U.S. Municipal Bond Market

Fed Signals September Shift and Tax Threat Resurfaces

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- ***A September rate cut appears increasingly likely*** after Fed Chair Powell signaled a shift in policy and acknowledged rising economic risks.
- Municipal bonds still offer ***attractive yields and strong relative value***, reinforcing urgency to act before the Fed moves and the opportunity fades.
- While not under immediate threat, the municipal bond tax-exemption—recently reaffirmed in the One Big, Beautiful Bill Act—is ***once again facing scrutiny***. A new memo from the Economic Policy Innovation Center calls for its repeal, signaling potential future challenges for infrastructure financing. This development underscores the importance of continued vigilance and proactive advocacy.

September Rate Cut Now Highly Likely

Mounting macroeconomic and labor market weakness has been pointing toward a potential FOMC rate cut in September. Last week's developments—especially Fed Chair Jerome Powell's dovish remarks—added further weight to that outlook. Generationally attractive tax-exempt yields may continue to fall, potentially closing one of the most compelling municipal bond buying windows in years.

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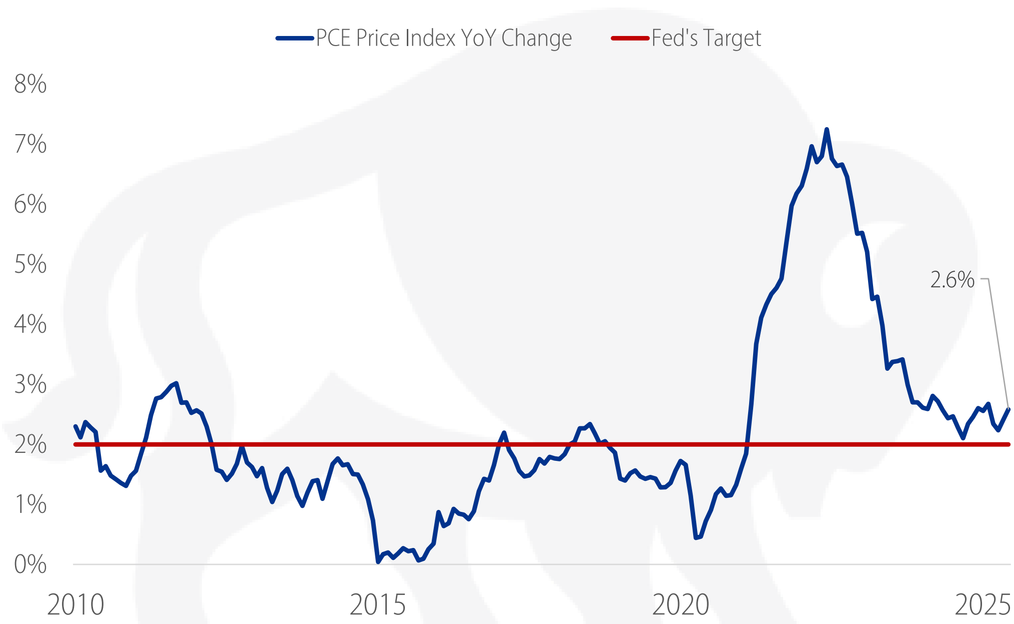
PCE Price Index, change from a year earlier



Source: Bureau of Economic Analysis and HilltopSecurities.

The probability of a rate cut at the September 16–17 FOMC meeting surged Friday after Powell signaled a shift in tone, stating: "The baseline outlook and shifting risks may warrant adjusting our policy stance."

He also announced the end of the COVID-era "flexible average inflation targeting" (FAIT) framework and acknowledged that "the effects of tariffs on consumer prices are now clearly visible." Markets responded swiftly: equities rallied, and fixed-income yields declined, reflecting rising expectations of monetary easing—though some modest retracement is occurring this Monday morning.

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Looking ahead, the Fed has three more meetings in 2025:

- September 16-17
- October 28–29
- December 9–10

While a September cut now appears highly probable, future moves remain data dependent. As Hilltop's Scott McIntyre and Greg Warner noted Friday: "A September cut is a near certainty, but future incoming data will determine the degree and magnitude of future policy." Three weeks ago, in our August 4 commentary, Relative Value Remains Attractive as Economic Outlook Dims and Political Risks Rise, we urged investors to take advantage of historically high tax-exempt yields. That call is even more urgent today.

Tax-Exempt Yields Still Attractive, But Trending Lower

Since mid-July, the Bloomberg Municipal Bond Index has dropped 17 basis points—and 57 basis points since mid-April—reinforcing our view that declining yields could define the remainder of the year. With economic uncertainty rising and political risks intensifying, high-quality municipal bonds continue to offer strong relative value.

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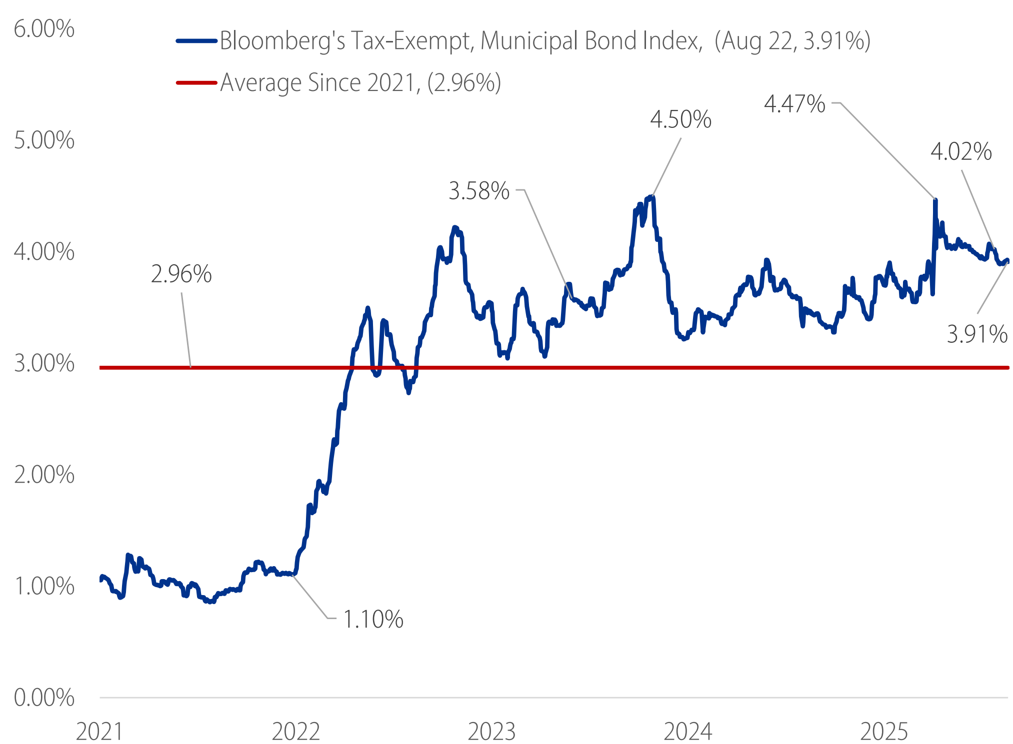
Tax-Exempt Yields Continue to Slowly Drop



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Now is the time to act—before the ship leaves the port.

Tax-Exemption Threat Re-Emerges

The next chapter in the fight to protect infrastructure financing is already unfolding—and Congress hasn't even reconvened. The municipal bond tax-exemption, preserved in the landmark One Big, Beautiful Bill Act (OBBBA), is once again under threat.

On August 18, the Economic Policy Innovation Center (EPIC), led by economist Paul Winfree, formerly of The Heritage Foundation, released a memo titled Seizing the Reconciliation 2.0 Opportunity to Build on the Wins of the One Big Beautiful Bill. Buried in the document is a call to repeal the municipal bond tax-exemption—an alarming signal for U.S. infrastructure finance and the public finance community.

Though still gaining traction, EPIC's influence is growing. Their proposal hints that the stability secured in the One Big, Beautiful Bill Act (OBBBA) may be short-lived.

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Passed just before July 4th, the OBBBA reaffirmed the federal tax-exempt status of both governmental purpose and private activity bonds—a major win for infrastructure, housing, energy, water and various other infrastructure projects nationwide. This outcome was far from certain. Early drafts floated eliminating or scaling back the exemption as a revenue offset, and the all-Republican Congress added to the uncertainty.

A broad coalition helped preserve the exemption. Key advocacy came from select lawmakers, the Government Finance Officers Association, Bond Dealers of America, American Securities Association, SIFMA, and the American Society of Civil Engineers. Academic voices also played a role: the University of Chicago's Harris School of Public Policy and UT Austin's LBJ School co-authored a policy brief on the exemption's history and future, while the Harris School published a dataset mapping bond activity by congressional district.

These efforts reinforced the U.S. municipal bond market's critical role in financing America's infrastructure.

But the threat is back. As Congress eyes a potential Reconciliation 2.0, deficit pressures and shifting political winds could again put the exemption on the chopping block. That it's being floated as a pay-for in a hypothetical bill underscores just how fragile its future remains.

We have said and written this before: ***the tax exemption is not safe***. The fight to protect it should begin again—sooner than expected and hoped.

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Recent HilltopSecurities Municipal Commentary

- The Municipal Bond Market's Post-Golden Age Realignment, August 12, 2025
- 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.