investors should welcome the outcome, which leaves today's starting yields at levels that still look attractive on a tax-adjusted basis.

Here's why: When it comes to total muni return performance for individual investors, mild—not wild—is best. The reason lay at the very heart of muni investing: the tax exemption. The most common base expectation among muni investors is the preservation of principal, typically accomplished through high-quality and well-structured bond selection and tax-exempt income. Additional positive returns are always welcome, but outsized gains bring challenges for muni investors in the form of sharply lower yields for reinvestment and for new cash. Since the goal of muni investing is to enjoy tax-free income, most individual investors choose not to take gains on tax-exempt bonds that have greatly appreciated.

Similarly, if there's a negative total return, which is generally less welcome, the higher yields are favorable for reinvestment and adding cash. But outsized losses can severely impact investor sentiment and beg questions like "What if yields continue to rise or even spike higher?" and "Why am I even in this asset class?" Today's environment, with moderate positive returns and still-elevated yields, strikes a balance that supports staying invested and, in many cases, adding to muni allocations.

With these scenarios in mind and the experience of both ups and downs during the past decade, we believe that a more stable band of outcomes tends to serve individual municipal bond investors best. Specifically, this year's likely pending outcome of a 4% to 5% positive muni return has given investors who prudently tax-loss-harvest year-round multiple opportunities to harvest losses at various points during the year. There has been value in the volatility. Further, the mild YTD decline in short to intermediate yields and mild increase in long muni yields offers investors the ability to reinvest, add cash and extend out on the yield curve to capture attractive yields that remain near decade highs. Conversely, if this year ended with a mildly negative total return, the opportunities to harvest tax losses may have been more frequent and with potentially larger losses, but not large enough to hurt investor sentiment.

We'd be remiss at this point if we neglected to explore the "mixed" performance across the muni maturity spectrum YTD through November, as well as the shape or slope of the muni yield curve. Regarding the mixed performance, we note that two- through 10-year maturity yields have declined 31 to 46 basis points (bps) YTD, while 30-year maturity yields have risen 26 bps. The directional difference between these two trajectories stems from the buyer base, as well as the nature and availability of supply. Simply stated, individual investors who invest directly in brokerage or through separately managed accounts tend to favor the front half of the 30-year yield curve and typically drive substantial durable demand, whereas the back half of the curve may be driven more by interest rate–sensitive institutional buyers like mutual funds and insurance companies that may be matching liabilities. In most years there's limited reward for extending to the very back end of the muni yield curve, but given the record-setting supply and the Fed's on-again/off-again easing policy path, today's yield pick-up is substantial and uncommon. In fact, according to MMD, the 89-bp steepness of the muni yield curve between 15 and 30 years on December 5 was the highest in more than a decade and more than twice what it was in 2017. That suggests substantial potential value for those willing to extend duration and lock in higher long-end, tax-exempt income as part of an asset-allocation decision. For many investors, that combination of resilient credit fundamentals, solid starting yields and an unusually steep long end argues for maintaining and, in some cases, increasing strategic muni exposure

Economic outlook

Speaking of duration and interest-rate risk, market sentiment entered the last Federal Open Markets Committee (FOMC) meeting in October with higher-than-90% expectation of a December rate cut and left the accompanying press conference with just 50% odds, with the end of the historic government shutdown doing little to improve visibility. The largest and most recent data set is currently the September payroll situation report, which was weaker than consensus forecasts but was already rather outdated by its November release date. And on December 10, the Fed lived up to the odds and approved a 25-bp rate cut.

That FOMC meeting also produced a new Summary of Economic Projections (the “dot plot”), which showed minimal change from September’s. This suggests that the current forecasted terminal (ending) rate for this easing cycle will remain in a range between 3% and 3.25%, based on the projected median dots. Considering the current Fed funds rate target of 3.75% to 4%, set in October, this would potentially leave two more 25-bp rate cuts on the table after the December easing.

Beyond the December Fed meeting, market pricing for the timing of additional cuts in 2026 appears to have settled on approximately 30% for each of the six meetings through September, with the exception of a 50% probability in June. Reflecting these more tepid expectations and reduced number of cuts compared with earlier this year, Bloomberg consensus forecasts for the 10-year Treasury at the close of 2026 average just 4.06%, remarkably close to today’s prevailing yield.

With this in mind, we could be looking at a less wild, more mild year ahead for munis, with a constructive backdrop for investors prioritizing predictable, tax-exempt income over outsized capital gains. The Fed’s projected path of measured cuts, combined with consensus expectations for only modest moves in longer-term Treasury yields, argues for locking in today’s tax-exempt yields rather than waiting for a dramatically better rate environment that may never arrive. At the same time, robust but manageable new-issue supply should continue to provide opportunities to put cash to work, while ongoing fund and ETF inflows help the market absorb that supply at generally attractive levels. Of course, markets rarely move in a straight line, so we also expect bouts of volatility resulting from shifting policy expectations, tariffs or data surprises to create periodic windows to harvest tax losses. These windows may also provide opportunities to add exposure or extend duration into pockets of value. Reasons to be cheerful, indeed.

Key economic data

Change in nonfarm payrolls (Sep.)	119,000
Unemployment rate (Sep.)	4.4%
Core CPI–YoY change (Sep.)	3%
Core PCE–YoY change (Sep.)	2.8%
Average hourly earnings–YoY change (Sepg.)	3.8%
Real GDP annualized (Q3 2025)	n/a

Source: Bloomberg, 11/28/2025.

ABOUT

Parametric Portfolio Associates® LLC ("Parametric"), headquartered in Seattle, is registered as an investment advisor with the US Securities and Exchange Commission under the Investment Advisers Act of 1940. Parametric is a leading global asset management firm, providing investment strategies and customized exposure management directly to institutional investors and indirectly to individual investors through financial intermediaries. Parametric offers a variety of rules-based investment strategies, including alpha-seeking equity, fixed income, alternative and options strategies. Parametric also offers implementation services, including customized equity, traditional overlay and centralized portfolio management. Parametric is part of Morgan Stanley Investment Management, the asset management division of Morgan Stanley, and offers these capabilities through offices located in Seattle, Boston, Minneapolis, New York and Westport, Connecticut.

DISCLOSURES

This material may not be reproduced, in whole or in part, without the written consent of Parametric. Parametric and its affiliates are not responsible for its use by other parties.

This information is intended solely to report on investment strategies and opportunities identified by Parametric. Opinions and estimates offered constitute our judgment and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions. We believe the information provided here is reliable but do not warrant its accuracy or completeness. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. Past performance is not indicative of future results. The views and strategies described may not be suitable for all investors. Investing entails risks, and there can be no assurance that Parametric will achieve profits or avoid incurring losses. Parametric and Morgan Stanley do not provide legal, tax or accounting advice or services. Clients should consult with their own tax or legal advisor prior to entering into any transaction or strategy described herein.

Charts, graphs and other visual presentations and text information were derived from internal, proprietary or service vendor technology sources or may have been extracted from other firm databases. As a result, the tabulation of certain reports may not precisely match other published data. Data may have originated from various sources, including, but not limited to, Bloomberg, MSCI/Barra, FactSet or other systems and programs. Parametric makes no representation or endorsement concerning the accuracy or propriety of information received from any third party.

The views expressed in this report are those of the authors and are current only through the date stated at the top of this page. These views are subject to change at any time based on market or other conditions, and Parametric disclaims any responsibility to update such views. These views may not be relied on as investment advice and, because investment decisions are based on many factors, may not be relied on as an indication of trading intent on behalf of any Parametric strategy. This commentary may contain statements that are not historical facts, referred to as "forward-looking statements." The strategy's actual future results may differ significantly from those stated in any forward-looking statement, depending on factors such as changes in securities or financial markets or general economic conditions.

References to specific securities and their issuers are for illustrative purposes only and are not intended to be, and should not be interpreted as, a recommendation to purchase or sell such securities. There is no guarantee as to its accuracy or completeness. Past performance is no guarantee of future results. All investments are subject to the risk of loss. Prospective investors should consult with a tax or legal advisor before making any investment decision.

The index data referenced herein is the property of ICE Data Indices, LLC ("ICE"), its affiliates and its third-party suppliers. ICE, its affiliates and its third-party suppliers accept no liability in connection with its use.

An imbalance in supply and demand in the income market may result in valuation uncertainties and greater volatility, less liquidity, widening credit spreads and a lack of price transparency in the market. As interest rates rise, the value of certain income investments is likely to decline. Investments in income securities may be affected by changes in the creditworthiness of the issuer and are subject to the risk of nonpayment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. While certain US government–sponsored agencies may be chartered or sponsored by acts of Congress, their securities are neither issued nor guaranteed by the US Treasury. Mortgage- and asset-backed securities are subject to credit, interest rate, prepayment and extension risk. Derivative instruments can be used to take both long and short positions, be highly volatile, result in economic leverage (which can magnify losses) and involve risks in addition to the risks of the underlying instrument on which the derivative is based, such as counterparty, correlation and liquidity risk. Diversification does not guarantee profit or eliminate the risk of loss.

Parametric is headquartered at 800 Fifth Avenue, Suite 2800, Seattle, WA 98104. For more information regarding Parametric and its investment strategies, or to request a copy of Parametric's Form ADV or a list of composites, contact us at 206 694 5500 or visit www.parametricportfolio.com.

NOT FDIC INSURED | NO BANK GUARANTEE | MAY LOSE VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A DEPOSIT