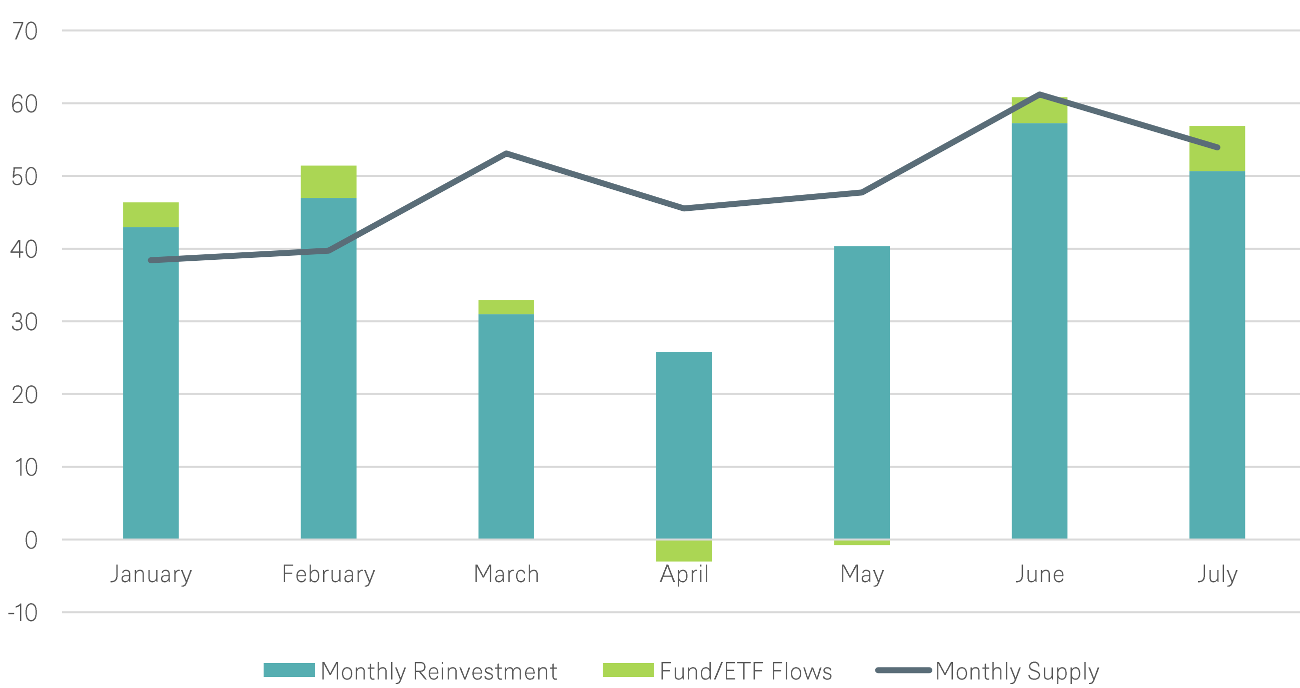
August 2025

Summer Hasn't Been Kind to Muni Market

- Strong reinvestment and lighter issuance usually bode well for summer performance, but large supply has overwhelmed market in 2025.
- Below investment grade yields are attractive, but caution is warranted given large default, negative headlines and poor performance that could lead to outflows.
- One Big Beautiful Bill Act left tax exemption alone and is largely positive for market, except for Medicaid cuts.

Summer has historically been one of the bright spots for the municipal bond market in most years as issuance declines and coupon and maturity money available for reinvestment peaks. This year, new debt issuance in June and July remained at above record pace. Meanwhile, reinvestment and flows into ETFs and mutual funds were barely enough to match supply, assuming all coupon and maturity money was reinvested back into the market. Plus, money from shorter maturing bonds isn't necessarily reinvested out in longer maturities, where the bulk of supply is issued. There was a belief that some of this increased supply was getting ahead of the potential curtailment or even elimination of the ability to issue tax exempt bonds. Therefore, there may be a return to more normal issuance levels once deals that were already in the queue prior to the July 4th signing of the One Big Beautiful Bill Act come to market. So far, market issuance has not fallen off, so market weakness from heavy new issuance remains a large contributing factor to municipal market underperformance.

Municipal Market Supply vs. Demand



Source: Bloomberg, IPREO, LSEG Lipper Global Fund Flows as of July 31, 2025

The high yield municipal market experienced unwelcome excitement in July with a surprise interest payment deferment by a large private train line in Florida and the almost complete liquidation of a small high yield fund. Since the Florida train bonds are a significant part of some high yield funds, performance among those high yield municipal bond funds took a significant hit. Negative performance can often result in subsequent outflows. After a strong start to the year, high yield flows have been anemic, especially when compared to the market as a whole. Since the first quarter of 2025 when high yield fund flows were a big part of the overall total, they have been overwhelmed by flows into investment grade funds and ETFs. While the accelerated selling in a small high yield fund called into question the integrity of market prices, we believe the event is a good reminder of the lack of liquidity in parts of the market, especially for very small, less widely held bonds. The extra yield available in the high yield municipal market, especially when considering the lower default rates when compared to high yield corporate bonds are partly to compensate for a market that can be less liquid at times. Forced selling doesn't necessarily reflect the true intrinsic value of a security.

Municipal Flows by Quality

Source: Bloomberg, IPREO, LSEG Lipper Global Fund Flows as of July 31, 2025

The One Big Beautiful Bill Act appears to be mostly positive for the municipal market, especially compared to some of the worst-case scenarios thought possible earlier in the year. The tax exemption remains in place, which is the biggest positive since there were fears it could be eliminated or curtailed for entities like higher education. Medicaid cutbacks are the biggest potential negative, but some provisions don't take effect until late 2026 and others in 2028. Work and other eligibility requirements may reduce Medicaid rolls (estimated to be close to 12 million people), which would increase bad debt and reduce revenue for hospitals. Caps to provider taxes and restrictions on other state directed payments could further hurt hospital revenues.

Certain universities will pay a higher endowment tax, but much less than what was initially proposed (8% instead of 21%). The highest rate only applies to a few universities with massive endowments, so not material to their credit quality. The State and Local Tax (SALT) deduction cap was increased. This could be slightly negative for municipal bond demand since the lower cap increased demand when implemented in 2017 but given the fact that it only went up $30k and has income restrictions, it shouldn't have noticeable impact on market demand. Alternative Minimum Tax (AMT) thresholds were maintained at higher income levels and made permanent, which should be positive since it makes it more certain going forward.

Tax-exempt municipal bond market performance has significantly underperformed expectations for this time of year and is the only fixed income market to deliver negative returns year-to-date as of 7/31/2025. Heavy supply that is exceeding the record set in 2024 is the main driver of weak performance. If supply continues on record pace, it will be hard to see a sharp rebound in performance without an increase in mutual fund flows, especially in funds with long maturity focus where most supply is issued. In the meantime, investors can take advantage of high absolute yields and cheap relative valuations, especially on the long end of the maturity curve. With tax policy clarity and a Federal Reserve inching closer to more cuts to the Federal Funds Rate, today's high current yields may soon be a thing of the past.

Glossary

Municipal Bonds: Interest on municipal bonds is generally exempt from federal income tax; however, some bonds may be subject to the alternative minimum tax (AMT). Typically, state tax exemption applies if securities are issued within one's state of residence and, if applicable, local tax exemption applies if securities are issues within one's city of residence. The tax-exempt status of municipal securities may be changed by legislative process, which could affect their value and marketability.

Credit risk, also known as default risk, is the likelihood that a borrower won't repay a loan or meet their debt obligation.

Credit quality is a measure of a bond issuer's ability to repay interest and principal in a timely manner. Rating agencies assign letter designations such as AAA, AA and so forth. The lower the rating, the higher the probability of default. Credit quality does not remove market risk and is subject to change.

Duration is the measure of price sensitivity to changes in interest rtes. In general, the higher the duration, the more a bond's price will drop as interest rates rise. This also indicates a higher level of interest rate risk.

Federal Funds rate is the interest rate banks charge each other for overnight loans.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

An **exchange-traded fund (ETF)** is a security that tracks an index or asset like an index fund, but trades like a stock on an exchange.

Municipal to Treasury Ratio compares the yield of municipal bonds to the yield of U.S. Treasury bonds This ratio helps investors assess the relative value of municipal bonds, especially considering their tax-free nature. The ratio is calculated by dividing the yield of a municipal bond by the yield of a Treasury bond with the same maturity.

Yield is the income return on an investment referring to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value. Yields and distribute rates are historical and subject to change.

Yield to worst (YTW) refers to the lowest possible yield an investor can expect to receive on a bond, assuming the issuer does not default.

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