U.S. Municipal Bond Market

Risk and Fragile Stability Persist as Public Pension Momentum Slows in 2025

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- Funded ratio improvements remain modest and fragile, with risks spanning the near to long term—driven by market volatility, concentrated equity exposure, persistent underfunding, overly optimistic actuarial assumptions, and mounting demographic pressures.
- Despite years of scrutiny, some governments still fail to meet minimum funding benchmarks, leaving some municipal bonds—long viewed as wealth preservation instruments—exposed to ongoing credit, market and fiscal risks.
- Equity exposure and interest rate sensitivity remain core risks for public pensions, while growing interest in cryptocurrency adds a volatile new dimension to investment management challenges.

Why Public Pensions Risks Still Matter in 2025

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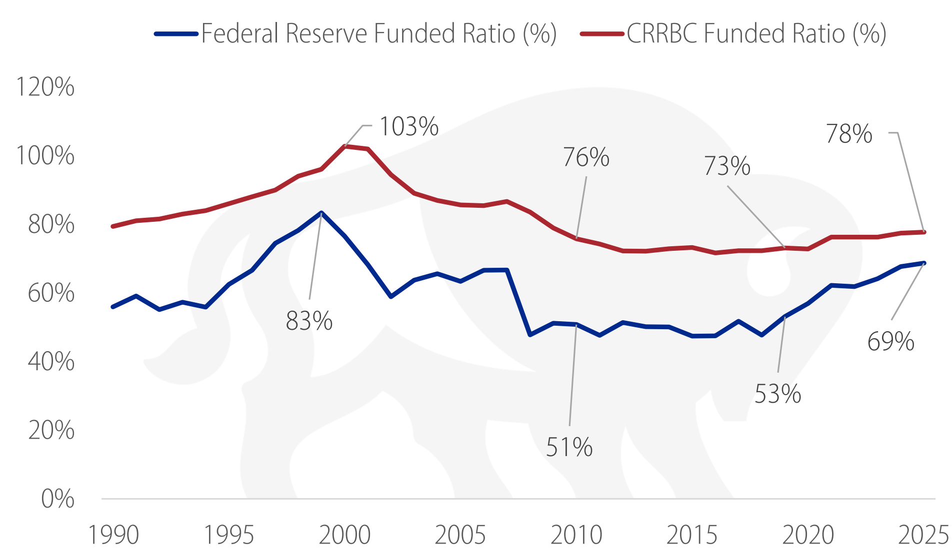
Market volatility, concentrated equity exposure, persistent underfunding, overly optimistic actuarial assumptions, mounting demographic pressures, and exposure to volatile investments continue to challenge the sustainability of many of these public plans. In the years leading up to the COVID-19 crisis, public pension obligations increasingly strained state and local budgets, diverting resources from essential services like infrastructure and, in some cases, contributing to a decline in bond issuance.

We are Seeing Only Modest Improvements in Public Pension Funded Ratios



Source: Center for Retirement Research at Boston College, Fed Reserve and HilltopSecurities.

Although mortality rates temporarily shifted during the pandemic, they are now returning to pre-pandemic patterns. Meanwhile, demographic pressures are intensifying. Retirees are living longer, birth rates are falling, and the ratio of active workers to retirees continues to decline. These trends are further stressed by the potential return of public workforce reductions, as governments eventually could seek to rebalance budgets in ways reminiscent of the post-2008 financial crisis. Technological disruption and automation may also reduce public sector employment, gradually weakening the contributor base.

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These forces collectively threaten the long-term balance between pension inflows and outflows. While recent improvements in funded status are welcome, they remain fragile. Without sustained fiscal discipline and prudent oversight, today's relative calm could quickly unravel in the face of future economic shocks. Investors should remain vigilant. Rising pension pressures can erode credit quality, limit fiscal flexibility, and elevate long-term investment risk. ***Given that municipal bonds are widely regarded as wealth preservation instruments, unchecked pension liabilities represent an outsized threat to their stability and reliability***.

A Lesson From the Financial Crisis

The 2008 financial crisis exposed the vulnerability of public pension systems. As markets collapsed, pension portfolios suffered steep losses, deepening funding gaps just as state and local revenues were falling. Warren Buffett, in his 2008 (page 20) and 2009 (page 14) shareholder letters, warned of the looming pension pressures. He noted that public pension promises were enormous and often woefully underfunded, and that the gap between assets and realistic liabilities was staggering. His remarks underscored that public pensions were not merely victims of the crisis—they were weakened by decades of underfunding, unrealistic return assumptions, and reluctance to make difficult fiscal decisions.

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The Trillion Dollar Gap (2010) and Ongoing Scrutiny

In 2010, the Pew Center on the States published The Trillion Dollar Gap, a landmark report that quantified the shortfall between what states had set aside for pensions and what they owed. The report marked a turning point in public awareness and has since been followed by regular updates from Pew, The Center for Retirement Research at Boston College, and others. Yet despite this sustained scrutiny, some state and local governments still fall short of making even tread-water contributions toward their pension obligations. The disconnect between awareness and action may reflect a deeper issue: asymmetric information between policymakers, investors, other stakeholders and the public.

2025 Update: Modest Gains, Persistent Risks

According to a July 2025 brief from the Center for Retirement Research, the aggregate funded ratio for state and local pension plans has improved slightly, rising from 76.3% in 2021 to 77.7% in 2025. This progress reflects positive investment returns, regular contributions, lower interest rates, and the continued impact of benefit reforms enacted in the years after the Great Recession.

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Moody's Ratings reports that adjusted net pension liabilities (ANPL) have declined significantly—from a peak of $6 trillion in 2020 to an estimated $2.1 trillion in 2025. This 65% drop is largely due to higher interest rates, which have slowed liability growth. GASB net pension liabilities have also fallen, reaching $810 billion in June 2025, down from $1.1 trillion the previous year. These developments are ***a credit-positive*** and may slightly ease fixed cost pressures heading into near-term budget cycles.

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Risks From Overheated Markets and Crypto Exposure

Despite recent gains in funded ratios, other important risks remain. The long-term sustainability of public pensions, particularly in relation to asset allocation, remains a critical concern.

Public pension plans continue to maintain substantial allocations to equities, leaving them highly exposed to potential market corrections. While rising interest rates have recently benefited these plans by reducing liability growth, they are equally vulnerable to falling rates. Lower inflation may reduce the risk of unexpected cost escalations, but such a scenario also increases the likelihood of rate cuts. A decline in interest rates and discount rates could sharply inflate unfunded liabilities.

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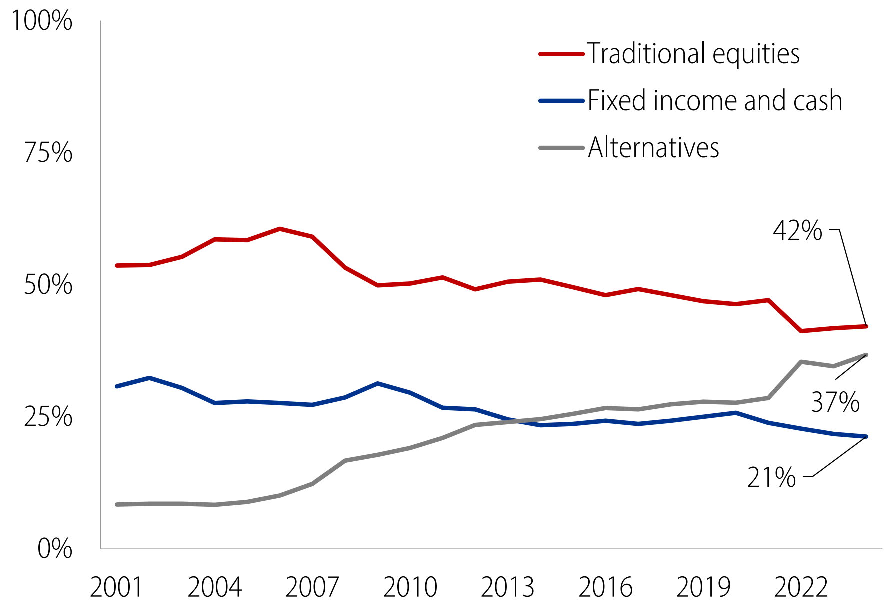
Investment Allocation for State and Local Plans, FY 2001-2024



Source: Center for Retirement Research at Boston College, Fed Reserve and HilltopSecurities.

Investment allocation data from FY 2001 to 2024, from The Center for Retirement Research at Boston College shows a steady increase in exposure to alternative investments. ***In addition, more recently, growing public and legislative interest in cryptocurrency—particularly Bitcoin—has introduced a new layer of risk***. We touched on this concern as it relates to public entities' investment policy in our November 2024 report, Crypto Abstinence: Safeguarding Public Entity Credit Quality, Taxpayer and Public Funds by Avoiding Digital Illusions.

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Although current exposure to crypto remains minimal and appropriately constrained, a few state pension systems have made limited allocations to cryptocurrency-linked ETFs. Several states have also proposed legislation to expand such investments, according to Moody's Ratings. Given their volatility, speculative nature, and lack of underlying economic fundamentals, cryptocurrencies are fundamentally misaligned with the fiduciary standards and long-term obligations associated with the trust of public funds.

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Any increase in crypto allocations heightens volatility risk and poses a serious challenge to the prudent management of public funds. This emerging interest may signal a broader trend, and we are closely monitoring whether it parallels the rise in alternative investments over the past quarter-century.

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