Parametric

Municipal Bond Market Insight | July 2025

Positioned for Performance

Key takeaways

- It's been a challenging first half of 2025 for munis, but we think we're well positioned for the second half.
- Muni yields remain near decade highs and offer above-average relative value.
- Supply has been relentless but may slow in coming months.
- Challenges to the federal exemption of munis now appear off the table.

General market update

There's no dancing around it: 2025 has thus far been a challenging year for the municipal bond market. At the close of the first half on June 30, the Bloomberg Muni Bond Index year-to-date (YTD) total return was -0.35%—basically flat. While that's not a terrible position to be in considering prior years, compared with the Bloomberg US Treasury Index at 3.79%, it's certainly uninspiring, if not disheartening. What's keeping the municipal bond market down has nothing to do with credit quality, demand destruction or market function. There were simply too many new-issue bonds coming to market, and that supply has stunted muni price performance compared with Treasurys. We'll dive deeper into this state of affairs momentarily, but it looks like an opportunity.

Meanwhile, market volatility has increased markedly, for both equity and fixed income. As we discussed last month, headlines continue to demand the markets' attention. The second quarter began with tariff-related announcements and related granularity that rattled the markets for weeks, but approximately a month later, any losses in the broad equity indexes were erased, and the 10-year Treasury yield found itself range-bound roughly between 4.3% and 4.5%. Along the way, Moody's downgraded US government debt to Aa1-stable outlook from Aaa-negative outlook. The bond markets took the move in stride, as it was largely expected. Standard and Poor's had enacted a similar downgrade more than a decade ago.

As we write this, we await expiration of the tariff extensions on July 9 and the July FOMC meeting at the end of the month. Market expectations for rate cuts during this calendar year have ebbed and flowed in recent months, ranging from zero to four, but have more recently centered on just two, consistent with the Fed's updated dot plot released in May.

Supply

Supply was the dominant theme in the muni market during the first half, with issuance up more than 14% year-over-year (YoY) from 2024, itself a record year for the primary market. With more than $280 billion already brought to market, 2025 is on track to be another record-setting year, and many muni strategists have already raised their forecasts well north of $500 billion.

Fixed income returns as of June 30, 2025

	MTD return	YTD return
Bloomberg Muni Index	0.62%	-0.35%
Bloomberg US Treasury Index	1.25%	3.79%
Bloomberg US Aggregate Index	1.54%	4.02%
Bloomberg US Corporate Index	1.87%	4.17%

Source: Bloomberg, 6/30/2025. 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 June 30, 2025

Year	Current	MTD change	YTD change
2-year	2.58%	-19 bps	-24 bps
5-year	2.67%	-17 bps	-20 bps
10-year	3.26%	-7 bps	20 bps
30-year	4.54%	2 bps	64 bps

Source: Thomson Reuters Municipal Market Data, 6/30/2025. For illustrative purposes only. Not a recommendation to buy or sell any security.

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Figure 3: US Treasury yields as of June 30, 2025

Year	Current	MTD change	YTD change
2-year	3.72%	-18 bps	-53 bps
5-year	3.80%	16 bps	-60 bps
10-year	4.23%	-17 bps	-35 bps
30-year	4.78%	15 bps	-1 bp

Source: Bloomberg, 6/30/2025. For illustrative purposes only. Not a recommendation to buy or sell any security.

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Because of a combination of muni-specific factors, including pent-up demand, dwindling federal stimulus funds, pull-forward demand (from 2026) over the uncertain longevity of the full federal tax exemption for munis and sector-specific concerns around private higher education, hospitals and private activity bonds regarding potential loss of tax-exempt status, the inflow of new-issue municipal bonds has been relentless.

Accordingly, issuance in June was up over 16% YoY and included two mammoth weeks. The first was more than $20 billion, the largest YTD and the second largest on record, and it was followed by a $15-billion-plus week. For context, typical weekly issuance before last year was approximately $7 billion. Both these "triple" and "double" weeks were easily digested, given the prevailing favorable pricing dynamic.

The question at hand is: Will this torrid pace of new supply continue and, if not, can muni performance recover or catch up during the second half?

Market opportunity

Aside from the outsized tariff-related volatility of early-April, the muni market's ability to accommodate such a large supply of bonds has been truly impressive and was helped by 10 consecutive weeks of inflows into muni mutual funds. That accommodation came with a material lag in performance compared with both Treasurys and corporate bonds, which also means tax-exempt yields are now quite compelling. How compelling? Benchmark 10-year AAA-rated bond yields remain near sustained decade-highs, and their relative value against Treasurys is a full 10 percentage points higher than the two-year average.

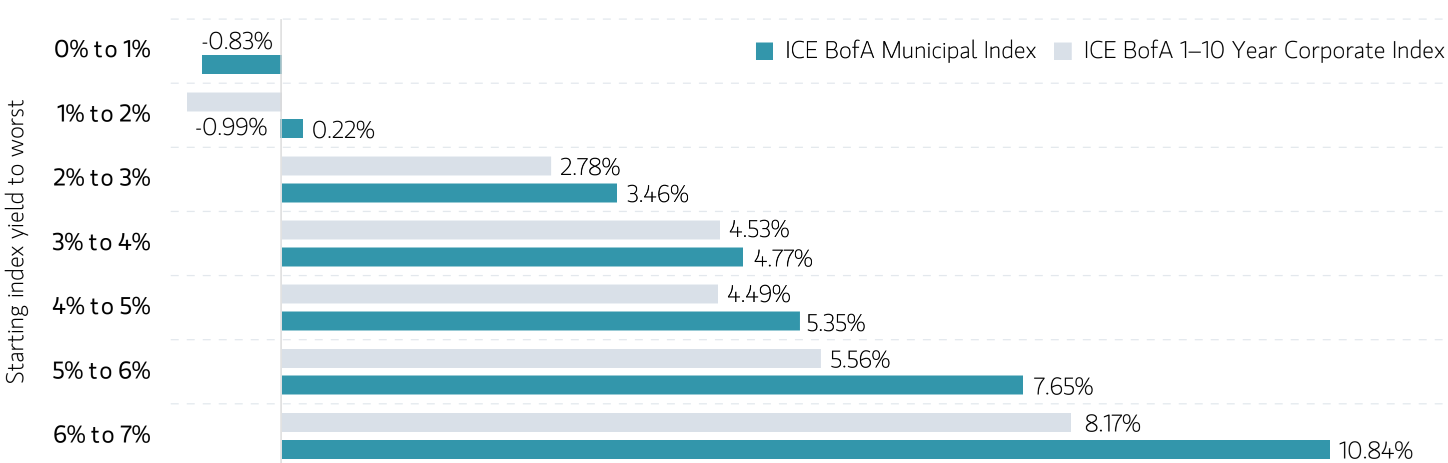
Regarding whether this outsized supply will continue, we note that the primary driver of pull-forward issuance—threats to the tax exemption—has largely been removed, given the absence of such language in the President's budget proposal and subsequent adjustments in Congress. This means there's no longer a sense of urgency for municipal bond issuers to beat the timing of that bill. In fact, issuers may now want to postpone issuance slated for 2025 in favor of next year, when most market pundits believe the Fed will resume cutting interest rates more consistently.

When you pair these two prospects—less new supply and rate cuts—the potential for a dual tailwind emerges. If supply slows in the second half of the year and demand remains constant, a return to the two-year relative value average of 66% could bring significant price improvement from current levels. Using the current 10-year Treasury yield (4.33%) and applying the current 76% relative-value ratio equals a tax-free muni yield of approximately 3.29%. Even if that 10-year Treasury yield remained unchanged, simply returning to the two-year average relative-value ratio of 66% equals a muni yield of 2.86%. That potentially 43-basis-point (bps) reduction would mean a healthy 13% move from current levels. Assuming the resumption of rate cuts, applying that same 66% relative value ratio to a materially lower 10-year Treasury yield would obviously imply additional price appreciation.

As we mentioned in our opening, it's been a tough year for muni bondholders. This follows a five-year stretch of the bond markets underperforming their longer-term averages. The reason is straightforward: Starting yield matters, and five years ago they were at or near record lows. This has changed drastically. Today's muni yields are near the decade highs and well above the long-term average…opposite of five years ago.

DISPLAY 4

Average three-year annualized forward returns, based on starting index yield to worst



Source: Parametric and ICE BofA index returns, 6/30/2025. Data analyzed from 5/1/2000 through 5/1/2025. Starting yields are represented by index yield to worst. Starting yields and forward index returns based on daily values for the last 25 years. It is not possible to invest directly in an index. Indexes are unmanaged and do not reflect the deduction of fees or expenses. Past performance is not indicative of future results.

In fact, the prevailing 10-year benchmark muni yield is also 50 bps higher than almost a year ago when the Fed started cutting rates last September. Further, the muni yield curve has steepened substantially, as front-end yields are almost 20 bps lower YTD, while back-end yields are more than 60 bps higher. This steeper muni yield curve—which is also much steeper than Treasurys—suggests that investors are better compensated for extending duration in munis than in Treasurys or corporates.

Finally, the muni market is subject to seasonal swings in both supply and demand. June, July and August represent the three largest months of the year (in that order) in terms of maturing bonds, called bonds and coupon payments, all sources of potential reinvestment demand. Typically, new-issue supply ebbs materially during July and August. It's likely that munis will outperform in the summer if supply slows. We continue to believe it's an opportune time to add muni exposure and extend out on the yield curve to intermediate- and long-duration strategies. For now, the pre-summer sale appears extended, but who knows for how long.

Economic outlook

Among the many headlines that vie for the markets' attention, data from the monthly Payroll Situation Report routinely captures an outsized focus. The June payroll report was no different. With consensus estimates looking for just 106,000 new jobs created, the data revealed a 147,000 increase, along with a mildly upward revision of last month's gain. This release steps up the three-month moving average to 150,000. Also, the unemployment rate dipped to 4.1% from the previous 4.2% and thwarted expectations for an increase to 4.3%. Hourly earnings increases slowed significantly to 0.2% month-over-month, compared with expectations of 0.3% and last month's 0.4% print. Accordingly, the YoY increase slowed to 3.7%, compared with the consensus forecast of 3.8%, also the prior month's revised reading. All-in, it appeared to be yet another solid nonfarm payrolls report.

Key economic data

Change in nonfarm payrolls (Jun.)	147K
Unemployment rate (Jun.)	4.1%
Core CPI–YoY change (May)	2.8%
Core PCE–YoY change (May)	2.7%
Average hourly earnings–YoY change (Jun.)	3.7%
Real GDP annualized (Q1 2025)	-0.5%

Source: Bloomberg, 6/30/2025

This leaves the marketplace and the Fed once again waiting for evidence of US economic slowing in the hard data to corroborate weaker sentiment that has already surfaced in business surveys, or the so-called "soft-data."

Looking ahead, it seems unlikely that the next FOMC convocation July 29 and 30 will be considered a "live" meeting regarding a possible rate change. This intensifies the focus on the September meeting for the next rate cut. If there's no change to the Fed funds target range in July, there will be just three meetings left for the Fed to accomplish the 50 bps of policy easing indicated by its latest dot plot.

While the Fed is presumably in a comfortable position to wait for hard data to support a rate cut, as the US economy appears robust and inflation continues to ebb slowly, chair Powell has been under pressure from President Trump to cut rates. This political dynamic places the Fed in a difficult position and likely increases the need for hard data to support additional rate cuts. Without such data, the Fed risks losing credibility in terms of its independence and risks fanning inflation tariffs could exacerbate. Lastly, the expected departure of Jerome Powell next May when his term as Fed chair expires adds an additional uncertainty to the mix. The President will appoint Powell's successor, and rumored front-runners include Fed governor Christopher Waller, former Fed governor Kevin Warsh, World Bank president David Malpass, National Economic Council director Kevin Hassett and Treasury Secretary Scott Bessent.

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