U.S. Municipal Bond Market

Policy Ambitions, Market Reactions Keep the Municipal Bond Window Wide Open

Tom Kozlik
Head of Public Policy and Municipal Strategy
214.859.9439
tom.kozlik@hilltopsecurities.com

- The current market dynamic—and the attractiveness of municipal yields—are being shaped by a mix of optimism and realism. Key drivers include tariff-related uncertainty, elevated supply in the primary market, heightened investor demand for stronger credit quality, growing concerns over federal fiscal strain, and the recent Moody's downgrade of U.S. sovereign debt.
- Municipal bond yields remain near the peak of generational highs, offering a rare opportunity to lock-in high-quality, tax-advantaged income amid policy uncertainty and market volatility.
- In today's relatively higher rate environment, investors can look beyond yield alone and carefully consider structure. Combining defensive features, longer duration, extended call protection, and lower coupons can help reduce reinvestment risk, improve long-term returns, and strengthen a portfolio's resilience across different interest rate scenarios.

Opportunity in the Crosscurrents of Market Optimism and Realism

In investing, politics, world-class boxing—and even 1980s sitcoms—some plans come together beautifully. Others get punched in the mouth. Today's financial markets are experiencing a bit of both: moments of progress and optimism, tempered by realism in the form of volatility and disruption. Investors are contending with a landscape shaped by bold policy shifts, mixed economic signals, and a widening gap between expectations and outcomes.

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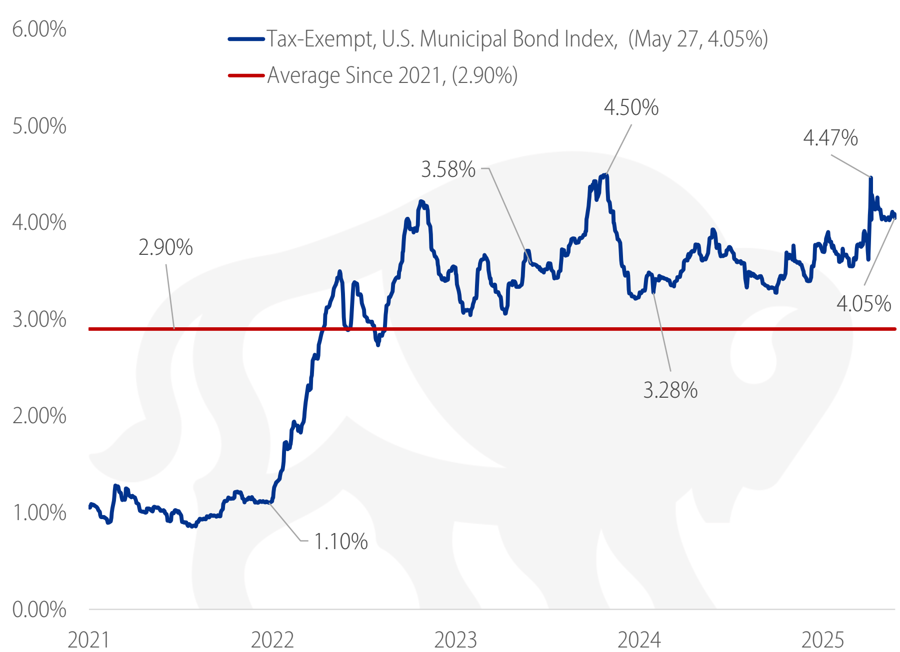
Municipal Bond Window Still Wide Open, Yields Remain Very Attractive



Source: Bloomberg and HilltopSecurities.

On one hand, investors are navigating a high-stakes environment shaped by President Trump's bold economic agenda, particularly the House passage of the "One Big Beautiful Bill." On the other, uncertainty looms as the bill faces a more difficult path in the Senate, while sweeping tariff reforms hint at deeper structural changes in labor and trade policy still potentially to unfold.

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Moody's Downgrades, Municipal Yields Shine

On Friday, May 16, near the close of business, Moody's downgraded the U.S. sovereign credit rating from Aaa to Aa1, citing persistent deficits and a deteriorating fiscal outlook. While widely anticipated, this move—following similar actions by S&P in 2011 and Fitch in 2023—reinforces a critical message: fiscal strain is no longer a future concern; it is a present reality.

For more on our perspective and the potential market implications of the Moody's downgrade, see: Another Warning, Not a Shock: U.S. Downgraded by Moody's Ratings (May 19).

Taken together this is a moment that calls for both optimism and realism from investors. The encouraging news? For municipal bond investors, the plan may be coming together—just not in the way many expected at the beginning of the year. As the fictional Col. Hannibal Smith famously said, "I love it when a plan comes together."

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For those already positioned in, or looking to add to, high-quality tax-exempt bonds, that sentiment may seem more justified now than ever.

This is a time for discipline: continue allocating investment dollars consistently. Do not try to time the market. Stick to a regular investment plan—whether monthly, every-other month, or quarterly—based on your goals and resources.

If there has ever been a time in recent memory to consider allocating more than your typical amount to municipal bonds, it may be now. This is thanks to the continued strength and attractiveness of absolute yields. See our chart on the first page.

Don't Miss it Twice, A Rare Window, Reopened and Widened

Municipal bond yields have edged higher in recent weeks—but this modest move conceals a much larger story. The current environment presents a renewed and potentially more attractive entry point for most municipal investors. Yields are now approaching levels not seen since the three-to-four-week aftermath of Liberation Day, extending what can only be described as a generational opportunity to lock in high-quality, tax-advantaged income.

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This is not just a technical bounce. The rise in yields is being driven by real and persistent forces—most notably, tariff uncertainty and growing market awareness of Washington's fiscal lack of focus. Treasury Secretary Bessent recently warned that steep reciprocal tariffs could return after the current 90-day pause—a risk that markets are beginning to price in. Until this uncertainty is resolved, yields are likely to remain elevated, especially if growth expectations begin to soften.

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Structure Matters as Well

Considering today's market dynamic, where generationally attractive yields should be drawing renewed interest, it is equally prudent to look beyond yield alone and thoughtfully consider the role and importance of structure. A well-constructed portfolio that blends defensive structures, longer-duration bonds, extended call protection, and even lower-coupon options can offer strategic advantages.

These structural elements can help mitigate reinvestment risk, enhance long-term total return potential, and provide resilience—particularly in declining interest rate environments. By intentionally diversifying across maturities, call features, and coupon profiles, investors can position themselves to capture enduring value while maintaining both flexibility and stability in their municipal bond strategy.

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Stay the Course, Seize the Moment (Again)

This is a market that challenges assumptions and delivers volatility. It is a landscape where plans are tested—but also where opportunities emerge for those who remain focused and flexible. For municipal bond investors, the current environment presents yet another rare opportunity to secure high-quality, tax-advantaged income at the upper end of the generationally attractive range we have been tracking.

The window remains open. The plan may not be perfect—but for those prepared to act, it is coming together.

Recent HilltopSecurities Municipal Commentary

- Another Warning, Not a Shock: U.S. Downgraded by Moody's Ratings, May 19, 2025
- Another Reason for Cautious Optimism – No Change to Tax-Exemption in Draft House Text, But the Tax-Exemption is Still Not "Safe", May 12, 2025
- Top Municipal Bond Opportunity Closing Fast as Market Heals, May 2, 2025
- Last Week's Big Beautiful Budget Framework: A Potential Lifeline for the Tax-Exemption, April 16, 2025
- Rising Yields, Falling Confidence: Seizing the Next Municipal Bond Opportunity, April 14, 2025

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Readers may view all of the HilltopSecurities Municipal Commentary here.