U.S. Municipal Bond Market

The Wisdom of the Market in an Era of Looming Fiscal Reckoning

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- Persistent high yields reflect a complex interplay of macroeconomic ambiguity, policy uncertainty, and mounting fiscal strain.
- The bond market is signaling both caution and opportunity—not complacency—highlighting the need for investors to look beyond yield and consider structure, risk, and overall portfolio resilience.
- Markets may be influenced in the short term, but over time, supply and demand reassert themselves—reminding investors that economic gravity cannot be ignored.
- The bond market may not cast ballots, but it sends powerful signals—today's elevated yields are a warning, not just an opportunity, as markets **demand accountability** amid rising trade policy and fiscal uncertainty.

Why Yields Aren't Falling and the Forces Driving Persistent Market Pressure

Although many, me included, anticipated the Federal Reserve would begin lowering its target rate by midyear 2025, fixed-income and municipal yields have remained persistently high, staying near levels not consistently seen in some time. This resilience reflects a complex interplay of macro-economic and market forces that continue to shape investor sentiment.

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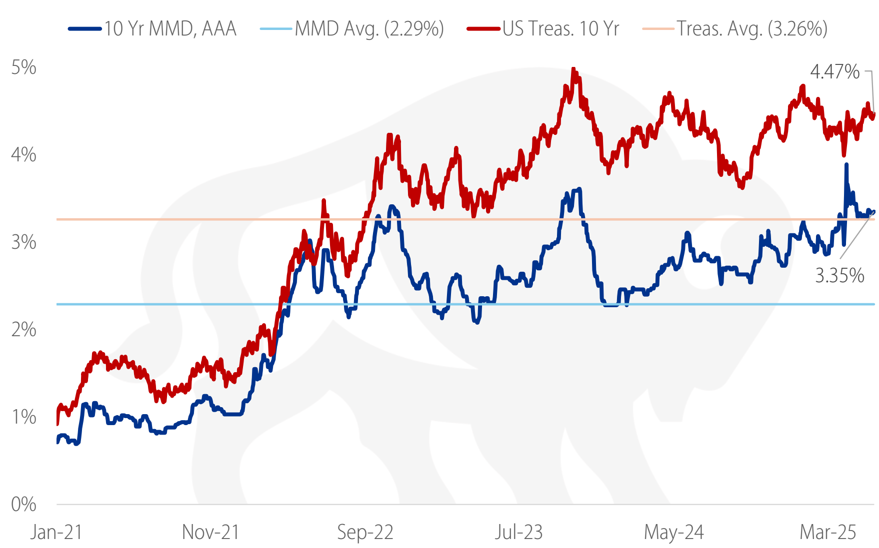
As we noted in last week's report, Policy Ambitions, Market Reactions Keep the Municipal Bond Window Wide Open, factors such as tariff-related uncertainty, elevated new issuance, and concerns over federal fiscal sustainability are keeping upward pressure on yields. Combined with the recent Moody's downgrade of U.S. sovereign debt and a growing investor preference for higher credit quality, these forces help explain why the municipal bond market remains both dynamic and compelling, with yields that continue to offer long-term value.

Persistently High Yields in 2025



Source: LSEG and HilltopSecurities.

In this environment, understanding why yields remain high is essential for investors seeking to balance opportunity with risk. This is also a key reason why last week we informed investors they should be looking beyond yield alone and carefully consider structure as well. (See page 3, "Structure Matters as Well" in last week's report.

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While today's elevated yields offer compelling income potential, today's elevated yields also signal a market that remains highly sensitive to evolving macro-economic, fiscal, and monetary policy dynamics. History reminds us—notably during the 1994 bond market sell-off—that even periods marked by strong fundamentals and fiscal discipline can be swiftly disrupted by unexpected shifts in central bank policy or investor sentiment.

The current environment, shaped by policy uncertainty, geopolitical tensions, and fluctuating inflation expectations, carries similar risks. Investors would be prudent to stay alert, recognizing that attractive yields often come with embedded volatility and the potential for sudden repricing.

Lawmakers on Both Sides of the Aisle Sleep through Worsening U.S. Deficit

It's emblematic —perhaps even ironic—that a New York congressman briefly fell asleep during the May vote when House Republicans passed their version of President Trump's and Speaker Johnson's so-called "One, Big, Beautiful Bill."

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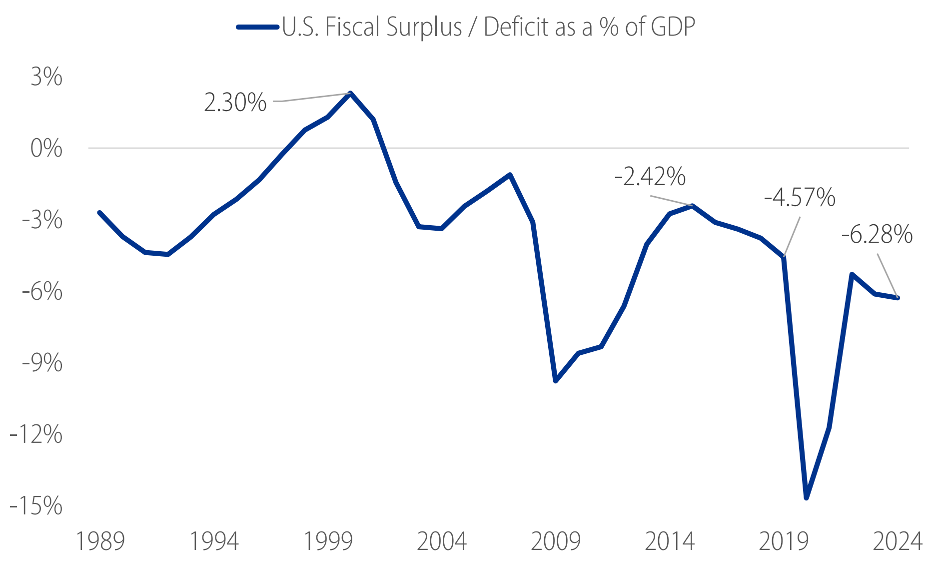
According to the Committee for a Responsible Federal Budget (CRFB), the House reconciliation bill would massively increase near-term deficits, adding an estimated $3.3 trillion. Meanwhile, the nonpartisan Joint Committee on Taxation projects minimal economic growth resulting from the bill's fiscal policies contrary to the optimistic claims Speaker Johnson made on Meet the Press Sunday.

The U.S. Fiscal Situation Has Worsened Under Both Parties



Source: St. Louis Fed's FRED and HilltopSecurities.

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Despite the 119th Congress's mandate for change, the House version of reconciliation suggests more of the same fiscal policy that exacerbates the deficit rather than reins it in. The growing fear of a continued deteriorating U.S. fiscal outlook, compounded by uncertainty from economically damaging tariff policies, continues to drive elevated and in some cases rising yields.

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The congressman's nap is symbolic of a broader truth: Congress has been asleep at the wheel as the U.S. fiscal situation has steadily worsened since the early 2000s. The May 2025 Moody's downgrade wasn't a shock —it was a warning, another reminder of long-standing structural issues.

We outlined the causes of the U.S. deficit in detail on page 2 of our Moody's downgrade summary (see Causes of U.S. Deficits), by drawing from CRFB analysis. In other words, the U.S. deficit didn't emerge solely from COVID-era spending. In fact:

- 37% of the current deficit stems from major tax cuts,
- 33% from net discretionary spending increases and Medicare expansions, and
- 28% from responses to the Great Recession and COVID-19 (mostly).

There's plenty of blame to go around and both parties must take responsibility for repairing the damage before the cracks in the fiscal foundation become irreparable.

Crack in the Bond Market

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At the 2025 Reagan National Economic Forum, JPMorgan CEO Jamie Dimon issued a blunt warning: "You're going to see a crack in the bond market. It is going to happen." He added, "I just don't know if it's going to be a crisis in six months or six years." For investors and policymakers wondering why Treasuries (and other fixed-income securities) demand higher compensation, the answer lies in plain sight.

Undefeated

I have been pleasantly preoccupied since last week with a striking insight I came across. In his Wall Street Journal piece, JD Vance Is Wrong: The Market Isn't a 'Tool', Matthew Hennessey makes a sharp and timely observation:

> Markets, whether for cheap consumer goods or government bonds, can't be bullied into compliance with a political agenda. They aren't governed by the philosophies and desires of men like Mr. Vance. They are governed by the laws of economics the way the physical world is governed by the laws of gravity. You can moan about them all you want, you can lament the trade-offs they demand and the constraints they impose, but you can't ignore or wish them away. No amount of political will or spilled ink can overrule them. Supply and demand are undefeated.

"Supply and demand are undefeated."

I repeat Hennessey's final line deliberately because it deserves the emphasis. This principle is not just a clever turn of phrase; it's a foundational truth that resonates deeply, especially when viewed through the lens of fixed-income markets and the current dynamic.

There's plenty of blame to go around and both parties must take responsibility for repairing the damage before the cracks in the fiscal foundation become irreparable.

Supply and demand are foundational economic forces in a market economy. They help determine prices, allocate resources, and influence behavior. That said, markets aren't always perfectly efficient in the short run. Activities like manipulation, speculation, regulation, monopolies, or even psychological factors can distort prices temporarily.

In the 1980s and early 1990s, economist Ed Yardeni coined the term "bond vigilantes" to describe investors who sold off government bonds in protest of irresponsible fiscal policy.

Warren Buffet has famously said, and he would likely attribute this wisdom to Benjamin Graham, "In the short run, the market is a voting machine, in the long run it's a weighing machine. Weight counts eventually. But votes count in the short term."

There are many potential inputs investors consider under differing economic scenarios. Sometimes, investors act based on what they perceive to be in their financial best interest. They may respond to shifting expectations about inflation and its potential to erode the real purchasing power of their fixed income returns. At other times, investor decisions may be driven by changing assessments of credit risk or broader market instability fearing that they may not be fully repaid.

Over time, foundational forces usually reassert themselves and supply and demand acts like gravity in economics.

The Plight of Edward Yardeni's Bond Vigilantes

The principle—that markets ultimately [or sometimes can] enforce discipline—has played out before, most notably through the rise of the so-called bond vigilantes. In the 1980s and early 1990s, economist Ed Yardeni coined the term "bond vigilantes" to describe investors who sold off government bonds in protest of irresponsible fiscal policy. These self-appointed enforcers of fiscal discipline signaled that if policymakers wouldn't act, the bond market could.

As Howard Paster, one of Clinton's congressional advisors, famously asked, "How many votes does the bond market have?"

This dynamic shaped President Bill Clinton's early economic agenda. Initially proposing ambitious spending plans and a middle tax-cut, Clinton's team quickly pivoted toward deficit reduction in 1993 after feedback from his economic advisors. As Howard Paster, one of Clinton's congressional advisors, famously asked, "How many votes does the bond market have?" The answer, it turned out, was enough to reshape policy.

James Carville captured the sentiment well also when he famously said: "I used to think that if there was reincarnation, I wanted to come back as the President or the Pope or as a .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody."

Market Misjudges the Fed in 1994

In early 1994, investors expected stable rates and low inflation. But the Fed, concerned about overheating inflation, raised its target rate from 3.00% to 3.25% on Feb. 4. The surprise move, and later FOMC actions, triggered a massive bond sell-off. The 10-year Treasury yield surged from 5.17% in October 1993 to 8.03% by November 1994. The FOMC ended its hiking cycle in February 1985, raising rates another 50 basis points to 6.00% from 5.50%.

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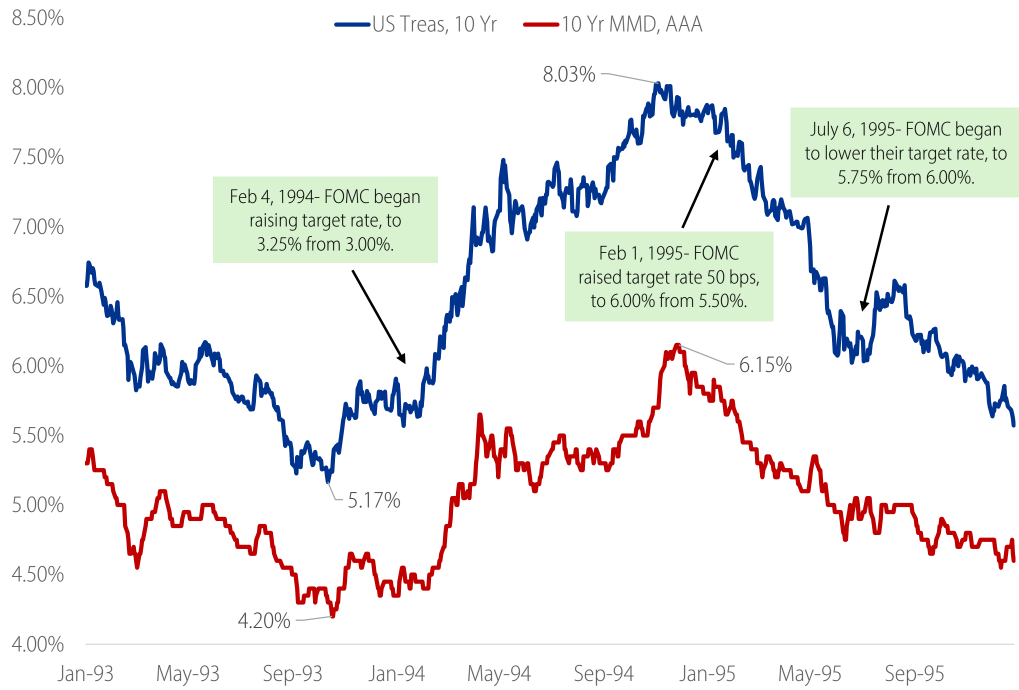
The Great Bond Massacre of 1994



Source: LSEG and HilltopSecurities.

Investors are once again recalibrating expectations in real time, responding not only to Fed policy but also to ongoing trade policy volatility, potential fiscal uncertainty, geopolitical risk, and structural imbalances.

A Market That Still Votes

Today's market echoes many of the same tensions seen in the early 1990s. Investors are once again recalibrating expectations in real time, responding not only to Fed policy but also to ongoing trade policy volatility, potential fiscal uncertainty, geopolitical risk, and structural imbalances. The persistence of high yields is not just a reflection of inflation or growth—it's a signal that the market is **demanding accountability**.

If lawmakers continue to ignore fiscal realities, and if investors continue to be surprised by policy shifts, the risk of another "crack" in the bond market becomes more than just a prediction.

The bond market may not cast ballots, but it sends powerful signals. Elevated yields are not just an opportunity—they are a warning. If lawmakers continue to ignore fiscal realities, and if investors continue to be surprised by policy shifts, the risk of another "crack" in the bond market becomes more than just a prediction. It becomes a probability.

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