Parametric

Municipal Bond Market Insight | April 2025

Higher Yields and Better Value: Will They Last?

Key takeaways

» Strong supply and tepid demand drove a sharp March and April downturn.

» That downturn has unearthed both multi-year absolute and relative value.

» The bond market reacted to federal policy changes that overshadow monetary policy.

» Threats to the federal tax exemption for municipal bonds remain.

General market update

With the first quarter of 2025 now in the history books, the tax-exempt municipal bond market exits a very challenging March—one that erased prior months' gains—looking ahead toward better performance in coming months. While the factors behind the March muni madness were largely technical and seasonal in nature, such as basic-but-severe supply-demand imbalances, the broader concerns facing both bond and equity markets continue. And they've been particularly acute and reflected in volatile trading across financial markets in the wake of the new tariffs imposed by the Trump administration.

As we've discussed before, much of the investor angst stems not from uncertainty around monetary policy but around fiscal policy under a still-new administration. As we write this, markets are bracing and positioning for economic impacts from the recently unveiled slate of reciprocal tariffs, with bonds rallying, then reversing, and equities faltering, then stabilizing, on related uncertainties. By the close of the first full day of post-tariff announcement trading on April 2, the S&P 500® decreased 4.8% for the day, the 10-year US Treasury yield rallied down to 4% during the flight to safety and the US dollar declined by the most it has in two decades. Despite a strong March Payroll Situation Report released on April 4, the subsequent minimal reaction suggests that markets largely dismissed the data and kept their focus on potential fallout from tariffs. By market close on Tuesday, April 8, the 10-year US Treasury yield was back up to 4.26%, right where it was before the tariff announcement. Muni yields also came roaring back, and then some, setting a new year-to-date high of 3.54%, just 11 basis points (bps) shy of the decade high.

The US economy has held up relatively well, considering the potential headwinds, with the latest employment situation reports not yet reflecting the impacts of federal government layoffs and deferred retirements and resignations. Looking forward, we expect to see such impacts show up in the data as the US economy enters the "detox" period of reductions in federal spending. Meanwhile, Wall Street strategists have been lowering estimates for US economic growth.

Fixed income returns as of March 31, 2025

	MTD return	YTD return
Bloomberg Muni Index	-1.69%	-0.22%
Bloomberg US Treasury Index	0.23%	2.92%
Bloomberg US Aggregate Index	0.04%	2.78%
Bloomberg US Corporate Index	-0.29%	2.31%

Source: Bloomberg, 3/31/2025. For illustrative purposes only. It is not possible to invest directly in an index.

Past performance is no guarantee of future results.

Figure 2: AAA municipal yields as of March 31, 2025

Year	Current	MTD change	YTD change
2-year	2.68%	14 bps	-14 bps
5-year	2.86%	23 bps	-1 bps
10-year	3.26%	40 bps	20 bps
30-year	4.24%	31 bps	34 bps

Source: Thomson Reuters Municipal Market Data, 3/31/2025. For illustrative purposes only. Not a recommendation to buy or sell any security.

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Figure 3: US Treasury yields as of March 31, 2025

Year	Current	MTD change	YTD change
2-year	3.92%	-8 bps	-33 bps
5-year	3.99%	-4 bps	-41 bps
10-year	4.25%	2 bps	-33 bps
30-year	4.62%	10 bps	-17 bps

Source: Bloomberg, 3/31/2025. For illustrative purposes only. Not a recommendation to buy or sell any security.

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The Fed has been satisfied remaining on the sidelines, with the Federal Open Markets Committee (FOMC) leaving the Fed funds overnight lending rate unchanged at the March meeting and presenting a refreshed dot plot still showing two rate cuts this calendar year. That same dot plot revealed lowered sub-2% expectations for GDP growth and slightly higher inflation expectations for the balance of 2025. Street consensus expectations for policy accommodation have swung frequently year to date (YTD) within a tight band of one to four cuts. Currently the Street and the Fed appear aligned in their forecast of two cuts by year-end, though it's worth noting that post-tariff equity market volatility pushed street pricing toward three and even four cuts, expectations that may prove fleeting.

In March, 10-year yields for Treasurys were volatile within a tight band but finished the month largely unchanged at 4.25%. For the quarter, 10-year Treasury yields declined by 35 bps. In sharp contrast, 10-year benchmark muni yields spiked by 40 bps during March to end at 3.26%. For the quarter, 10-year benchmark muni yields finished 20 bps higher. Accordingly, related bond indexes ended the month and quarter in very different positions, with the Bloomberg Muni Index registering 0.22% YTD and the Bloomberg US Treasury Index attaining 2.92% YTD. As we write this, bond and equity markets are experiencing a bout of significant volatility resulting from angst regarding the new administration's tariff policy.

Supply

The new-issue muni bond market continued its trend in March, with a robust $41 billion coming to market—well above average. This was an increase from February, higher than the $37 billion five-year average and approximately 6% greater than the same month last year. Total issuance for the quarter stands at $111 billion. We expect primary market issuance to continue its heady pace this month.

Importantly, net supply—meaning the difference between bonds entering (new issuance) and exiting (maturing and called)—was approximately $23 billion in March. This represented a sharp increase from February's tepid $5.6 billion and helps explain the strong headwinds tax-exempts experienced and the resulting material underperformance compared with Treasurys. In fact, almost 60% of the $39 billion net supply during the first quarter came in March.

We also expect April to be similarly challenging for the muni market, as it's likely to be another heavy-issuance month with another strong net supply that may eclipse even the March total. Redemptions—or the lack thereof—are a key driver of this heavily positive net supply trend. In addition, the muni market is subject to seasonal swings in both supply and demand. March, April and May tend to be lighter in terms of maturing and called bonds—sources of organic reinvestment demand—and heavier in terms of primary market activity (supply). While we expect these negative technical factors to reverse in June, July and August, April brings the added distraction of the tax-filing deadline to a market primarily driven by individual investor buyers. This year also carries the admittedly slow-developing investor concern regarding potential myriad implications from tax reform for the tax-exempt muni market, as we'll discuss later in this insight.

With the phrase "be careful what you wish for" in mind, we wrote last month that March could bring better pricing compared with Treasurys and accordingly present an opportunity to add muni exposure while supply is available at an attractive price on a relative-value basis. This dynamic arrived right on time and, as a bonus, included absolute value. The recent trend of +$10 billion new-issuance weeks continues, while underwriters have been successfully and appropriately pricing bonds to enter a supply-saturated market. We expect this relative-value muni sale to extend through April. We continue to view this as an opportunity to add or increase tax exempt bond positions.

Market opportunity

VALUE UNEARTHED

Now that we've spilled considerable ink discussing what went wrong in munis, let's pivot to what this dislocation offers, why it matters and the related historical context for both relative and absolute value. Before presenting the case for each, it's important to note what hasn't changed: namely, our advocacy for extending duration in muni bonds to lock in attractive yields along the intermediate and long sections of the full muni yield curve. Although the very front end of both Treasurys and munis still hold value while the Fed has paused its rate cuts, that allure may fade as policy easing continues.

Over the last five rate-cutting cycles, intermediate munis have outperformed three-month Treasurys four out of five times, from first cut to last cut. The one outlier was in the aftermath of the 2008 global financial crisis, when spreads for all sectors other than Treasurys were exceptionally wide and still reeling from an extreme flight to quality. We expect intermediate and long-duration munis to again outperform during this easing cycle. That expectation brings us to the muni value unearthed over the past month and into early-April.

Prevailing benchmark muni yields have reached close to decade highs. Nominal 10-year muni yields are fewer than 11 bps away from the decade-high, which was set on October 30, 2023, when the Fed was still in a hiking cycle. Currently, 30-year muni yields are above 4%, a milestone that's occurred on fewer than 100 days over the past decade, which amounts to less than 3% of the time. In terms of muni relative value, the 10-year muni yield expressed as a percentage of the corresponding 10-year Treasury yield at 83% on April 8 is its highest since 2022 and more than 10 percentage points above the three-year average.

Stepping back from the granularity of yields and percentages, the full muni yield curve remains more than three times as steep as the full Treasury curve. Studying the trajectory of the municipal yield curve compared with Treasurys also reveals a sharp disparity and related opportunity, with the 10- to 20-year section of the muni curve being more than twice as steep as Treasurys and the 20- to 30-year section being more than four times as steep. This steepness—or *slope*—suggests that investors are being rewarded with additional yield for extending maturities in the muni market significantly more than in Treasurys.

It's difficult to say how long this oversold muni condition will last, but modest mutual fund outflows during each of the past four weeks are keeping the pressure on. We believe it's likely a good time to consider adding intermediate and long-duration muni exposure.

MUNI TAX-EXEMPTION RISK

In each of our monthly insights this year, we've discussed the prospect of a change to the status of the federal tax exemption that applies to muni bond interest payments. That potential for change stems from the new administration's desire to extend the Tax Cuts and Jobs Act of 2017 (TCJA) and the need to raise revenue to offset the cost of that extension.

In January, we described that risk as a wild card that could drive volatility because of related investor concerns. Having recently been included in the list of potential "pay-fors" in the quest for offsetting revenues, this muni scenario is no longer a wild card. Even so, it's worth noting that the Federal government has never interrupted or mitigated the tax exemption, including during the passage of the TCJA itself. On the pessimistic side, we've been here before and experienced outsized volatility during the Obama administration, when the prospect of capping the value of that exemption was included in Federal budgets but never enacted.

While there haven't been any material updates on this front to speak of, it bears mentioning because tax-exemption risk may have played a role in March's downside price volatility. Although recent market weakness has had a dire feel to it, as most downturns tend to have, the magnitude of the dislocation appears consistent with prior seasonally-driven bouts of muni volatility.

Earlier we noted that muni-to- Treasury relative value is the highest it's been in three years at 83%. By contrast, during the Obama years, when the muni exemption was at risk, that same relative value ratio eclipsed 100% for an extended period. While that period ultimately represented a rare opportunity to buy tax-exempt munis while the tax exemption was essentially free, our point in mentioning it is that such investor angst would likely be quite visible, and we aren't quite there yet.

Our base case remains that this concern over the longevity of the broad tax exemption is likely a low-probability risk and, further, that should such a change transpire, the tax-exempt status of outstanding bonds will likely be unchanged or "grandfathered." This blog article gives more detailed information about our thoughts on the topic.

TAX-LOSS HARVESTING: ALWAYS IN SEASON

Finally, making lemons into lemonade, March offered a significant opportunity to conduct tax-loss harvesting trades, an exercise discussed in market commentaries throughout Wall Street in recent weeks. Simply stated, there is value in the volatility. The price weakness in March and early April offers many muni bondholders the opportunity to harvest tax losses on their positions while replacing them with higher-yielding securities with similar attributes, such as credit quality, coupon income, final maturities and call features.

Muni bondholders who take advantage of the price retrenchment to harvest tax losses, as well as investors with ready cash or money-market range holdings, have the opportunity to purchase tax-exempt bonds at the highest muni yields of the year and at levels within striking distance of decade highs. Though many individual investors still follow the more traditional pattern of conducting tax-loss trades in the fourth quarter, this opportunity has occurred early in the year. If the US economy slows like the post-tariff announcement markets are initially signaling, there may not be another opportunity to harvest tax losses this year. If that proves to be the case, 2025 would be the third consecutive year when it paid to embrace year-round tax-loss harvesting.

The magnitude of price volatility in the bond markets has been immense in recent years because of the pandemic, inflation, an active Fed and the 2024 presidential election. We can now add fiscal policy implementation and related risks to that list. How investors respond to these swings is often a key determinant of account performance in both the near and long term.

Outsized volatility also supports the case for active portfolio management. A longer-term market perspective and depth of experience can inform decisions that could capture additional yield while others simply step back. We believe in having a year-round plan in place to harvest losses as they occur, while leveraging the necessary acumen, tools, resources and market access to seize an opportunity that may quickly vanish.

Economic outlook

With the financial markets looking for evidence of US economic impacts from recent high-profile federal spending reductions, the data releases we rely on have yet to show a material effect from recent downsizing and cuts by the new administration.

The latest example is the Payroll Situation Report for March released on April 4. By many measures, it was a solid report, with non-farm payrolls adding an impressive 228,000 jobs, compared with consensus expectations of a 140,000-job gain, though the unemployment rate again ticked higher to 4.2% against forecasts for an unchanged 4.1%. Average hourly earnings month-over-month met expectations for a second month at 0.3%, and the year-over-year increase adjusted lower to 3.8%, compared with expectations for an unchanged 4%. Average weekly hours worked was directly in line with expectations and a touch longer than last month at 34.2. The labor force participation rate was 62.5% in March, slightly above market expectations of 62.4%. The general tone of the report appears to indicate a US economy that's maintaining its momentum, with inflation only slightly decelerating. Typically, such a report would likely comfort the Fed and encourage it to relax on the sidelines pending further data, but these times aren't typical.

That said, the market had the benefit of hearing directly from chair Powell at an unrelated speaking event just hours after the payroll data release. His comments appeared to be very on-brand and consistent with his press conference at the last FOMC meeting just weeks ago, though a touch more cautious. The Fed chair noted that the US economy "is still in a good place", but also mentioned that the new tariffs are "highly likely to generate at least a temporary rise in inflation, [and] it is also possible that the effects could be more persistent". This comment appears to tamp down his "transitory" reference during the last FOMC meeting. Also consistent with his post-FOMC comments was his statement that "we are well-positioned to wait for greater clarity before considering any adjustments to our policy stance."

With bonds reversing all their flight-to-quality gains and equities seemingly stabilizing, the market turns its attention to the upcoming Consumer Price Index and Producer Price Index reports, as well as the FOMC meeting in early May. We expect no cuts from the May meeting and, though there may be political pressure on the independent Fed to cut rates sooner than later, the bond market started doing that work for them months ago. Finally, we turn to the comment by Treasury secretary Scott Bessent that "there's going to be a detox period." Perhaps it's already begun.

Key economic data

Change in nonfarm payrolls (Mar.)	228K
Unemployment rate (Mar.)	4.2%
Core CPI–YoY change (Feb.)	3.1%
Core PCE–YoY change (Feb.)	2.8%
Average hourly earnings–YoY change (Mar.)	3.8%
Real GDP annualized (Q4 2024)	2.4%

Source: Bloomberg, 4/4/2025.

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