U.S. Municipal Bond Market

Navigating the Chaos: Embracing Selectivity in Today's Municipal Bond Market

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

- Investors face a chaotic environment marked by fading federal aid, structural uncertainty, and shifting sentiment—but elevated yields and strong fundamentals in some sectors present a compelling case for strategic and selective municipal bond market engagement.
- **From Stability to Selectivity:** The end of the "Golden Age of Public Finance" has ushered in a new era of credit normalization, where careful credit selection is essential amid rising climate, political, and fiscal risks. Some investors are becoming increasingly shy—even with familiar credits—as uncertainty reshapes their approach.

Navigating Today's Investment Landscape Amid the Old & New Chaos

The investment environment remains chaotic. Volatility, uncertainty, and a flood of competing narratives have created a sense of and some actual dislocation across markets. While this affects all asset classes, the municipal bond market is undergoing particularly meaningful shifts—both in fundamentals and investor behavior.

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Investors today face a deluge of choices—some driven by FOMO (fear of missing out), others by less transparent incentives. Many investors are opting to stay on the sidelines. As of June 5, 2025, more than $7 trillion sits in money market funds, according to the Investment Company Institute. This isn't just caution—it is paralysis brought on by information overload, structural uncertainty, and chaos.

Beyond monetary and trade policy questions, new sources of instability are reshaping the municipal landscape. Climate-related events are intensifying. Political volatility—particularly from Washington—has become a persistent source of risk as well. This instability is no longer just headline noise; it's developing into structural uncertainty that's influencing credit selection and portfolio construction.

Some individual investors are responding with increased selectivity. In some cases, **behavior could be described as shy**—a reluctance to engage even with familiar credits. This hesitation may ease with time and better data, but for now, many are increasingly steering clear of issuers exposed to climate, political, or budget-related turmoil. This could be the new normal in the municipal bond market.

Credit Normalization and The End of the "Golden Age of Public Finance"

We declared the end of the "Golden Age of Public Finance" in January—a call that continues to hold. The expiration or wind-down of pandemic-era federal aid marks the beginning of a multi-year adjustment period, especially for issuers still working toward structural balance.

While headlines often focus on the most challenged credits, most state and local governments and public entities have stabilized. Municipal bond credit quality is generally very strong. The shift away from federal support does not diminish our conviction in municipal bonds. On the contrary, strong fundamentals and elevated yields make this one of the most attractive environments for municipal investors in recent years.

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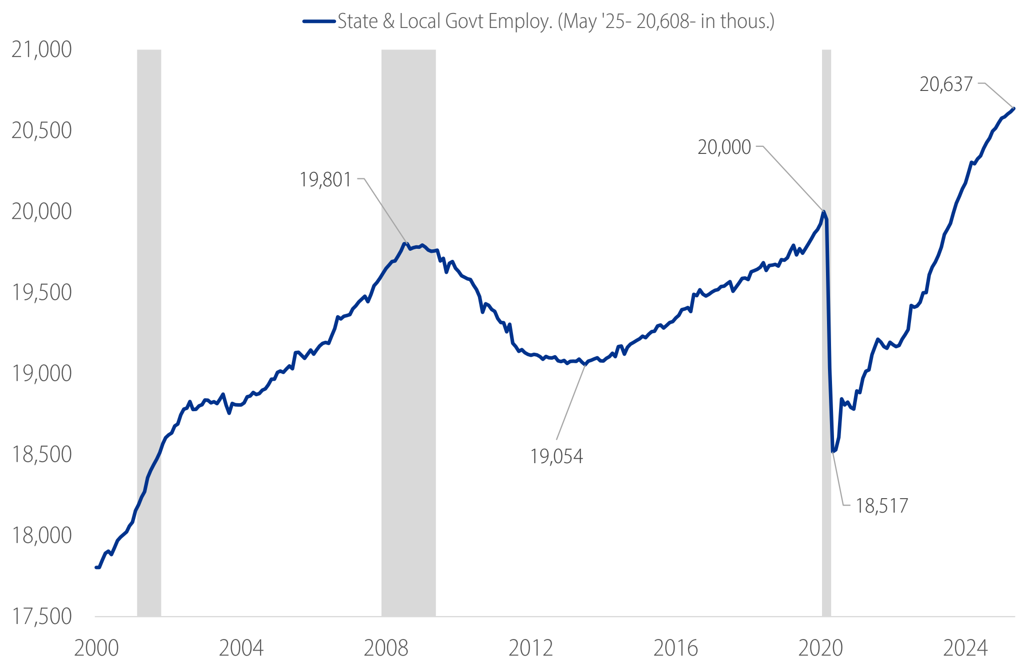
State and Local Government Employment Continues to Peak



Source: Bureau of Labor Statistics, St. Louis Fed's FRED database, and HilltopSecurities.

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State & Local Governments and Housing Sector Credit Outlooks

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For the State sector, according to the National Association of State Budget Officers (NASBO) Fall 2024 Fiscal Survey, adjustments are smartly evolving:

- Fiscal year 2025 general fund spending is projected to decline slightly (-0.3%) after a nearly 12% increase in FY 2024.
- Revenue projections are up 1.9% year-over-year.
- Tax policy is stabilizing, with 27 states enacting net tax cuts and 10 implementing tax increases.

Single-family housing bonds issued by state housing finance agencies remain among the highest-quality credits in the municipal bond market. However, investors should be mindful of prepayment risk and optional redemption features in this sector.

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Non-profit Health Care, K-12 Schools & Higher Education Credit Outlooks, and Mass Transit

We expected improved margins and strong patient volumes for the Non-profit Health Care sector in 2025. However, inflation, labor, and supply costs remain headwinds. Credit outcomes will vary by geography and payer mix.

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We lowered our outlook on the K–12 school district sector to "Cautious" from "Stable" in January, a move validated by ongoing credit deterioration. Enrollment declines driven by demographic shifts are creating long-term structural challenges for some.

The Higher Education sector continues to face systemic challenges. We are continuing to see in some cases:

- Declining enrollment,
- Rising costs, rising tuition (moderating a little lately) and heavy student debt levels,
- Reduced government support,
- Inflationary pressures,
- Waning public confidence in the value of a degree.

These issues have led to an elevated number of higher-ed sector downgrades, closures, and consolidations—especially among smaller, private institutions. We have a "Negative" outlook for both Private and Public entities in the Higher Education sector still.

We do not assign a sector outlook to the mass transit segment, but troubles for mass transit agencies remain. Ridership remains well below pre-pandemic levels in most cases. The sector's reliance on subsidies makes it vulnerable to political shifts. Its future will depend heavily on public policy and political will.

Looking Ahead in General, Buckle Up for More Turbulence

Since President Trump's "Liberation Day" on April 2, markets have been anything but calm. Volatility has surged, and despite mixed signals from the latest jobs report, concerns about economic fragility persist. Tariff and tax policy uncertainty, a lack of fiscal discipline, and growing deficit concerns all add to the complexity.

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Even if or when President Trump's "Big, Beautiful Bill" passes, long-term fiscal risks will remain in focus. As long as the U.S. deficit remains near record levels, the threat to the municipal bond tax-exemption will remain elevated as well.

Final Takeaway: Embrace, Then Strategically Navigate the Chaos

Despite ongoing uncertainty, we remain optimistic about municipal bonds. Elevated yields, resilient fundamentals, and a favorable supply-demand balance present a compelling case for disciplined, strategic allocation.

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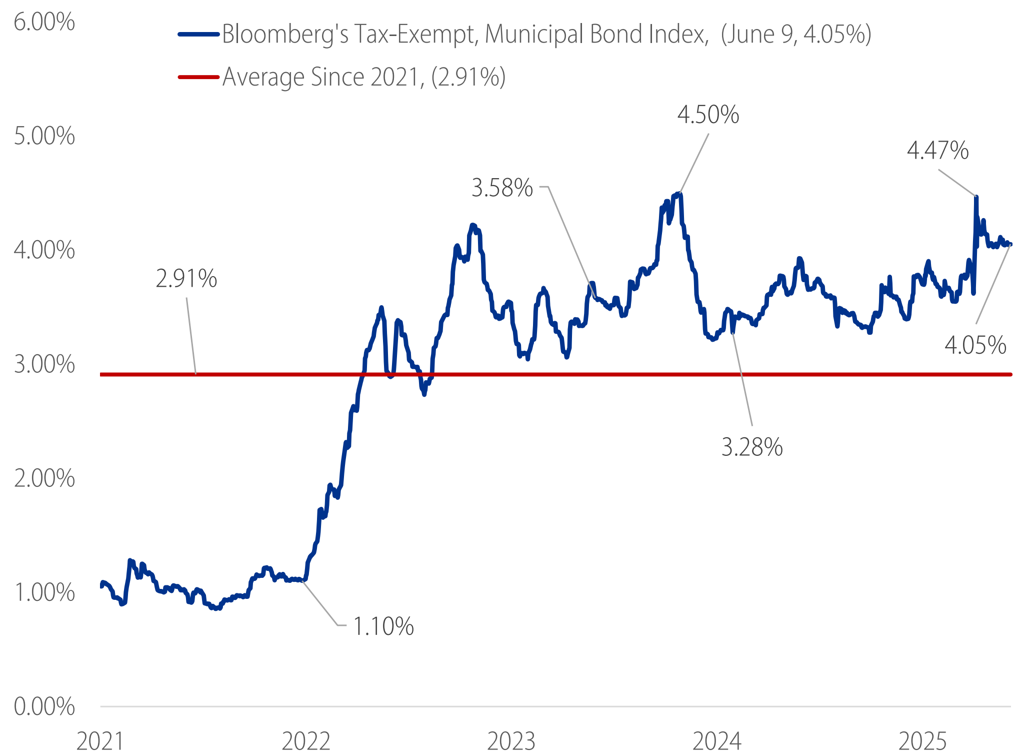
Reminder: Window for Attractive Municipal Bond Yields Remains Wide-Open



Source: Bloomberg and HilltopSecurities.

With generationally attractive yields and a supportive technical backdrop, this is a pivotal moment to engage selectively and with purpose.

Municipal bond investors are navigating a complex environment shaped by the wind-down of federal aid, rising structural risks, and shifting sentiment. While caution—even shyness—is understandable, some sectors remain fundamentally strong. With generationally attractive yields and a supportive technical backdrop, this is a pivotal moment to engage selectively and with purpose.

The chaos may be elevated—but so is the opportunity.

Recent HilltopSecurities Municipal Commentary

- The Wisdom of the Market in an Era of Looming Fiscal Reckoning, June 3, 2025
- Policy Ambitions, Market Reactions Keep the Municipal Bond Window Wide Open, May 28, 2025
- 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

Readers may view all of the HilltopSecurities Municipal Commentary here.