



Markets & Economies

Six Key Themes for Today's Municipal Bond Market

A closer look at the factors that could influence the municipal bond market in the months ahead.



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The first half of 2025 brought several notable developments in the municipal bond market. Yields at the long end of the municipal curve (i.e., maturities 10 years and longer) have risen 40 to 70 basis points (bps) from the start of the year, contributing to a slightly negative performance for the Bloomberg Municipal Bond Index through June 20. This was partially driven by uncertainty around the new administration's fiscal policies, which have also made Treasury bond rates rise somewhat, but municipals have risen more due to very heavy new-issue bond supply.

Recent developments have brought some clarity for municipals on the federal budget side, most notably, that municipal bond interest will remain tax exempt, with no changes coming out of the House and Senate budget bills under consideration near midyear.

Elevated supply has presented the main challenge for the market. Last year, new-issue supply set a record at approximately \$500 billion, and this year the amount is ahead of 2024's pace. Issuers have been looking to raise money, after not issuing much debt in the aftermath of COVID-19, and want to tap the market now rather than wait for any policy changes coming out of Washington. Investor demand has been generally strong enough to absorb newly issued muni bonds throughout much of the year, but the increased supply has pressured rates to move higher than other fixed-income markets. Meanwhile, municipal credit fundamentals remain solid, bolstered by the domestic focus of issuers and continued fiscal discipline, so that is helping the market as well.

In the sections that follow, we'll take a closer look at the current municipal bond landscape and highlight the key themes we believe will shape the market in the months ahead.

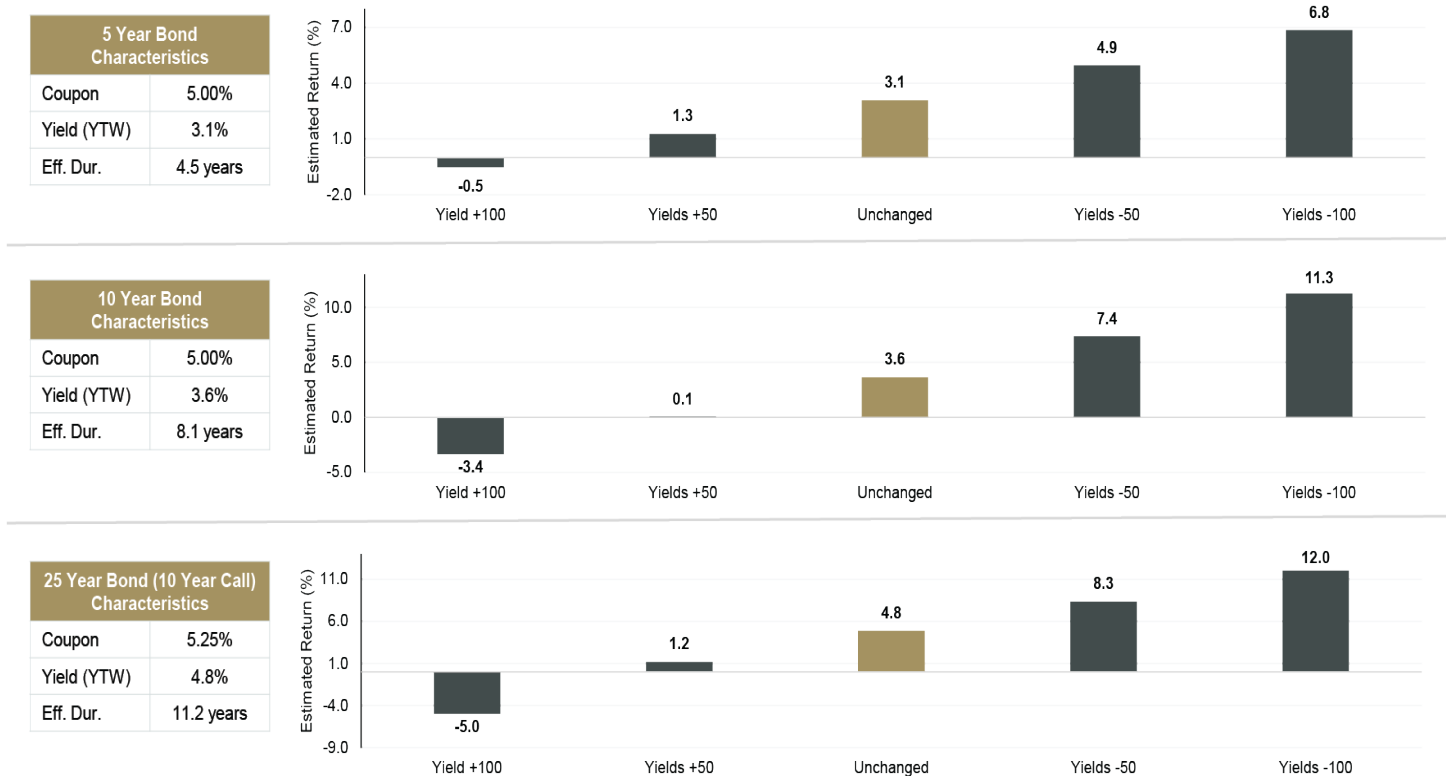
1. Municipal Bonds Show Attractive Relative Value

Reflecting fears over federal spending, tariff uncertainty, and above-average supply, municipal yields have reached attractive levels, particularly compared to what has been seen in taxable markets. Since the start of the year, the 10-year U.S. Treasury yield is lower by 19 bps, while yields on 10-year AAA-rated muni bonds have risen 14 bps. In the long end of the municipal curve, this trend is even more pronounced. While most fixed-income curves have steepened so far in 2025, long-term municipal yields have risen approximately 50 bps more than long Treasuries. Therefore, municipal bonds remain one of the few sectors of the fixed-income market that generously compensate investors to extend duration.

We think current yields—near their highest levels in over a decade—present appealing opportunities for investors. As starting yield is one of the best predictors of future performance, today's yields present compelling total return opportunities regardless of whether the U.S. Federal Reserve lowers rates later in 2025. Additionally, these higher yields bring a more attractive risk/reward dynamic for investors. As shown in Figure 1, the enhanced carry in today's environment can cushion returns should rates continue to rise.

**Figure 1. Bond Math: How Might Muni Bonds Respond to Different Rate Environments?**

Estimated one-year holding period returns (in %) by maturity under scenarios based on stated changes in 10-year U.S. Treasury yields



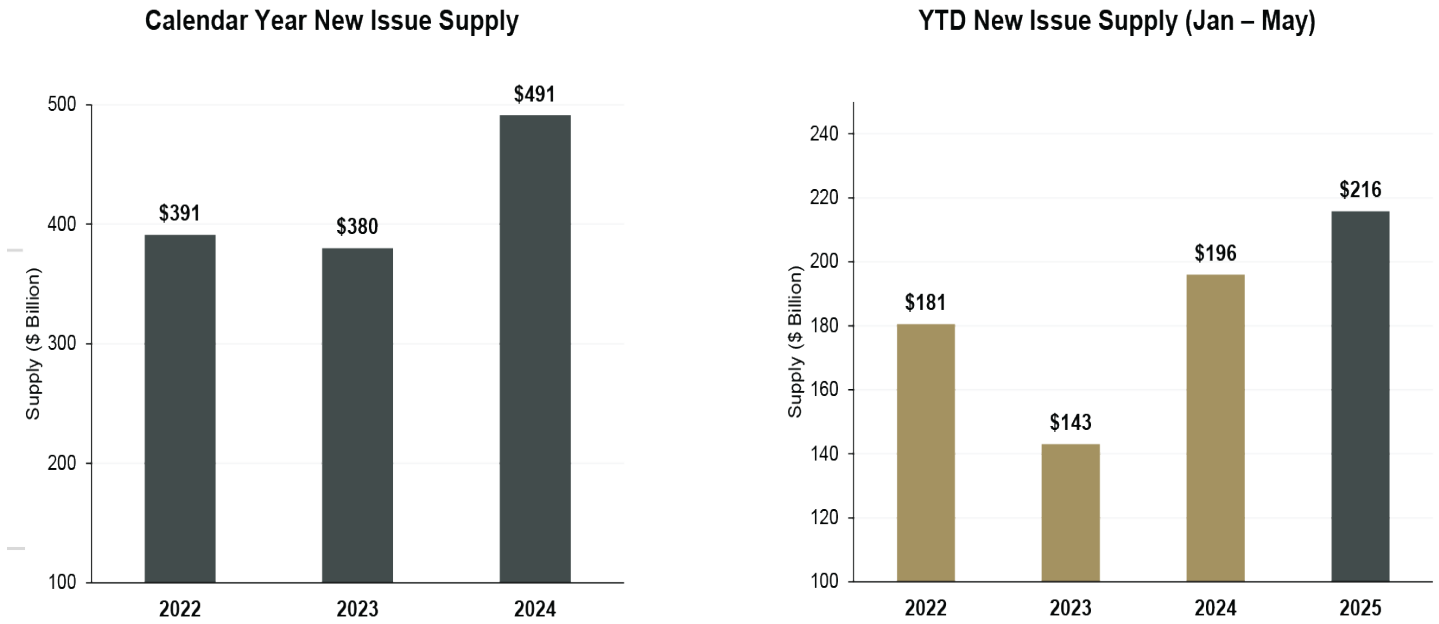
Source: Bloomberg Total Return Analysis calculations. Data as of June 3, 2025. Mod. Dur. = modified duration. This is for illustrative purposes only, to provide information on possible performance variations of municipal bonds of different maturities in varying interest rate environments. It is not intended to be a guarantee or a predictor of future results.

2. Supply Remains Elevated

Part of the reason for attractive municipal yields has been the record-breaking municipal bond supply. After below-average new issuance in 2022 and 2023—due to leftover pandemic stimulus and a better-than-expected economic recovery from the COVID-19 pandemic—muni issuers came back to market in 2024. Over the calendar year, supply reached almost \$500 billion. So far in 2025, supply has continued to come in at elevated levels. Through the first four months of the year, 2025's issuance has eclipsed last year's pace. (See Figure 2.)

**Figure 2. New-Issue Supply Continues To Be Elevated**

Calendar year new-issue supply (left) and YTD new-issue supply through May of each year (right)



Source: Barclays. Data (monthly) as of May 31, 2025. YTD supply represents total new issuance through May of each year, 2022, 2023, 2024, and 2025. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment.

As noted earlier, some of the new municipal supply this year has been driven by the uncertainty around the new administration's fiscal agenda. Given possible changes, municipal issuers have pulled forward new issuance. We believe supply may continue to be elevated in the coming months, but as the market receives more clarity around U.S. fiscal policy, new issuance likely will revert back to more normalized levels, which will remove this source of market pressure.

3. Demand Could Accelerate

On the other side of the technical picture, demand continues to be healthy. While separately managed account (SMA) flows across the industry are not regularly tracked, anecdotal reports suggest that demand remains very strong. So far in 2025, municipal bond funds have experienced over \$9 billion in inflows, which is good but not great. While demand has generally been positive for much of the year, the market saw seven consecutive weeks of outflows following the April 2 U.S. tariff announcement that totaled \$6.4 billion. Since then, municipal bond funds have experienced seven consecutive weeks of inflows through 6/18/2025.

And while demand has improved from the 2022–23 outflow cycle, we believe there's room for inflows to strengthen further. Given attractive tax-exempt yields and the record amount of investable cash "on the sidelines" (i.e., held in money market funds, CDs, and similar instruments) we expect demand to accelerate once rate volatility declines, and the new administration's policy plans become clearer. This may have significant implications for municipal bond performance, particularly favoring longer-dated and credit-sensitive municipal bonds because mutual funds typically are the best source of demand for longer municipal bonds, while buying from SMAs is typically concentrated in the intermediate range.



4. Municipal Fundamentals Remain Sound

Credit quality for the overall municipal bond market continues to be in a strong position, with continued tax revenue growth and rainy-day balances of state and local governments near record levels. While recent tariff news has significantly impacted markets, it's important to remember that municipal fundamentals have historically shown resilience. They are supported by a diverse range of revenue sources, including income, real estate and sales taxes, healthcare costs, university tuition, water and sewer fees, and toll expenses—all essential costs that people continue to pay even when the economy slows. Additionally, municipal bonds are a domestic asset class and support industries relatively insulated from the effects of tariffs.

5. Policy Uncertainty Should Improve

The new administration's fiscal policy direction and cost-cutting initiatives have introduced a degree of uncertainty to the municipal bond market so far in 2025. While we expect sector-specific impacts from tariffs and other fiscal changes, we believe the market's core fundamentals will remain largely intact. Moreover, with the House and Senate's recent tax bills excluding any reference to changes in the municipal tax exemption, the likelihood of this negative scenario materializing has diminished even further.

While we expect much of the current uncertainty to ease as the new administration's agenda takes shape, we would also note that potential impacts to the valuation of municipal bonds from news reports on funding changes—relative to the actual impacts on credit quality—are likely to lead to attractive opportunities for research-driven active managers.

6. High Yield Municipal Bonds Continue to Offer Relative Value

With credit quality strong and much of the municipal bond fund demand focused upon high yield, the opportunity in this part of the market remains relatively attractive. Many investors mistakenly think that valuations in the taxable bond market always carry over to municipal high yield, but that is not the case.

For municipal high yield, new-issue supply is not at record levels, but has trended in line with historical averages. Today's higher rates mean that fewer projects that would typically be financed by high yield munis are economical, so there aren't as many opportunities coming to the market. Also, the heavy demand for SMAs does not carry over to the high yield space. Default rates for the past couple years have been historically low at under 2% and don't show any signs of changing. Typically, municipal high yield bonds go into distress a while before they default, and we don't see any indications that distress is increasing.

Credit spreads vary considerably by sector in municipal high yield, and with many new bond issues coming in the 6.5% to 7.5% range on a tax-exempt basis, the tax-equivalent yields are in the double-digit range,¹ making them relatively attractive.

So, attractive rates, strong credit quality, reasonable credit spreads, and good supply/demand fundamentals support the case for high yield.

A Final Word

At the midpoint of 2025, we believe the municipal bond market presents attractive opportunities, given elevated yields, solid credit fundamentals, and improving policy clarity. Despite earlier uncertainty and a supply-heavy backdrop, strong investor demand and compelling valuations—for all maturities, but especially at the long end of the curve—make for a compelling entry point for investors, in our view. Moreover, past instances of municipal bonds underperforming the taxable market by this degree have historically been followed by strong returns over the subsequent years.

¹Tax-equivalent yield assumptions based on top U.S. tax rate of 40.8% (37% plus 3.8% Medicare tax).



Glossary & Index Definitions

Treasuries are debt securities issued by the U.S. government and secured by its full faith and credit. Income from Treasury securities is exempt from state and local taxes.

A **basis point** is one one-hundredth of a percentage point.

Carry refers to the return earned from holding a bond, primarily the coupon payments, minus the cost of financing the bond's purchase (typically through borrowing). It represents the net income generated by holding the bond.

Duration is a measurement of a bond's interest rate risk that considers a bond's maturity, yield, coupon and call features. **Modified duration** is a measure that estimates the percentage change in a bond's price for a 1% change in its yield to maturity.

Rainy day funds, also known as budget stabilization funds, are reserve accounts that U.S. states set aside to help weather economic downturns or unexpected financial challenges.

Yield is the income returned on an investment, such as the interest received from holding a security. The yield is usually expressed as an annual percentage rate based on the investment's cost, current market value, or face value. **Yield-to-maturity (YTM)** represents the expected return (expressed as an annualized rate) from the bond's future cash flows, including coupon payments over the life of the bond and the bond's principal value received at maturity. **Yield-to-worst** refers to the lesser of a bond's (a) yield-to-maturity or (b) the lowest yield-to-call calculated on each scheduled call date.

The **tax-equivalent yield** is the pretax yield that a taxable bond needs to possess for its yield to be equal to that of the tax-exempt yield on a municipal bond. This calculation can be used to fairly compare the yield of a tax-free bond to that of a taxable bond to see which bond has a higher applicable yield.

The **Bloomberg Municipal Bond Index** is a rules-based, market-value-weighted index engineered for the long-term, tax-exempt bond market. Bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two ratings agencies. They must have an outstanding par value of at least \$7 million and be issued as part of a transaction of at least \$75 million. The bonds must be fixed rate, have a dated-date after December 31, 1990, and must be at least one year from their maturity date.

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The Municipal Market Data (MMD) AAA Curve is a proprietary yield curve that provides the offer-side of "AAA" rated state general obligation bonds, as determined by the MMD analyst team. The "AAA" scale (MMD Scale), is published by Municipal Market Data every day at 3:00 p.m. Eastern standard time, with earlier indications of market movement provided throughout the trading day. The MMD AAA curve represents the MMD analyst team's opinion of AAA valuation, based on institutional block size (\$2 million+) market activity in both the primary and secondary municipal bond market. In the interest of transparency, MMD publishes extensive yield-curve assumptions relating to various structural criteria, which are used in filtering market information for the purpose of benchmark yield-curve creation.

Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

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Fixed-Income Investing Risks

The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. High yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, and general market risks. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price. There is a risk that a bond issued as tax-exempt may be reclassified by the IRS as taxable, creating taxable rather than tax-exempt income. Municipal bonds may be affected by local, state, and regional factors. These may include, for example, economic or political developments, erosion of the tax base, and the possibility of credit problems.

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