Municipal Bond Market Review: 2Q25

Massive new-issue supply amid tariff-spooked demand weighed on municipal bond performance during the second quarter.

While the resumption of mutual fund and exchange-traded fund (ETF) inflows after April's dislocation helped municipal bonds recover, the asset class generally underperformed Treasuries and most other fixed income sectors for the quarter; longer-duration and lower-quality issues were particularly challenged. Both the S&P Municipal Bond High Yield Index and the S&P Municipal Yield Index, which includes bonds across the quality spectrum, declined 1.0% during the period, while the S&P Short Duration Municipal Yield Index moved 1.0% higher. For context, the Bloomberg US Aggregate Bond Index gained 1.2%.[1]

KEY TAKEAWAYS

- The conclusion-less tariffs drama is complicating the Federal Reserve's job. While the central bank's outlook for the economy continues to moderate, it continues to forecast two policy rate cuts before year end.
- Municipal bond issuance was very strong in the first half, and 2025 is on track for a new record.
- Municipal bond mutual funds and ETFs saw significant outflows early in the quarter amid the broad-based selloff in assets. Net inflows returned as tariff-driven volatility eased, however, and we expect demand normalization to continue.
- For active fundamental investors, the shifting political winds may create interesting opportunities to go against the grain in select segments of the municipal bond market.

1. Source: FactSet; data as of June 30, 2025.

Tariff Uncertainty Meets Fiscal Certainty

The wide-ranging "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 more extreme than markets seemed to anticipate, unleashing a rout across risk assets worldwide and a significant spike in volatility. Reputed "safe haven" assets like US Treasuries caught a bid in the initial flight to quality after the tariff announcement but sold off just as quickly.[2]

Surveying the market fallout of his April 2 unveiling, Trump one week later offered trading partners a 90-day reprieve on the reciprocal portion of the tariffs to allow time for bilateral trade negotiations, to the great relief of financial markets. Global equities rallied sharply, while the yield on 10-year Treasuries settled into a jagged pattern to finish the quarter pretty much where it began. The Treasury curve steepened, however, as short bills and notes moved lower while long bonds broke out to the upside.

With little to show in the way of dealmaking progress, Trump post-quarter extended his July 9 deadline to August 1 while also announcing a steady flow of ad hoc sector and country tariffs—most recently copper, Brazil and Canada. In other words, trade policy is no clearer today than it was at the end of the first quarter.

The conclusion-less tariffs drama is complicating the Federal Reserve's job. At its June meeting, the central bank held its key policy rate at 4.25–4.50%, where it has been locked for the past six months, despite Trump's incessant hectoring. The Fed's outlook for the economy has continued to moderate, as the latest Summary of Economic Projections once again reported lowered expectations for 2025 GDP growth and raised expectations for 2025 inflation.[3] The federal funds forecast remained unchanged at two rate cuts before year-end, but the tide may be turning. Meeting minutes released in July suggested a not-insignificant minority of officials believed there was still work to be done on inflation: the core personal consumption expenditures price (PCE) index was at 2.7% in its May reading and the most significant price impacts of tariffs are likely still to come.[4]

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Over on Capitol Hill, Republican lawmakers successfully pushed their budget reconciliation bill through Congress and delivered it to the president before the self-imposed July 4 deadline. The new law is expected to add $3.0 trillion to the US debt over the next 10 years and widen the deficit to 6.9% of GDP, from 6.4% in 2024. If the temporary provisions in the bill are extended or made permanent, as they often are, the cost increases to $3.7 trillion and the deficit to 7.3%.[5] Long interest rates have broken out to the upside on the deteriorating fiscal picture, with the 30-year Treasury around 5%—a level it hasn't seen consistently since before the financial crisis.[6]

Despite some chatter that policymakers were considering adjustments to the tax-exempt status of municipal bond interest income, the budget reconciliation bill maintained the status quo. This outcome was not unexpected, but the certainty was welcomed. While the idea of changes to or restrictions on the muni bond tax exemption has been raised in the past, it has always been a nonstarter given the exemption's broad popularity among voters of all geographies, political orientations and income brackets.

2. Source: Bloomberg; data as of June 30, 2025.
3. Source: Federal Reserve; data as of June 18, 2025.
4. Source: *The Wall Street Journal*; data as of July 9, 2025.
5. Source: Yale Budget Lab; data as of July 1, 2025. This also assumes the backloaded spending cuts—largely to Medicaid—are enacted by a future Congress and president; if not the deficit would be even larger.
6. Source: Federal Reserve Bank of St. Louis; data as of June 30, 2025.

Technicals Were a Headwind, but Fundamentals Remain Robust

As noted earlier, the underperformance of municipal bonds during the second quarter was, in our view, primarily a technical phenomenon.

Municipal new issuance established a record high in 2024, and the $282 billion of new issuance in this year's first half—13% higher than the previous first-half record in 2007 and 16% higher than last year's first half—has 2025 on track for another new record.[7] Notably, high yield muni issuance tends to be particularly long dated, which provides an additional steepening impulse to the curve.

There are a few factors we believe have contributed to the surge in issuance. After sitting on the sidelines during the 2022–23 rate-hike period, municipalities have a pent-up need to issue paper as the benefits of Covid-19–era federal funding and post-pandemic tax receipts wane. Thanks to several years of very high inflation, every project funded through the capital markets costs more now than it would have a few years ago. Finally, uncertainty around pending tax legislation may have pulled forward some issuance into the first half that would have happened later.

Nearly $300 billion is a lot for the new-issue market to absorb even under the best of circumstances, and the second quarter was not the best of circumstances for muni demand. Rattled by the broad-based selloff in assets following Trump's tariff announcement, tax-exempt mutual funds saw outflows of more than $8 billion in April, with $3.7 billion leaving during the week of April 7 alone. With tariff-driven volatility easing somewhat in May, net inflows returned and persisted through the balance of the quarter, though not enough to make up for April's losses. The much smaller market for muni ETFs snapped back more quickly, however, posting $8 billion of inflows for the second quarter.[8] We expect demand normalization is likely to continue.

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Municipalities entered 2025 in generally strong fiscal condition, with strong reserves and rainy-day funds. Defaults remain very low, even by the standards of an asset class accustomed to very low default activity.[9] We are keeping our eye on the potential for tariff-related inflation and economic malaise, as well as the impact on state balance sheets of certain tax and spending provisions within the recently passed budget bill.

7. Source: Bloomberg, JPMorgan; data as of June 30, 2025.
8. Source: Municipal Securities Rulemaking Board; data as of June 30, 2025.
9. Source: Moody's Investors Service; data as of December 31, 2024.

Going Beyond Face Value

While the barrage of policy changes early in the second Trump administration has weighed on business and consumer sentiment and injected volatility into markets, at this point we don't see it adding a lot of incremental risk to tax-exempt municipal bond investment. If anything, the technical challenges that faced the muni bond market in the second quarter have made municipal bonds yields more attractive than in the past, especially at the longer end of the curve, which is where much of the high yield issuance resides. At 5.8%, the yield on the Bloomberg US High Yield Municipal Bond Index is nearly 100 basis points above its five-year average,[10] while the 30-year muni-to-Treasury ratio is at a 12-month peak.[11]

For active fundamental investors, the shifting political winds may create interesting opportunities to go against the grain. Take higher education, which has come under attack from the Trump administration. With the White House's ire focused on some of the highest-profile universities in the country, nearly 6,000 other postsecondary institutions are going about their business free from that sort of elevated political risk; strong operators with compelling yields may make for attractive investment opportunities.[12]

Hospitals are in a similar boat. The cuts to Medicaid will certainly have an impact, but $1 trillion isn't leaving the system today; many of the reconciliation bill's provisions phase in over several years, giving hospital operators time to adjust their business models to maintain stability and negotiate with commercial payors for higher reimbursement rates.[13] As others tar the entire hospital sector with the same brush, opportunities may emerge in select issuers.

10. Source: Bloomberg; data as of June 30, 2025.
11. Source: Refinitiv, US Treasury; data as of June 27, 2025.
12. Source: National Center for Education Statistics; data as of November 15, 2022.
13. Source: Congressional Budget Office, "Estimated Budgetary Effects of an Amendment in the Nature of a Substitute to H.R. 1, the One Big Beautiful Bill Act, Relative to Budget Enforcement Baseline for Consideration in the Senate," data as of June 28, 2025.

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Bloomberg US Aggregate Bond Index (Gross/Total) measures the performance of the investment grade, US dollar-denominated, fixed-rate taxable bond market in the US, including Treasuries, government-related and corporate securities, fixed-rate agency MBS (agency fixed-rate and hybrid ARM passthroughs), ABS, and CMBS. A total-return index tracks price changes and reinvestment of distribution income.

Bloomberg US High Yield Municipal Bond Index (Gross/Total) measures the performance of the non-investment grade US tax-exempt bond market. A total-return index tracks price changes and reinvestment of distribution income.

S&P Municipal Bond High Yield Index (Gross/Total) measures the performance of bonds in the S&P Municipal Bond Index that are not rated or whose ratings are below investment grade. 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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Exchange-traded funds (ETFs) are listed investment vehicles that seek to provide exposure to a benchmark, index or actively managed strategy.

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.

Personal consumption expenditures (PCE) price index measures changes in the prices of goods and services purchased by consumers in the US. Core PCE excludes food and energy prices.

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