



Municipal Bonds Market Review: 3Q25

The technical headwinds that held back municipal bond performance in the second quarter finally began to ease in the third, setting the stage for a September rally.

Though muni issuance remained robust over the last three months, renewed flows into mutual funds and exchange-traded funds following April's tariff-related dislocation helped the market absorb the new supply. The resulting performance pushed muni indexes well into positive territory for the year to date following a sluggish first half, though they still lag other fixed income assets.

The S&P Municipal Bond High Yield Index gained 2.3% during the third quarter, while the S&P Municipal Yield Index, which includes bonds across the quality spectrum, rose 2.6% and the S&P Short Duration Municipal Yield Index advanced 1.8%; year to date, those indexes are up a respective 1.7%, 1.8% and 3.6%. For context, the Bloomberg US Aggregate Bond Index gained 2.0% during the quarter and 6.1% thus far in 2025.¹

KEY TAKEAWAYS

- Perhaps more impressive than the solid returns of the municipal bond market during the third quarter was that they were achieved amid continued heavy new supply, as investor demand rebounded from the March/April tariff shocks.
- Should the Fed's more accommodative policy continue to weigh on long-term yields, investors may increasingly view municipal bonds as a more appealing cash equivalent.
- Municipalities entered 2025 in strong fiscal condition, and issuer fundamentals continue to be supportive.
- We think the factors driving the recent performance and fund flows of munis—credit stability, certainty around tax treatment, a Fed biased toward easing and relatively benign tariff impacts—should continue to support the asset class.

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

Continued Heavy Supply Was Met by Renewed Demand

Long US Treasury yields eased slightly in the third quarter, with 10-year and 30-year rates posting single-digit declines. The AAA muni curve was a bit more active, with bonds of those same maturities declining 30 basis points or so.²

While municipal bonds had a good quarter, perhaps more impressive than the magnitude of returns was that they were achieved in the face of continued heavy new supply. Third quarter issuance was down slightly from the second quarter, but the year-to-date pace suggests 2025 is likely to top 2024's record for annual volume. Notably, the long-dated nature of high yield muni issuance in general provides a steepening impulse to the yield curve, and the municipal bond curve has steepened considerably amid the flood of issuance.³

There are a few factors we believe have contributed to the ongoing 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-era federal funding and post-pandemic tax receipts wane. Meanwhile, pretty much every capital project costs more today due to the impact of inflation across inputs like steel, concrete, lumber, civil engineering, skilled and unskilled labor, etc. Further, potential legislative threats to muni bond tax treatment—since alleviated—likely pulled forward some issuance to the first half of the year.

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Fortunately, supply during the third quarter was met by renewed demand; after about \$9 billion of outflows during late March and April alongside the initial shock of Trump's tariff policies, positive municipal bond fund flows returned in May and have persisted.⁴ Though tariffs remain a wildcard, investors seem to have gotten comfortable with the uncertainty. The worst of the expected inflationary impacts haven't yet been realized, and signs that the most severe levies could be walked back, either through bilateral negotiation or judicial mandate, lends hope that trade policy may be less of a headwind.

Meanwhile, the passage of the budget reconciliation bill in early July removed an overhang to muni bond demand. Putting aside the provisions of the bill, the key for muni bond investors is what the bill lacked—namely, any adjustments to the tax-exempt status of municipal bond interest income. There had been some chatter that policymakers were considering changes to or restrictions on the muni bond tax exemption as part of this tax-and-spending plan. While a disruption to the status quo seemed an unlikely result of the recent legislative process, the certainty provided by the final bill was welcomed by both investors and issuers.

Also supporting demand for muni bonds has been the dovish tilt of the Federal Reserve. Throughout the third quarter investors sought to get a clear read on the central bank struggling to balance the weakening labor market against above-target inflation. Deciding the former is of greater concern at the moment, the central bank delivered a well-telegraphed 25 basis point cut to its policy rate in September, and markets have priced in an additional 50 basis points of rate cuts by year end.⁵ Should the Fed's more accommodative policy continue to weigh on long-term yields, investors may increasingly view municipal bonds as a more appealing cash equivalent.

2. Source: Bloomberg, US Department of Treasury; data as of September 30, 2025.

3. Source: Municipal Securities Rulemaking Board; data as of September 30, 2025.

4. Source: Investment Company Institute; data as of October 1, 2025.

5. Source: CME FedWatch; data as of October 13, 2025.

Fundamentals Remain Encouraging

Municipalities entered 2025 in strong fiscal condition, and issuer fundamentals continue to be supportive. State budgets for fiscal 2026 generally reflect a healthy environment, with fund balances well above the historical average.⁶ Though state general fund revenue has fallen off the record pace of fiscal 2021 and 2022 as the impact of Covid-era relief waned, it has continued to grow, and modest revenue gains are expected in fiscal 2026. Budgets that have been enacted to date call for only small increases in general fund spending, and most states plan to maintain or increase the size of their state's rainy-day fund—many of which are already at nominal highs—in anticipation of future needs.

Another sign of fiscal strength can be found in improvement in pension funding, as the aggregate median ratio for local government pensions climbed to 80% in fiscal 2024 from 78% in fiscal 2022. While this can be attributed in part to market performance, local governments have increased contributions and tweaked their benefit structures, demonstrating improved funding discipline and better long-term sustainability.⁷

All in all, muni bond ratings activity has continued to be positive in 2025, but just barely: positive activity (including both upgrades and favorable outlook revisions) outpaced negative activity at a rate of 1.1x year to date; this ratio stood at 3.5x in 2022.⁸ Defaults remain very low, even by the standards of an asset class accustomed to very low default activity.⁹

Start of a Turnaround?

Year-to-date muni bond performance flipped from negative to positive during the third quarter, and we're hopeful that the period represented an inflection point after what was a challenging first half for the asset class. It seems likely to us that the factors driving recent performance and fund flows—credit stability, certainty around tax treatment, an accommodative Fed and relatively benign tariff impacts—should continue to support the asset class.

Current levels suggest there is still significant value to be found on the longer end of the municipal bond curve.

With a yield to worst of 5.7%, the Bloomberg US Municipal High Yield Index continues to offer investors an attractive entry point, in our view.¹⁰ Although the outperformance of munis during the quarter pushed muni-Treasury ratios somewhat lower, current levels—70% for 10-year and 90% for 30-year maturities—suggest there is still significant relative value to be found on the longer end of the municipal bond curve, which is also most likely to benefit from an environment of stable or declining rates given its current steepness.¹¹

6. Source: National Association of State Budget Officials; data as of September 4, 2025.

7. Source: S&P Global; data as of September 16, 2025.

8. Source: S&P Global; data as of September 30, 2025.

9. Source: Moody's Investors Service; data as of December 31, 2024.

10. Source: Bloomberg; data as of September 30, 2025.

11. Source: Bloomberg, US Department of Treasury; data as of September 30, 2025.

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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.

A **credit rating** is an assessment provided by a nationally recognized statistical rating organization (NRSRO) of credit worthiness of an issuer with respect to debt obligations, including specific securities, money market instruments, or other bonds. Ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest); ratings are subject to change without notice. Not Rated (NR) indicates that the debtor was not rated and should not be interpreted as indicating low quality.

Default rate is the percentage of loans or bonds in which the borrower/issuer failed to make scheduled interest or principal payments, typically measured over a trailing 12-month period.

Exchange-traded funds (ETFs) are listed investment vehicles that seek to provide exposure to a benchmark, index or actively managed strategy.

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.

Tax exempt means that the interest component of a bond's debt service payments is exempt from federal and sometimes state and local income taxes for the bondholder.

Yield to worst is a measure of the lowest possible yield that can be received on a bond that operates within the terms of its contract without defaulting.

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

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.

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