First Eagle Investments

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Insights

Municipal Bond Market Overview: 4Q25

During the fourth quarter, the municipal bond market continued to rebound from the challenges of the first half of 2025.

Record-setting bond issuance continued to be met by strong demand, enabling muni indexes to post positive returns for the quarter and the year. The S&P Municipal Bond High Yield Index gained 1.5% during the fourth quarter, while the S&P Municipal Yield Index, which includes bonds across the quality spectrum, rose 1.7% and the S&P Short Duration Municipal Yield Index advanced 0.6%. Those indexes were up a respective 3.3%, 3.5% and 4.3% in full-year 2025. For context, the Bloomberg US Aggregate Bond Index gained 1.1% during the quarter and 7.3% in the year.[1]

Muni bond performance in 2025 was a tale of two halves, and we're encouraged by the asset class's momentum in the second half. 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—will continue to support the asset class, even in what is expected to be another year of robust issuance.

KEY TAKEAWAYS

- New issuance established a new annual record in 2025, while demand continued to rebound from the dislocations of the March/April tariff shocks.
- The short end of the Treasury yield curve fell sharply during the year, and investors may increasingly view fixed-rate municipal bonds as a more appealing cash equivalent in light of increasingly lower floating-rate yields.
- Municipal fundamentals remained positive at year end, and fiscal stimulus from the 2025 tax bill and potential monetary stimulus should be supportive of state revenues in 2026.
- In our view, the factors driving muni performance and fund flows in second-half 2025—credit stability, certainty around tax treatment, a Fed biased toward easing and relatively benign tariff impacts—should remain a tailwind for the asset class.

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

Market Able to Absorb Record Levels of Muni Issuance

Though the pace of muni bond issuance eased somewhat in the fourth quarter, the $100 billion-plus of new issuance during the period was enough to drive the market to a new annual high of $580 billion, about 13% above the previous record set in 2024. It's worth noting that the vast majority of issuance during the year was new capital, with refunding activity accounting for only about 12%.[2] Lower levels of refunding transactions suggest fewer bonds are being called, which can help support valuations for the market as a whole.

We were not surprised to see the municipal bond curve steepen considerably during 2025. The flood of issuance—high yield muni issuance in particular, given its long-dated nature, generally provides a steepening impulse to the yield curve—pushed long yields higher, although Federal Reserve policy rate cuts weighed on the short end of the muni curve.[3] The US Treasury curve also steepened over the year as term premia returned to the Treasury market after being mostly negative for nearly a decade.[4]

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 from the impact of inflation across inputs like steel, concrete and lumber, and increased costs for civil engineering, skilled and unskilled labor, etc. Further, potential legislative threats to muni bond tax treatment in the first half of the year—since alleviated—likely pulled forward some issuance.

Fortunately, the US government shutdown that began on October 1 did not have the same chilling effect on demand as the Liberation Day tariff announcements in April, and massive issuance was met by robust demand throughout the fourth quarter. Flows into municipal bond mutual funds and exchange traded funds ended the year strong, amounting to about $23 billion in the fourth quarter, which represented more than one-third of full-year 2025 flows.[5]

The Fed's dovish tilt in the second half of the year has also supported demand for muni bonds. Though it was cut off from official federal agency data during the government shutdown, the Fed followed up its September rate cut with another in October. The catch-up in economic data flow, after federal employees returned to work in mid-November, did little to change the central bank's viewpoint, which seemed to center more on a weakening labor market than inflation concerns, and an additional December cut brought the federal funds rate down to 3.50–3.75% to end the year.[6]

> In a world of increasingly lower floating-rate yields, investors may increasingly view fixed-rate municipal bonds as a more appealing cash equivalent.

The Fed appears well-positioned to wait and see how the economy evolves, and the dot plot of rate projections published in December points to only one additional 25 basis point cut in 2026.[7] That said, the Trump administration's very public desire for lower rates and conflict with Fed Chair Powell—highlighted by early-January reports that the Department of Justice had opened a criminal investigation into Powell related to the renovation of the Fed's headquarters—suggest that whoever replaces Powell when his term as Fed chair ends in May 2026 is likely to be more dovish than the average governor. In a world of increasingly lower floating-rate yields, investors may increasingly view fixed-rate municipal bonds as a more appealing cash equivalent.

2. Source: Municipal Securities Rulemaking Board; data as of December 31, 2025.
3. Source: Municipal Securities Rulemaking Board; data as of December, 2025.
4. Source: Federal Reserve Bank of New York; data as of December 31, 2025.
5. Source: Investment Company Institute; data as of December 31, 2025.
6. Source: Federal Reserve; data as of December 10, 2025.
7. Source: Federal Reserve; data as of December 10, 2025.

Fundamentals Remain Steady

The initial estimate of third quarter GDP for the US came in at 4.3%, up from 3.8% in the second quarter and well above the consensus estimate of 3.3%. While growth in the fourth quarter is likely to be negatively impacted by the government shutdown, fiscal stimulus from the 2025 tax bill and potential monetary stimulus should be supportive of economic activity in 2026, to the ongoing benefit of municipal issuer fundamentals.[8]

Municipalities entered 2025 in strong fiscal condition, and issuer fundamentals continue to be supportive. State budgets for fiscal 2026 overall reflect a healthy environment, and general fund balances remain well above the historical average even as they continue to ease from 2023's peak. 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 enacted to date suggest flat general fund spending in 2026, and most states plan to maintain or increase the size of their rainy-day fund—many of which are already at nominal highs—in anticipation of future needs.[9]

> State budgets for fiscal 2026 overall reflect a healthy environment.

Another sign of fiscal strength can be found in improved 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.[10]

Overall, muni bond ratings activity has been positive in 2025, but not by much: Positive activity (including both upgrades and favorable outlook revisions) outpaced negative activity at a rate of 1.4x year to date through November.[11] Both defaults and first-time distressed debt remained very low in 2025.[12]

Start of a Turnaround?

Issuance in 2026 is expected to remain robust, but we believe the factors that drove performance and fund flows in the second half of 2025—credit stability, certainty around tax treatment, an accommodative Fed and relatively benign tariff impacts—will help the asset class maintain its momentum.

8. Source: Reuters; data as of December 23, 2025.
9. Source: National Association of State Budget Officers; data as of November 14, 2025.
10. Source: S&P Global; data as of September 16, 2025.
11. Source: S&P Global; data as of September 30, 2025.
12. Source: BofA Global Research; data as of January 9, 2026.

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Municipal bonds are subject to credit risk, interest rate risk, liquidity risk, and call risk. However, the obligations of some municipal issuers may not be enforceable through the exercise of traditional creditors' rights. The reorganization under federal bankruptcy laws of a municipal bond issuer may result in the bonds being cancelled without payment or repaid only in part, or in delays in collecting principal and interest.

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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.

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.

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.

A **yield curve** is a graphical representation of interest rates on debt of equal credit quality across a range of maturities.

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.

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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