Top 5 Municipal Bond Market Insights for 2025

The Old Normal Is Back. Prepare for It with Meaningful Municipal Allocations

From MacKay Municipal Managers™

At the midpoint of 2025, we believe the municipal bond market continues to offer investors compelling reasons to allocate. Yields remain elevated by historical standards, and valuations are attractive relative to both taxable debt and even U.S. equities. A combination of durable tax-exempt income, solid credit fundamentals, and the potential to capture relative value supports the case for a larger role in investor portfolios. As investors recalibrate in a shifting environment, we believe active management — grounded in bottom-up credit research and focused on uncovering relative value — remains essential to unlocking the potential of this market heading into the second half of the year and beyond.

Theme	Rationale	Portfolio in Action	Mid-Year Status
1 **Traditional tax-exemption persists, and we believe it's as attractive as ever**	As the federal government battles a budget deficit, some think the traditional tax exemption of municipal bond income could become a casualty. But at a 2024 cost of just $33 billion[1], it is a small line item compared to the $1.8 trillion deficit. Noise around this question will persist, but given the exemption's entrenched support in Washington and its purpose toward financing America's $3.7 trillion deficiency in infrastructure investment[2], we believe that Congress will determine the usefulness of the exemption far outweighs its cost. With the continuation of this benefit, our opinion is that the investor community has an opportunity to correct their underweight exposure to municipals. The current market offers attractive tax-equivalent yields, which can act as a ballast to portfolios against risk assets such as equities, while capitalizing on a buyers' market stemming from a projected surplus of issuance.[3]	Our view has held up through the first half of the year. House Republicans have reached agreement on a tax package that, crucially, leaves the municipal exemption untouched. The proposed framework reinforces our belief that tax-exempt income remains a durable and attractive feature of municipal bonds. We expect this clarity to support ongoing investor interest. The same legislation also proposes maintaining a sharply reduced number of individuals subject to the Alternative Minimum Tax (AMT) — a key provision originally introduced in the 2017 Tax Cuts and Jobs Act. AMT-subject municipal bonds continue to trade at wider spreads, even though very few taxpayers are likely to be impacted. We have selectively identified value in this space where spreads remain dislocated relative to actual tax exposure. Additionally, the U.S. House of Representatives has passed legislation to increase the State and Local Tax (SALT) deduction cap to $40,000, though the Senate may opt for a lower level. Negotiations are ongoing at the time of this writing. Retaining or raising the deduction cap may further support municipal bond demand, particularly in high-tax states. While the direct impact on valuations is modest, past experience has shown that the existence of the SALT cap has had behavioral effects, including increased retail buying of municipals. We are also mindful of the potential credit implications of raising the cap — reduced pressure on state and local taxpayers may ease resistance to local tax measures, helping stabilize credit conditions in certain regions. As always, we continue to monitor tax policy closely, identifying pockets of relative value and positioning the portfolio to benefit from structural strengths that, in our view, remain underappreciated by the broader market.	**On Target** • We believe it's a buyer's market. • At 3.96%, the yield-to-worst (YTW) of the Bloomberg Municipal Bond Index has only been higher 4.9% of the time over the last 10 years (Bloomberg as of 6/30/2025). • The spread between municipal taxable-equivalent yields and the S&P 500's earnings yield has reached its widest level since 2001–2002, now favoring municipals by +244 basis points. From 2010 to 2021, this relationship was mostly negative — so a positive spread of this size suggests that municipal bonds are trading at their most attractive relative value to equities in over two decades (Source: Bloomberg as of 6/30/2025). • Municipals look attractive relative to U.S. Treasuries. Pre-tax, a 30-year AAA municipal bond currently yields 94% of a 30-year U.S. Treasury — even as the Treasury hovers near 5%, a level last seen in 2023 and, before that, not since 2007. On a taxable-equivalent basis, that figure jumps to 158%. At these yield levels, that ratio reflects not only relative value, but also an opportunity to lock-in long-term tax-exempt income (Source: Bloomberg as of 6/30/2025).

1. Estimated by the Joint Committee on Taxation, as of December 2023.
2. According to the American Society of Civil Engineers' Report Card for America's Infrastructure, as of May 2024.
3. According to Lerner, J. Threats to tax-exemption the X factor in 2025 issuance projections, Bond Buyer, as of December 2024.

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2 **Capitalizing on the supply wave will require seizing initiative in multiple ways**	Many forecasters[4] have insisted that record levels of new bond issuance in 2024 appear likely to continue in 2025, especially in the first half of the year as the future of tax-exempt interest generates noise in federal budget negotiations. We agree with these issuance forecasts and welcome such a scenario because we expect that an especially heavy calendar of new deals would garner investor attention and cash flow. This would potentially leave esoteric deals, private offerings and secondary market inefficiencies to fly under the radar. We believe active and flexible investment managers have the opportunity to explore certain advantages in this environment by using those overlooked opportunities to allocate to favored credits and sectors, but doing so will require creativity and diligence. Managers who do not purposefully tread outside the well-beaten paths, even if they are equipped to do so, may not reap the same rewards.	In the primary market, our team was able to negotiate favorable terms, taking advantage of new issue concessions to purchase bonds at yield spreads we view as above long-term equilibrium levels. These entry points reflect the benefit of maintaining liquidity and being an active participant in periods of elevated supply. At the same time, we identified and acted on dislocations in the secondary market, where instances of headline-driven volatility led to forced selling and mispriced credits. We also capitalized on select private market offerings, an often less trafficked corner of the municipal market. These esoteric deals, which are typically less visible, presented a unique opportunity this year. By leveraging our relationships and due diligence process, we were able to access and underwrite transactions that others may have overlooked. Our disciplined credit process and agility enabled us to deploy capital into these pockets of inefficiency — potentially enhancing portfolio returns while maintaining our focus on quality and long-term income generation.	**On Target** • Tax-exempt municipal bond new issue supply through June 30, 2025, totaled $256 billion, a 16% increase year-over-year and a 49% increase over the five-year trailing average. This marks the highest issuance on record for the first half of any year, surpassing the previous peak set in 2007 by 9% (Source: JP Morgan as of 6/30/2025). • Municipal-to-Treasury ratios cheapened by 6 to 14 basis points (bps) across the 5- to 30-year range since the start of the year, mostly due to supply-driven pressures (Source: Bloomberg as of 6/30/2025).
3 **Selection comes to the fore of the investment-grade market**	We believe state and local governments will return to a more normal budget environment as federal aid winds down. It is our view that this will create a bifurcation between municipal borrowers which spent that money prudently and those which will face financial headwinds. We expect state and local political and fiscal tensions to resume in this environment, creating volatility and potential opportunity. As the pace of rating upgrades is likely to slow, identifying opportunities will require a depth of experience, thorough understanding of borrower financials and relationships with issuer management teams in order to separate the wheat from the chaff. We believe that research-driven active managers will achieve that understanding before the average investor and will be able to allocate capital accordingly. We see this as an opportunity for alpha. Additionally, we anticipate favorable performance arising from the prepaid gas and housing sectors. In 2024, both sectors saw spreads widen to between +100 bps to +140 bps over the AAA scale[5] due primarily to technical factors. We expect those technical factors to continue in 2025, which would provide an attractive pair of areas for allocation.	We've remained cautious on issuers we believe may face structural budget pressures as federal aid winds down. Fiscal tensions are already emerging among certain borrowers, contributing to growing dispersion in credit spreads. Our research team continues to focus on detailed financial analysis to differentiate fundamentally strong credits from those more vulnerable to fiscal or political strain. Alongside this issuer-level positioning, we've also selectively added to sectors we view as temporarily dislocated by technical pressures, including prepaid gas and housing. These areas have traded at wide spreads to the AAA benchmark despite sound credit fundamentals.	**On Target** • After years of steady improvement, credit rating actions remain net positive, though they may have passed their peak. Year to date (YTD), General Obligation issuers have been upgraded 1.26 times for every downgrade; a decline from 2024, when the ratio for the full year was 2.13 (Source: Bloomberg, 6/30/2025). • Municipal credit remains fundamentally sound, but headlines can influence investor behavior, leading to temporary market dislocations and pockets of relative value. This is where continuous, 24/7 credit research and surveillance can provide a meaningful edge.

4. According to Lerner, J. Threats to tax-exemption the X factor in 2025 issuance projections, Bond Buyer, as of December 2024.
5. According to Municipal Market Data (MMD), as of December 2024.

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4 **The high yield market is likely to outperform investment grades again, despite historically tight spreads**	While we expect certain issuers to face inflection points in their credit cycles, the overall quality of the high yield sector at large remains strong thanks to the health-giving effects of economic growth. At the same time, below-investment-grade debt has received a meager share of the boom in new municipal bond supply. These two trends have combined to squeeze high yield spreads down to some of their lowest historical levels.[6] While this spread compression leaves less room for outperformance, we expect the strong credit fundamentals to continue and new issue supply to remain dominated by investment-grade issuers. We believe this should keep a lid on high yield spreads in 2025 and allow the sector to benefit from yield-driven outperformance. When allocating into this strength, it is our view that managers must use a research-driven approach to avoid the temptation of reaching for poorly secured deals with far greater risk, which has enticed some investors in the past but is counterproductive to long-term returns.	Our high yield portfolios have shifted toward a higher-quality posture, reflecting tight spreads and a lack of adequate compensation for deeper credit risk at present. We remain constructive on liquid high yield bonds and those offering meaningful investor protections — such as strong covenants. We are also seeking to take advantage of discounted structures that offer potential upside while providing a degree of downside protection. As always, we uphold rigorous underwriting standards and avoid yield-chasing behavior, which often involves overpaying for securities with limited protections and exposure to speculative, highly leveraged issuers.	**Pending** • So far this year the Bloomberg HY Municipal Index is outperforming the Bloomberg Municipal Index (IG) by 2 bps (Source: Bloomberg as of 6/30/2025). • The yield differential between the Bloomberg High Yield Municipal Index and the Bloomberg Investment Grade Municipal Index has been stable this year, only increasing from 177 bps to 186 bps, a level that is still historically tight. For context, the differential has been higher than 186 bps, 87% of the time over the past 10 years (Source: Bloomberg as of 6/30/2025).
5 **The front end of the municipal yield curve should outperform cash-like instruments**	As the Federal Reserve considers normalizing its interest rate policy through cuts to the federal funds rate, the savings deposits and money market funds in which American households are currently holding $14 trillion[7] may not be able to offer the incomes they produced in 2023 and 2024. This applies to both taxable and tax-exempt products. Yet, we believe reallocating those assets from cash products into bonds does not necessarily require adding undue risk. Returns from short-term municipal bond funds are generally much less sensitive to changes in interest rates than long-duration products while still offering the same tax-exemption and high credit quality. We believe short municipal funds will outperform cash products this year, and investors may wish to consider rotating into those funds early enough to outpace what could be a large wave of demand.	Short-term municipal bonds have outperformed cash-like instruments year-to-date — exceeding the returns of both tax-exempt money market funds outright, and taxable money market funds on an after-tax basis. This outperformance underscores the value of capitalizing on elevated short-term tax-exempt yields. Our broader market portfolios were well-positioned to take advantage. We took advantage of elevated short-term yield levels, while also deploying cash into longer-maturity bonds as the yield curve steepened throughout the first half of the year. This posture allowed us to generate attractive income, manage interest rate risk and enhance income durability.	**On Target** • Beware re-investment. Taxable and tax-free money market fund yields have declined in 2025, with taxable funds falling from an average of 4.16% at the start of the year to 3.90%, a drop of 26 bps. Tax-free fund yields fell from an average of 3.21% to 2.23%, a drop of 98 bps (Source: Morningstar as of 6/30/2025). • On a taxable-equivalent basis, the 3-Year Municipal Index yield-to-worst is 5.02%, offering a 112 bps advantage over taxable money market funds (Source: Bloomberg as of 6/30/2025). • The Bloomberg 3-Year (2–4 Year) Municipal Index has outperformed taxable money market securities on an after-tax basis by 114 bps year-to-date (YTD) (Source: Bloomberg, Morningstar as of 6/30/2025). • The 3-Year Municipal Index has also outperformed tax-free money market funds by 86 bps YTD (as of June 5, 2025) (Source: Bloomberg, Morningstar as of 6/30/2025).

6. According to Municipal Market Data (MMD), as of December 2024.
7. According to Federal Reserve data, as of December 2024.

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Bloomberg Municipal High Yield Index is an unmanaged index of municipal bonds with the following characteristics: fixed coupon rate, credit rating of Ba1 or lower or non-rated using the middle rating of Moody's, S&P, and Fitch, outstanding par value of at least $3 million, and issued as part of a transaction of at least $20 million. **Bloomberg Municipal Managed Money Intermediate 1-17 Year Bond Index** is an unmanaged, tax-exempt bond market index that measures the 1-17 year maturity component of the Bloomberg Barclays Municipal Managed Money Bond Index. **Bloomberg Municipal Bond Index:** 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. **ICE BofA U.S. Taxable Municipal Securities Index** tracks the performance of U.S. dollar denominated investment grade taxable municipal securities publicly issued in the U.S. domestic market. **ICE ICE BofA U.S. Corporate Index** tracks the performance of U.S. dollar denominated investment grade corporate debt publicly issued in the U.S. domestic market.

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