Municipal Bond Market Review: 1Q25

While the supportive technical dynamics that had buoyed the municipal bond market for much of 2024 remained intact to start the new year, increasing uncertainty about US trade policy and its potential macroeconomic impact cast a pall over financial markets in general as the quarter wore on.

The S&P Municipal Yield and S&P Short Duration Municipal Yield indexes gained 0.4% and 0.8%, respectively, for the first quarter, outpacing the 0.2% decline of the broader S&P Municipal Bond Index. Performance deteriorated markedly across muni indexes during March, as tax-season pressures weighed on investment inflows and issuance remained strong.[1]

Of course, circumstances changed dramatically in the early days of the second quarter. The US announcement of a sweeping and severe global tariff package—along with the inevitable retaliatory actions, partial back-tracking and all-around ad hoc vibe of the whole thing—has introduced significant uncertainty that doesn't seem likely to be quickly resolved. The shift in Washington's attention to matters of the budget and taxes represents another potential wildcard for financial markets, we believe municipal bonds remain an attractive option given appealing yields and supportive technicals and fundamentals.

KEY TAKEAWAYS

- While fading economic growth expectations weighed on Treasury yields during the first quarter, yields on longer municipal bond yields backed up to levels that appear very cheap on a historical basis.
- Already in a bind from slowing growth and persistent inflation, the Federal Reserve now finds its policy path further complicated by the tariffs' potential to exacerbate both of these conditions.
- Muni bond supply and demand has remained strong, excepting some seasonal flow weakness around tax time. Municipalities entered the year in generally strong fiscal condition, marked by robust reserves and rainy-day funds.
- The wide dispersion of credit spreads in the muni bond market highlights the potential value-add of credit selection, particularly during times of uncertainty.

1. Source: FactSet; data as of March 31, 2025.

Macro Backdrop Grows Murkier...

Donald Trump began his second term as US president in chaotic fashion, and the optimism that had fueled a post-election run in risk assets soon started to unravel. As it became clear the new administration's policy timeline prioritized tariffs and program cuts over more economically stimulative measures like tax cuts and deregulation, the collective mood dimmed, weighing on Treasury yields and municipal bond prices.

While hard economic data released in the first quarter continued to show persistent economic growth alongside stubborn above-target inflation, soft indicators appeared to capture the early negative impacts of the new administration's policy erraticism and aggressive cost cutting. Consumers, for one, have grown decidedly more cautious in the face of the prevailing uncertainty. Consumer confidence as measured by The Conference Board has declined for four consecutive months, and its expectations index—which captures consumers' short-term outlook for income, business and labor-market conditions—fell to a 12-year low in March and sits well below the threshold that usually signals a coming recession.[2] Business attitudes have also darkened; the NFIB Small Business Optimism Index, for example, depicted waning confidence in the economy and high and rising uncertainty in what the future holds.[3]

> Rising muni-to-Treasury ratios during the quarter suggest muni bonds have become relatively cheap.

These fading growth expectations weighed on Treasury yields across the curve. Municipal bond yields, in contrast, moved higher beyond five years and the municipal curve steepened. The underperformance of munis in this tumultuous environment can be seen in the muni-to-Treasury ratio, which on 30-year AAA rated paper went from 90% (cheap relative to long-term trends) to 95% (very cheap). At one point, the yields on a number of high-rated muni bonds were higher than the Treasury rate in the same maturity, meaning that investors could essentially get the tax benefits of certain muni bonds for free.[4]

...and Still Murkier

Trump championed the benefits of tariffs throughout his presidential campaign, and he quickly—if with shifting degrees of conviction—slapped new levies on specific countries (notably, Canada, Mexico and China) and industries (steel and aluminum) upon taking office. Even so, the wide-ranging package of "Liberation Day" tariffs—including a baseline 10% charge on all imports globally and steeper rates (referred to as, but not actually, "reciprocal") on countries deemed to be bad actors—was far more extreme than markets seemed to have anticipated.[5]

The April 2 tariff announcement unleashed a rout across risk assets worldwide and a significant spike in volatility. Perhaps of greater concern was the behavior of Treasuries and the US dollar. Though both caught a bid in the initial flight to quality after the tariff announcement, the sharp selloff that soon followed suggested wavering confidence in these assets as reliable "safe havens" during periods of unrest, especially given the country's massive and growing debt load and superficial attempts to close the budget deficit. The weakness in Treasuries, in particular, seemed to be the impetus for Trump to hit pause on certain elements of the tariff package just a week after its unveiling.[6]

2. Source: The Conference Board; data as of March 25, 2025.
3. Source: NFIB; data as of March 11, 2025.
4. Source: FactSet; data as of March 31, 2025.
5. Source: Bloomberg; data as of April 2, 2025.
6. Source: *The Wall Street Journal*; data as of April 9, 2025.

The Federal Reserve held its key policy rate at 4.25–4.50% following both its January and March meetings, and the Summary of Economic Projections released in March showed lower expectations for 2025 GDP growth and higher expectations for 2025 inflation. Perhaps acknowledging these opposing policy drivers, its federal funds rate forecast remained unchanged at two rate cuts before year end.[7] While the subsequent tariff announcement amplified both the inflation and recession risks alluded to in the Fed's revised forecast, the appropriate policy response remains amorphous. Per Fed Chair Powell regarding the tariff announcement, "We're going to need to wait and see how this plays out."[8] Futures markets, meanwhile, are expecting four rate cuts from the central bank before year-end, with the first coming in June.[9]

Investment Case for Munis Remains Strong Amid Policy Uncertainty

While the barrage of policy changes early in the second Trump administration has weighed on business and consumer sentiment and roiled markets, at this point we don't see it adding a lot of incremental risk to tax-exempt municipal bond investment. This is especially true with muni bonds currently offering yields that are high both nominally and relative to Treasuries and corporates of similar risk profiles.

After a strong 2024, muni bond mutual funds and exchange-traded funds continued to attract assets in early 2025, fueled by high absolute and tax-equivalent yields. First quarter inflows amounted to more than $11 billion, even as seasonal weakness set in during March with income tax payments looming. Around 40% of these assets went into high yield portfolios.[10] We believe demand normalization is likely to continue, as investors gradually roll short-term cash into fixed rate muni bonds.

While the higher inflation and slower economic growth implied by Trump's tariff package ultimately could weigh on certain issuer fundamentals, municipalities entered 2025 in generally strong fiscal positions. States, for example, took advantage of outsized federal funding as a result of several large Covid-19–related bills in 2020 through 2022 to bolster their reserves and rainy-day funds, and strong tax receipts in the years that followed have supported balance sheets as federal transfers returned to more normal levels. Defaults remain very low, even by the standards of an asset class accustomed to very low default activity.[11]

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As the federal policy focus shifts to the budget and taxes, however, there has been considerable hand-wringing about potential cost cuts and their impact on state balance sheets. Medicaid, which represents more than half of federal funding to states, is seen as particularly vulnerable to the government's chainsaw as it seeks to offset the extension and expansion of tax cuts set to expire this year.

The budget resolution recently approved by the House and Senate increases the primary deficit by up to $5.7 trillion over its 10-year window, $5.3 billion of which is attributable to tax cuts (notwithstanding the Senate's accounting magic to zero out the real-world impact of nearly $4 trillion in extensions).[12] It is now subject to reconciliation, a multi-month process in which multiple congressional committees will draft legislation to meet the spending and revenue targets they have been assigned. The House Committee on Energy and Commerce has been directed to find at least $880 billion in budget cuts to the programs under its legislative purview, almost all of which relates to Medicaid and Medicare. With Medicaid slightly more politically expedient than Medicare, it may be the preferred savings target.

7. Source: Federal Reserve; data as of March 20, 2025.
8. Source: Reuters; data as of April 7, 2025.
9. Source: CME FedWatch; data as of April 15, 2025.
10. Source: Morningstar; data as of March 31, 2025.
11. Source: Moody's Investors Service; data as of December 31, 2024.
12. Source: Bipartisan Policy Center; data as of April 10, 2025.

Medicaid—which provides health care and long-term care coverage to almost 82 million low-income children, adults and seniors, and people with disabilities—is jointly funded by the federal government and individual states. From a municipal bond perspective, federal Medicaid funds help pay the operators of health care and senior-living facilities.

With Republicans carrying only a slim majority in both chambers of Congress, the biggest unknown is whether lawmakers can craft passable legislation effecting a program so broadly popular both nationally and within their states and districts. Medicaid covers 21% of the US population, with particularly high concentrations in Republican-leaning states like Louisiana, Kentucky, West Virgina, Arkansas and Mississippi (as well as large Democratic-leaning states like California and New York).[13] Because the formula used to determine the federal share of Medicaid costs is designed to provide greater funding to states with lower per capita incomes, red states also are strongly represented at the high end of the reimbursement scale; the federal government reimburses 77% of Mississippi's Medicaid outlays, for example, while California and New York are among the 10 states funded at the 50% statutory floor.[14]

> Republican lawmakers are considering changes to Medicaid and the muni bond tax exemption as potential offsets to proposed tax cuts.

In addition to targeted federal spending cuts, lawmakers are also considering ways to boost revenues. Tariffs are a possible contributor to federal coffers, even if they act as a sort of backdoor consumption tax on Americans and weigh on economic growth; in his "Liberation Day" speech, Trump claimed the levies will raise "trillions and trillions of dollars."[15] While waiting for that revenue to come in, GOP lawmakers reportedly are evaluating the creation of a new, higher tax bracket for the wealthiest Americans, a significant break from Republican orthodoxy.[16]

Also among the revenue concepts reportedly being batted around DC is the possible elimination of or cap on the federal tax exemption of municipal bond interest income.[17] This idea has been raised periodically—including during the negotiations that produced the sweeping tax cuts in Trump's previous term[18]—but it has never gathered meaningful momentum in the past for the same reason we believe it is unlikely to now. As it reduces the cost of capital for public-benefit projects and thus the necessary local-tax burden on individuals, the muni bond tax exemption is widely popular among voters of all geographies, political orientations and income brackets. Studies have concluded that approximately 90% of the dollars raised and spent on US infrastructure come from the issuance of municipal bonds.[19] With US infrastructure spending needs not likely to slow—the American Society of Civil Engineers graded America's infrastructure a C in its 2025 report card, which was actually a modest improvement from its 2017 grade of D+—the municipal bond market remains the most important and highly efficient mechanism by which these costs are funded.[20]

13. Source: KFF; data as of August 14, 2024.
14. Source: Congressional Research Service; data as of April 2, 2025.
15. Source: *Foreign Policy*; data as of April 2, 2025.
16. Source: Bloomberg; data as of April 15, 2025.
17. Source: *Barron's*; data as of March 21, 2025.
18. Source: *The Wall Street Journal*; data as of December 18, 2017.
19. Source: Justin Marlowe, "Municipal Bonds and Infrastructure Development — Past, Present and Future," International City/County Management Association (August 2015).
20. "A Comprehensive Assessment of America's Infrastructure" American Society of Civil Engineers

The reduction or elimination of the muni bond tax exemption would be significantly disruptive to municipal and household budgets. A number of influential members of the House appear to agree, having recently beseeched the chairperson of the Ways and Means Committee to preserve the tax exemption of munis.[21] Trump hasn't weighed in on the issue, as far as we know, but we are comforted that Congress remains the final authority on taxation—as it does on entitlements like Medicaid—and it's hard to envision a legally defensible tactic that would enable him to wrest that power away.

In the unlikely event that significant changes are made to tax-exemption rules, it seems even more unlikely to us that the new rules would be applied to existing bonds. Assuming the tax-exempt status of currently outstanding bonds remains intact, scarcity value could drive increased demand and higher prices for this paper. The same concept would apply if the tax exemption were repealed on a limited basis to impact only certain types of issuers.

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Selectivity Is Key

Beyond the noise of the past few weeks, we believe both technical and fundamental dynamics should continue to be supportive of municipal bonds in 2025. While many policy outcomes and their impacts remain uncertain, municipalities enter this period in robust health and bond yields remain at levels well above the historical average, especially with the recent adjustments since April 2.[22]

Notably, the fragmentation of the very large muni market results in significant dispersion of yields and prices for similar bonds, particularly in the lower credit-quality spectrum and especially unrated bonds. In our view, this dispersion represents a bountiful hunting ground in which active managers can leverage their credit underwriting skills to identify bonds that are undervalued relative to the overall market. The potential for increased volatility as a result of the uncertain path of policy may provide additional opportunities to demonstrate the value of rigorous credit selection.

21. Source: *The Wall Street Journal;* data as of April 15, 2025.
22. Source: Bloomberg; data as of March 31, 2025.

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Diversification does not guarantee investment returns and does not eliminate the risk of loss.

Indexes are unmanaged and do not incur management fees or other operating expenses. One cannot invest directly in an index.

NFIB Small Business Optimism Index is a widely recognized economic indicator measuring the sentiment and outlook of US small business owners across a variety of areas critical to their operations.

S&P Municipal Bond Index (Gross/Total) measures the performance of fixed-rate tax-free bonds subject to the alternative minimum tax, including bonds of all quality and from all sectors of the municipal bond market. A total-return index tracks price changes and reinvestment of distribution income.

S&P Municipal Yield Index (Gross/Total) measures the performance of fixed-rate tax-free bonds subject to the alternative minimum tax, including bonds of all quality and from all sectors of the municipal bond market. A total-return index tracks price changes and reinvestment of distribution income.

S&P Short Duration Municipal Yield (Gross/Total) measures the performance of high yield and investment grade municipal bonds with maturities of one to 12 years. A total-return index tracks price changes and reinvestment of distribution income.

AAA credit rating—as used by S&P Global Ratings and Fitch Ratings—is an investment grade rating on a bond considered to have an extremely strong capacity to meet its financial commitments. The equivalent rating from Moody's Investors Service is Aaa.

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Federal funds rate is the interest rate at which depository institutions (banks and credit unions) lend reserve balances to other depository institutions overnight on an uncollateralized basis.

Municipal-to-Treasury ratio compares the yield on a AAA rated muni bond to a US Treasury security of the same maturity to assess relative value.

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