

Municipal Bond Market Insight | May 2025

Too Much of a Good Thing

Key takeaways

- » Heavy municipal bond supply challenged the market in April.
- » Tariff-driven fixed income volatility prompted an outsized volatility in munis.
- » Both absolute and relative muni value set new highs in April and remain compelling.
- » There appears to be light at the end of the tunnel with June reinvestment approaching.

General market update

Following a period of rapidly rising municipal yields that peaked in 2023 then eased in early 2024, subsequent bouts of yield increases have been viewed opportunistically by many current and prospective muni bond investors. In addition to the occasional and, at times, sustained rises in yield, adequate supply is also readily welcomed by most muni bond investors. April's muni bond market brought both in abundance, and there was much more going on in tax exempts than munis simply following along with Treasury market volatility.

Before delving into the muni-specific developments of April, we need to discuss volatility and developments in the broader markets that began on April 2. That afternoon President Trump announced the administration's long-awaited details regarding their often-referenced tariffs. With country-by-country granularity, details of threatened reciprocal tariffs left equity and bond markets to ponder the related uncertainty regarding economic impact to an otherwise resilient US economy, as well as related impacts to the timeline of bringing inflation down to the Fed's still-desired 2% goal.

Not surprisingly, the heavy dose of uncertainty wreaked havoc on equity markets, which prompted a flight to quality response in the bond markets, with bond yields plummeting by over 20 basis points (bps) within two trading days only to then reverse course and rise 50 bps in US Treasuries (USTs) and 92 bps in munis before settling back into mildly higher yields (approximately 20 bps) than where the ride began. As of this writing, the 10-year Treasury yield is 19 bps higher than the April open, and 10-year benchmark munis are 12 bps higher than on April 1.

Meanwhile, equity markets appear to have largely recovered from the tariff-driven turbulence, and US economic data has yet to meaningfully show the impacts of various actions taken by the new administration during its first 100 days. This isn't to say that evidence of a slowdown isn't showing up. We see it in surveys like the Institute for Supply Management and the University of Michigan Consumer Sentiment, as well as in corporate leadership rhetoric and earnings guidance, but it isn't readily visible in hard economic data just yet. The lone data point that suggests weakness has been a slight contraction in first quarter US GDP growth (advanced), registering at -0.3% compared with expectations for -0.2% and following a 2.4% reading for Q4 2024. The year-to-date (YTD) resiliency of the US economy and stable but stubborn inflation have relegated the data-dependent Fed to the sidelines, with chair Powell indicating that more data is needed before resuming its rate-cutting regimen.

Fixed income returns as of April 30, 2025

| | MTD return | YTD return |
|------------------------------|------------|------------|
| Bloomberg Muni Index | -0.81% | -1.03% |
| Bloomberg US Treasury Index | 0.63% | 3.57% |
| Bloomberg US Aggregate Index | 0.39% | 3.18% |
| Bloomberg US Corporate Index | -0.03% | 2.27% |

Source: Bloomberg, 4/30/2025. 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 April 30, 2025

| Year | Current | MTD change | YTD change |
|---------|---------|------------|------------|
| 2-year | 2.92% | 24 bps | 5 bps |
| 5-year | 3.02% | 16 bps | -4 bps |
| 10-year | 3.34% | 8 bps | 20 bps |
| 30-year | 4.38% | 14 bps | 48 bps |

Source: Thomson Reuters Municipal Market Data, 4/30/2025. For illustrative purposes only. Not a recommendation to buy or sell any security.

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

| Year | Current | MTD change | YTD change |
|---------|---------|------------|------------|
| 2-year | 3.63% | -29 bps | -62 bps |
| 5-year | 3.76% | -23 bps | -64 bps |
| 10-year | 4.18% | -7 bps | -40 bps |
| 30-year | 4.68% | 6 bps | -11 bps |

Source: Bloomberg, 4/30/2025. For illustrative purposes only. Not a recommendation to buy or sell any security.

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Supply

In April supply stepped up to star status and set the tone for the month directly after a robust March performance. While tax-exempt new issuance in April secured its place as the second-highest on record and cemented an 18% year-over-year (YoY) growth trend, the month's behind-the-scenes action occurred on the week-to-week basis.

To set the story, tax-exempt muni bond issuance has been on a positive YoY trajectory since January, with double-digit YoY gains in January, February and March of 16%, 27% and 14%, respectively. Although April issuance was indeed healthy and looked like a force to be reckoned with, the percentage increase YoY was just 4%.

So, what happened? Circling back to that intense early-April volatility in both Treasuries and munis and noting that weekly muni new issuance had already been running at a +\$10 billion clip for many weeks, the outsized downside price volatility and sharply higher yields during the week of April 7 drove many underwriters to postpone their deals pending a more orderly market, which took a number of days to achieve. Since the downside price volatility occurred on April 8 and 9—a Wednesday and Thursday, both prime days for muni issuance—a large percentage of that +\$11-billion week's deals were postponed. This created a shadow calendar of sidelined deals waiting to enter the market, on top of the already-significant +\$10 billion weekly trend. This combination drove three weeks of primary issuance ranging from \$12 billion to more than \$14 billion, which the muni market thankfully handled quite well at admittedly adjusted and attractive price levels.

There's more to the story. As we've frequently discussed, the supply/demand pendulum rarely rests at center in the muni market. According to Intercontinental Exchange data, the months of March, April and May are historically robust when it comes to primary market supply. These same months are also historically tepid when it comes to organic reinvestment demand, and this year was no exception. In fact, April was the lowest month of the year in terms of maturing bonds, called bonds and coupon payments hitting bondholder accounts, all sources of municipal reinvestment demand.

But there's still more. An entrenched seven-week trend of mutual fund outflows has added to this acute lack of reinvestment demand by adding supply into the secondary market. Little did the muni market know, but there was an accelerant within those fund flows that would play a breakout role. In a case that can best be described as the tail wagging

the dog, the smaller (compared with SMAs and open-end funds) but fast-growing ETF component experienced record \$1.4 billion outflows during the week ending April 9, then record \$1.9 billion inflows just three weeks later during the week ending April 30. The impact of both record events added an element of volatility that the normally staid muni bond market was just not accustomed to. Stepping back from the minutia of day-to-day trading activity and flows, these two record events occurring within the same month could be a harbinger of things to come in the muni market, namely for the potential for an enhanced level of volatility that brings with it both risks and rewards. This is yet another reason we recommend professional portfolio management.

Finally—and this serves as a good segue to discussing market opportunity—there appears to be light at the end of the tunnel for this challenging two-to-three-month cycle. June is the largest month of the year for reinvestment cash hitting bondholder accounts and leads into the very strong months of July and August. Also, note that this largest month follows the smallest month in May. With mutual fund flows now turning positive, muni market volatility settling down and seasonally lighter supply expected for June, July and August (meaning more dollars chasing fewer bonds), the stage could be set for improved muni total return performance during the summer months.

Market opportunity

Despite the many challenges that have faced the muni market, the prevailing market offers attractive entry points throughout the muni yield curve. As we noted earlier, while there's soft evidence of US economic slowing and concerning rhetoric from corporate leaders regarding the varied impacts of tariffs on forward earnings, that has yet to show up in the hard data. This lack of hard evidence leaves the Fed on hold and in data-dependent mode. Meanwhile, inflation data isn't coming down as quickly as expected. This combination of macro factors has contributed to uncertainty in the bond markets that has kept bond yields higher than we expect them to be once economic slowing shows up in the data and the Fed resumes easing its monetary policy. Adding to this general sense of uncertainty and elevated bond yields is a muni market still recovering from weeks of oversupply and epic volatility. Because of the many muni-specific factors we outlined in our previous Supply section, tax exempts are currently attractive on both an absolute- and a relative-value basis, with both remaining well-above 10- and two-year averages, respectively.

DISPLAY 4**Weekly 10-year AAA muni yields, 2015-2025**

Source: LSEG 5/09/25. For illustrative purposes only. Not a recommendation to buy or sell any security. Past performance is no guarantee of future results.

Given the value of the opportunity at hand, it makes sense to consider stepping out of cash, even without extending duration to the intermediate- or long-duration strategies we suggest. Since ultra-short-term rates have started to come down and considering that Fed funds futures pricing in April ranged from one to four expected rate cuts this year, the time to lock in attractive yields for longer could be now. While a four-handle ultra-short yield may still seem attractive, remember that it was a five-handle last year and could become a three-handle by this time next year. Reinvestment risk is real.

For investors interested in keeping maturities within 10 years, a tax-optimized ladder offers the flexibility to custom-tailor the asset class mix—munis, Treasuries and corporate bonds—based on the investor's individual tax profile, including their federal marginal rate and any applicable state and local income taxes. Additional customization includes choosing minimum credit quality of A- or BBB-rated and whether to include year-round tax-loss harvesting, which has been quite popular YTD. Customized muni bond ladders may also be a consideration, with maturities ranging from one to 20 years.

For investors interested in extending duration with intermediate or long muni strategies, consider that during four of the last five rate-cutting cycles, intermediate strategies—both muni and corporate—have outperformed three-month Treasury bills from first cut to last cut. The lone outlier was the cycle coming out of the global financial crisis, when credit spreads for all products other than Treasuries were distended. But even in that case, intermediate outperformed three-month Treasury bills 24 months after the initial cut.

What about muni credit and headlines?

Along with heightened uncertainty and bond market volatility has come a seemingly endless string of headlines. While numerous and far-reaching, many of these headlines related to the administration's threats to cut federal funding to cities that don't cooperate with its immigration policies and to cut federal funding and remove the tax-exempt status of certain higher educational institutions for what it views as anti-semitic behavior.

Such headlines may be troubling to muni bondholders of affected cities, but it's worth noting that such actions, if pursued, may trigger years of litigation. Further, the ultimate financial impact to large cities may be much a lower percentage of their budgets than the headlines would suggest.

As for the university headlines regarding tax exemptions, such action would require a formal legal process that would likely take years to resolve, and federal law prohibits the president from directing the IRS to investigate specific taxpayers. No major research university has ever lost its tax-exempt status.

From a state credit perspective, the largest impact could come from Medicaid cuts, and it would be at the discretion of each state as to how it manages those reductions. Mitigation measures could include a combination of Medicaid eligibility adjustments, service or payment reductions, drawing down reserves and other austerity measures.

Generally municipal credit quality remains in good shape. It's worth noting however, that states and local governments have been adjusting to normal budget realities after a period of excess liquidity resulting from federal stimulus funds. This means that gaps will appear and need to be closed during the normal budget cycle. This dynamic will likely experience heightened visibility in the coming months, as most states have fiscal years that begin on July 1. The intricacies of muni bond credit quality present yet another reason to consider professional portfolio management by a manager with a robust credit research team.

Economic outlook

The financial markets continue to grasp for evidence of US economic impacts from tariff announcements and federal spending reductions. As was the case last month, we've yet to see readily visible effects on US economic data.

When it comes to data, the brightest spotlight each month shines on the Payroll Situation Report. Released on Friday, May 2, April's was yet another solid report. Non-farm payrolls added 177,000 jobs, above consensus expectations of 138,000, though last month's gain was revised down to 185,000 from 228,000. The unemployment rate was in line with expectations, holding steady at 4.2%. Market reaction to the high-profile report was minimal, as markets viewed it as giving the Fed more time to wait before cutting rates further.

Key economic data

| | |
|---|-------|
| Change in nonfarm payrolls (Apr.) | 177K |
| Unemployment rate (Apr.) | 4.2% |
| Core CPI–YoY change (Mar.) | 2.8% |
| Core PCE–YoY change (Mar.) | 2.6% |
| Average hourly earnings–YoY change (Apr.) | 3.8% |
| Real GDP annualized (Q1 2025) | -0.3% |

Source: Bloomberg, 5/8/2025.

That expectation was fulfilled less than a week later at the Federal Open Markets Committee (FOMC) meeting on May 6 and 7, with the Fed remaining on the sidelines and leaving the Fed funds overnight lending rate target unchanged in a range between 4.25% and 4.5%. During the press conference, chair Powell reiterated that officials aren't in a hurry to adjust interest rates and added that tariffs could result in both higher inflation and higher unemployment. Echoing concerns evidenced by the markets since the beginning of April, Powell acknowledged, "Uncertainty about the economic outlook has increased further."

With an uneventful payroll report followed by an uneventful FOMC meeting in hand, the markets look ahead for inflation color in the upcoming Consumer Price Index and Producer Price Index reports. Meanwhile the headlines continue, bond yields remain elevated and the equity market appears to have regained its footing.

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