U.S. Municipal Bond Market

The Municipal Bond Market's Post-Golden Age Realignment

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- **Municipal bond credit quality remains robust** despite the conclusion of federal stimulus programs. Key indicators—including housing market performance, state reserve levels, credit ratings, employment trends, and issuance activity—continue to reflect strength and stability as the sector transitions from the *Golden Age of Public Finance into the Post-Golden Age Realignment*.
- **Strong housing markets and near-record state reserves** remain foundational to fiscal health, offering reliable revenue streams and flexibility for structural adjustments as government credit conditions normalize.
- **Municipal credit upgrades continue to outpace downgrades**, driven by prudent deployment of federal aid, conservative budgeting practices, and improved pension funding. These factors highlight the sector's resilience as it enters the *Post-Golden Age Realignment*.
- **State and local employment growth and record-setting bond issuance** are often underappreciated indicators of fiscal strength. They reflect government confidence, ongoing infrastructure investment, and sustained investor demand in a municipal market that remains attractive.

Municipal Bond Credit Quality Remains Strong, Even as the Boom Fades

Between 2021 and 2024, many U.S. public entities, particularly state and local governments, experienced an unprecedented era of abundance. Massive federal aid, unexpected revenue growth (in the face of mounting uncertainty), and a surprisingly resilient economy did not just stabilize many public sector budgets; they elevated them to historic highs. Early in this period, I described what was to come as a Golden Age of Public Finance, a time defined by expansive, largely unencumbered fiscal policy, booming revenues, and exceptional credit conditions. That is what occurred.

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This environment laid the foundation for a notable, though temporary, improvement in municipal bond credit quality beginning in 2021, driven largely by unprecedented federal fiscal support. Four years later, that upswing is tapering, and credit conditions are gradually returning to more typical levels. As we enter the second half of 2025, however, the macroeconomic outlook remains uncertain and, in some respects, appears to be deteriorating. This is due in part to inconsistent tariff and immigration policies and their unforeseen, and in some cases overlooked, consequences.

Public Finance's Golden Age ended in January 2025. But this is not a crisis. This is not 2009. We are now in what I am calling the *Post-Golden Age Realignment*—a phase marked by credit normalization, and a bit of discovery, but not broad credit deterioration. While some investors and market observers have recently expressed concerns about weakening municipal credit fundamentals, the data tell a different story: public finance has emerged from the pandemic not weakened, but fundamentally stronger, more resilient, and hopefully more disciplined. Revenue growth is slowing. Budget surpluses are shrinking. Yet credit quality remains robust, even by historical standards. Despite the need for greater fiscal discipline or need to regain structural balance, the underlying fundamentals of the U.S. municipal bond market remain exceptionally strong. Some of the big picture indicators that are worth highlighting to prove this are as follows.

Housing Supports Government Credit Quality

The housing market remains one of the most important economic drivers for state and local governments, especially when it comes to credit quality. Across the country, housing continues to provide a reliable and often growing revenue base. Property taxes, tied directly to individual home values, are a meaningful and mostly stable source of revenue for local governments.

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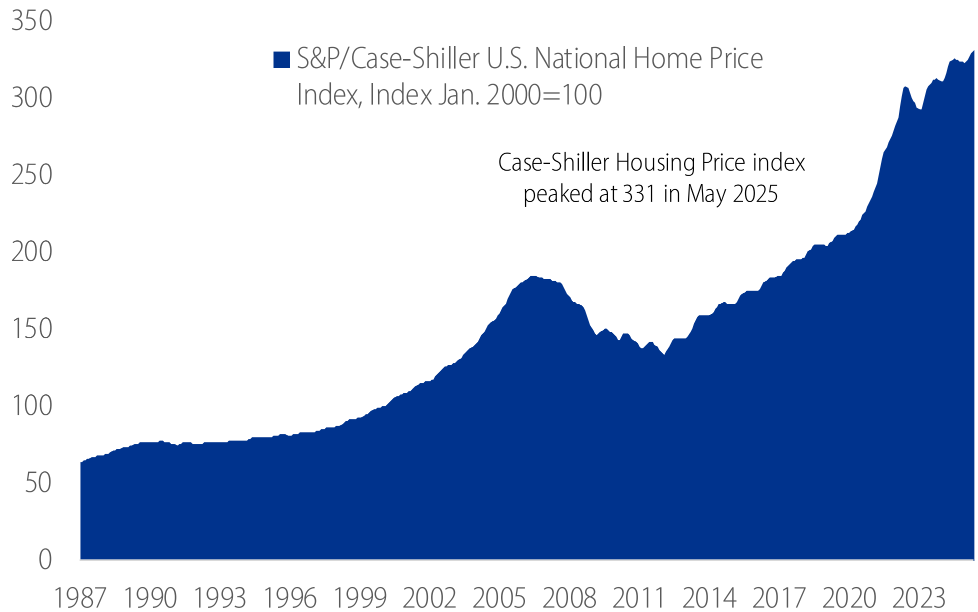
Unlike the post-2008 downturn, when falling home prices strained municipal budgets, today's housing market serves as a fiscal anchor. As of mid-2025, U.S. home prices are still more than 45 percent above 2019 levels, according to the S&P/Case-Shiller Index, despite higher mortgage rates. Limited inventory and steady household formation have helped sustain valuations and reinforce the strength of the property tax base.

Housing Market Values are Very Healthy



Source: FRED and HilltopSecurities.

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Affordability remains a concern. However, tight supply, steady demand, and high replacement costs continue to support assessed values. As federal pandemic aid phases out, state and local governments are increasingly relying on the stability of property tax revenue, which remains a cornerstone of local government finance.

Strong State Reserves

Yes, state balances are declining, but this trend should be viewed in context. According to the Spring 2025 National Association of State Budget Officers (NASBO) Fiscal Survey, total balances, which include rainy day funds and general fund ending balances, remain more than twice their highest levels before the COVID-19 pandemic, even after planned drawdowns.

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Many states continue to hold solid reserves. While some are drawing on these funds, many are maintaining or even increasing them in fiscal years 2025 and 2026. These reserves provide flexibility for structural adjustments, which will be critical during this period of credit normalization. According to NASBO's Spring 2025 Fiscal Survey of States, "General fund spending growth is expected to flatten in governors' budgets for fiscal 2026, reflecting fewer one-time expenditures from surplus funds and limited recuring spending increases."

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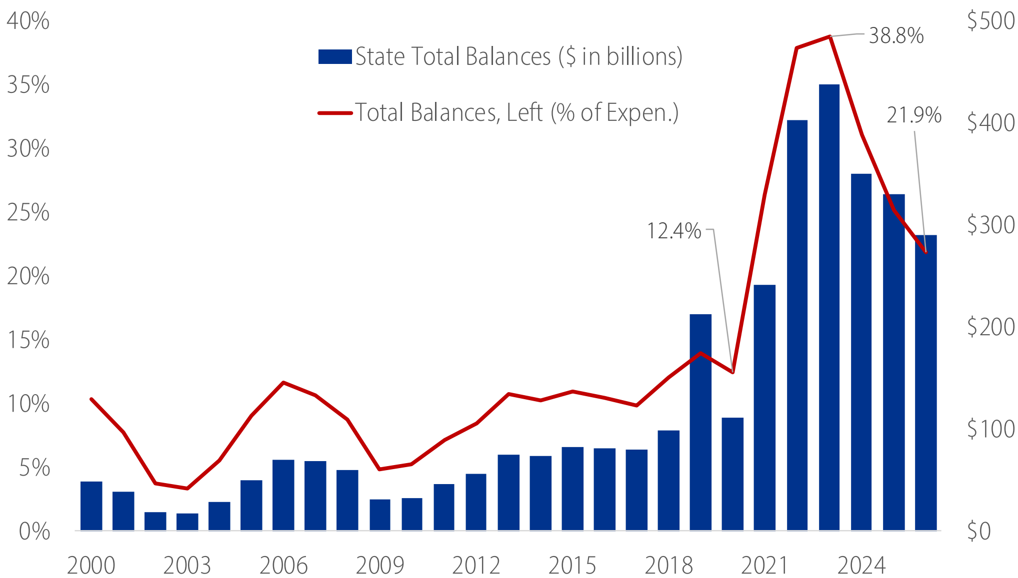
Realignment takes time, and strong reserves provide the foundation for that transition. This is not a retreat, but a strategic move toward normalization — a process where fiscal leadership must align recurring spending with recurring revenue. It reflects the kind of disciplined behavior municipal bond investors should welcome during the *Post-Golden Age Realignment*.

State Total Balances Remain Strong



Source: NASBO and HilltopSecurities.

Four Years of Net Credit Ratings Upgrades—And Counting

A strong endorsement of municipal bond credit quality comes from Moody's Ratings. Since 2021, Moody's has upgraded more municipal credits than it has downgraded every year. While the pace of upgrades has slowed, that's expected given the current economic backdrop and the realignment process we are expecting.

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Why are upgrades still outpacing downgrades? The 2021 federal aid is a leading reason in many cases. In addition, many governments continue to follow conservative budgeting practices adopted after the Great Recession. State and local governments also used federal aid prudently, usually for one-time expenditures. Going forward how they navigate the current credit normalization is a key theme we're watching in the *Post Golden-Age Realignment*.

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Public pension funding ratios have generally improved, supported by strong investment returns in 2023 and 2024. Adjusted net pension liabilities have declined by roughly 60% since their 2020 peak, driven by higher discount rates, solid market performance, and increased contributions. This trend has been broadly supportive of credit profiles and public finance ratings. This is much different that the period after the Great Recession when rising pension burdens stressed many state and local government balance sheets and crowded out other spending.

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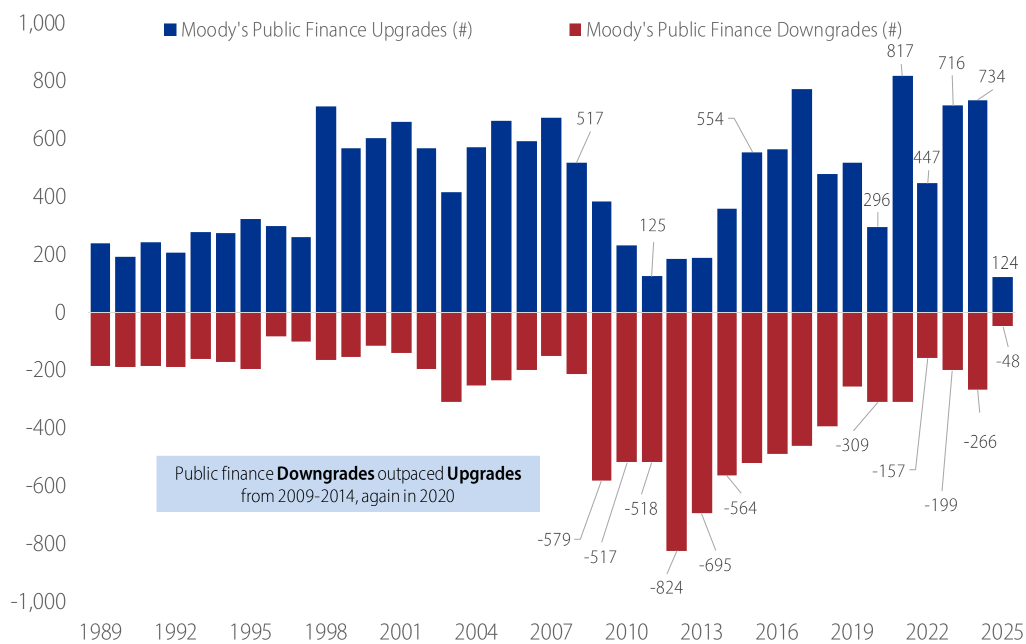
Everything is not perfect from a public finance ratings perspective. Some sectors are facing structural challenges. K–12 school districts continue to struggle with enrollment pressures, which led us to lower our sector credit outlook to "Cautious" from "Stable" in January 2025. Higher education is also under systemic strain, and downgrades have consistently outpaced upgrades in that sector, as we have previously noted.

Public Rating Upgrades Outpaced Downgrades For Four Straight Years



Source: Moody's Ratings and HilltopSecurities.

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Two Underrated Indicators of Strength

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State and Local Employment

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This trend reflects fiscal confidence. Governments typically expand payrolls only when supported by strong balance sheets and reliable revenue streams.

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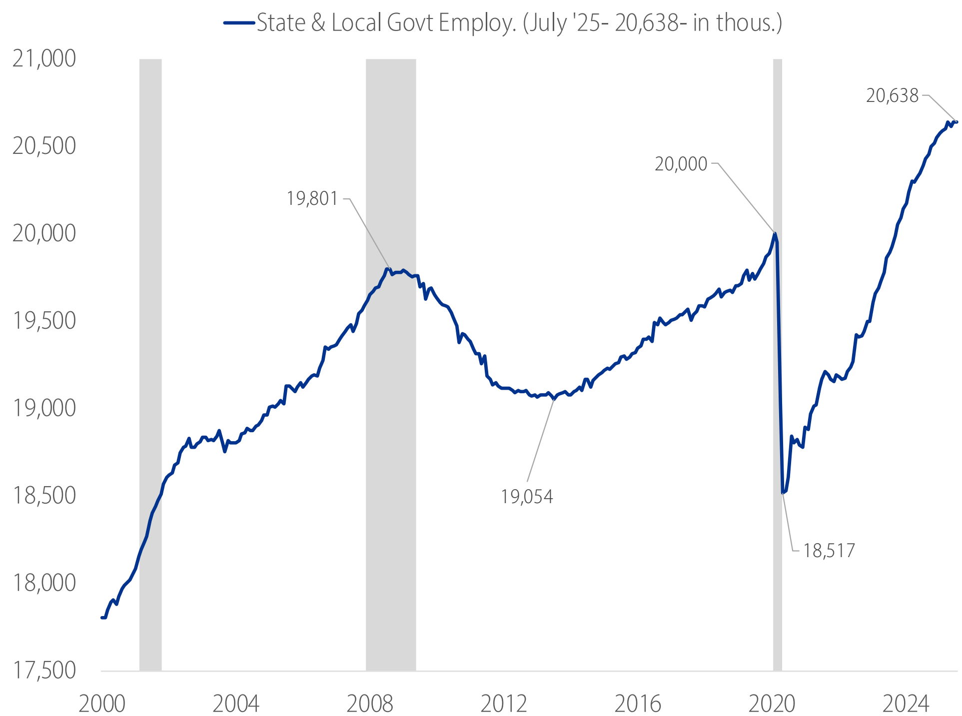
The rebound in public sector hiring is a positive signal for state and local credit quality. Because staffing decisions often trail revenue growth, this expansion suggests that many governments are not just stabilizing but operating from a position of strength. While not a leading indicator, sustained hiring reinforces the broader narrative of resilience and supports continued credit strength during the *Post–Golden Age Realignment*.

State and Local Employment Continues to Reach New Heights



Source: U.S. Bureau of Labor Statistics and HilltopSecurities.

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Record Bond Issuance

Municipal bond issuance set a record in 2024 with $508 billion in primary market volume. In 2025, issuance is running ahead of that pace, driven by a surge in new money bonds. The market is on track to exceed $535 billion this year.

Crucially, this is not crisis-driven borrowing. Much of the activity reflects infrastructure investment, not deficit financing. Issuers are locking in capital while balance sheets remain strong, and credit quality is near peak levels.

Investor demand has kept pace. The primary market remains unsaturated, and recent relative value indicators—especially on the long end—signal an attractive entry point for buyers. Please see more on this in our Aug. 4, 2025 report, Relative Value Remains Attractive as Economic Outlook Dims and Political Risks Rise.

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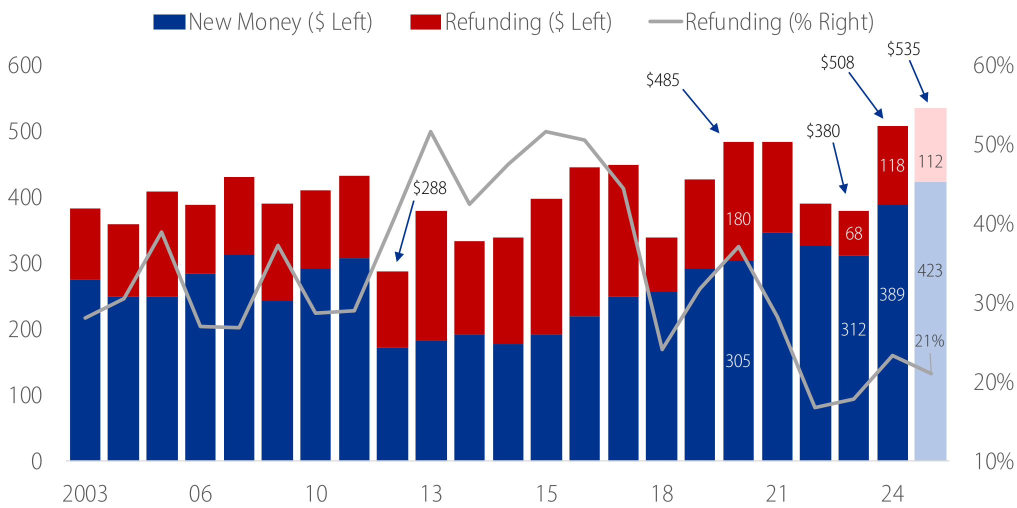
There Could Be Another Record Year of Municipal Bond Issuance in 2025



Source: Refinitiv and HilltopSecurities.

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Understanding the Credit Normalization Period: A Blueprint for Sustainable Fiscal Health

The *Post-Golden Age Realignment* is not a retreat—it's a strategic recalibration. As the era of federal stimulus winds down, governments must shift from abundance to discipline, anchoring budgets in today's economic fundamentals. This means adjusting revenue expectations, reassessing expanded services, and committing to long-term financial planning. The public finance sector is entering a more mature phase—less driven by aid, but far from fragile.

Governments are right-sizing operations and recalibrating policies to reflect a more sustainable environment.

Trend-level revenue growth and prudent reserve use are signs of fiscal strength, not weakness. Governments are right-sizing operations and recalibrating policies to reflect a more sustainable environment. Key indicators—employment, housing, reserves, and credit upgrades—remain strong, reinforcing that normalization is about stewardship, not retrenchment. Structural realignment is the path to lasting credit quality and resilience.

Still Investable. Still Resilient. Still Disciplined.

Municipal finance remains a compelling space for investors. With stable housing markets, strong reserves, and disciplined leadership, the sector continues to offer attractive opportunities. The real test is how governments perform without external aid—and many are rising to the challenge. *The Golden Age may be over, but the Realignment is leading into the next era of public finance.*

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Recent HilltopSecurities Municipal Commentary

- Relative Value Remains Attractive as Economic Outlook Dims and Political Risks Rise, August 4, 2025
- Risk and Fragile Stability Persist as Public Pension Momentum Slows in 2025, July 28, 2025
- Market Recalibration Ignites a Summer 2025 Municipal Bond Opportunity, July 21, 2025
- Manufacturing Revival Meets Economic Reality, July 17, 2025
- Infrastructure, Muni Investors, and Trump Score Big with the OBBBA, July 3, 2025

Readers may view all of the HilltopSecurities Municipal Commentary here.