U.S. Municipal Bond Market

The Municipal Bond "Moment" Persists—But Cracks Are Forming

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- Municipal bond yields remain at generationally attractive levels, hovering near their mid-September levels. Investor demand continues to be robust, with nearly $8 billion flowing into municipal bond mutual funds since mid-August—underscoring confidence in the asset class amid a cloudy economic landscape.
- A range of emerging risks is amplifying market uncertainty and revealing signs of labor market weakness. While some indicators point to economic deceleration and suggest further rate cuts ahead, overall growth expectations remain relatively solid despite these warning signals.
- October's robust primary market municipal bond issuance calendar presents a compelling opportunity for municipal investors, with abundant supply creating favorable entry points. Delaying until November or December could mean contending with declining rates, intensifying demand, and tightening supply conditions.

The Moment is Still Here

Last week, we highlighted that municipal bonds were having a moment—and that remains true as we begin the first full week of October. Tax-exempt yields continue to hold near their mid-September levels, offering compelling relative value compared to the late-September lows. The Bloomberg Municipal Bond Index, a proxy for tax-exempt yields, **closed at 3.64% on Friday, up 10 basis points** from a recent low of 3.54% on Sept. 17, underscoring the attractive entry point currently available in the market at this "moment".

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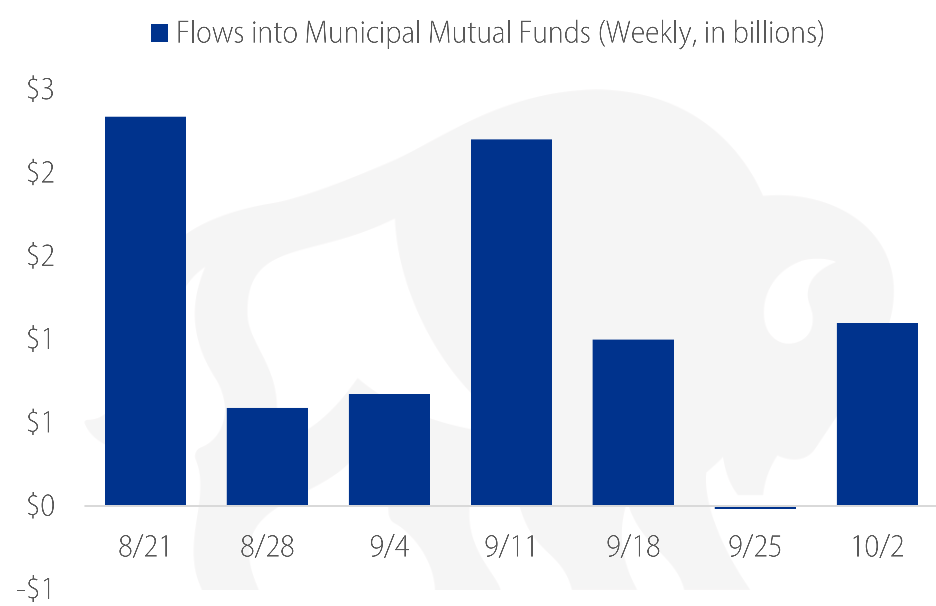
Municipal Mutual Fund Inflows Approach $8 billion Amid Market Momentum



Source: Lipper and HilltopSecurities.

Investor demand for municipal bonds continues to surge, just as anticipated. According to Lipper data released Thursday, Oct. 2, about $1 billion flowed into municipal mutual funds last week, bringing total inflows since mid-August to nearly $8 billion. This momentum aligns with our expectation for a heavy October issuance calendar, likely exceeding $50 billion, and well above the monthly average for the year and reinforcing our projection that 2025 is on track to set another record for municipal supply.

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For investors, the current environment presents a compelling opportunity: attractive tax-adjusted yields, resilient credit fundamentals, and heavy supply make municipals one of the most favorable segments in fixed income. However, this window may not remain open for long. Cracks are beginning to form in the opportunity, suggesting that the current window is closing.

Why Yields Could Begin to Fall Again Soon

Despite some perceived resilience in the broader macro-economic landscape, the backdrop is beginning to shift. Several emerging factors, including softening labor market data and slowing consumer momentum, suggest renewed downward pressure on yields. This is what we are seeing:

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- **Labor Market Weakness Deepens**: The labor market seems to be key to the Fed's mandate. Signals are telling us the labor market is weakening. The latest ADP report showed the U.S. private sector shed 32,000 jobs in September, defying expectations for growth and signaling a sharp slowdown in hiring. Jobless claims have surged to the highest since October 2021. August's non-farm payroll data was weak. We saw August's nonfarm payrolls increase by just 22,000, well below the 75,000-consensus forecast, underscoring fragility in employment trends.

- **Government Shutdown Adds Uncertainty**: The federal shutdown has delayed key economic data releases, including the September jobs report. This lack of visibility amplifies uncertainty for markets and policymakers. Federal layoffs could also complicate the weakening labor and consumer spending picture we highlighted above as well.

- **Fed Poised for More Cuts**: After September's 25 bp cut, markets are now pricing in a 100% probability of another cut at the October FOMC meeting and an 88% chance of one more in December. The Fed's own dot plot projects two additional cuts this year.

Implications for Municipal Investors

The takeaway: current tax-exempt yield levels are unlikely to last. This has been a common theme of ours for some time, but it is worth reiterating because of the circumstances. As the Fed cuts rates and economic uncertainty or its negative performance deepens, municipal yields will likely decline from here. When that happens, price appreciation will also favor those who acted early.

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Key Considerations to Take Advantage of This "Moment"

1. **Act Before Supply Tightens**: October's surge in new issuance presents a timely opportunity. However, supply is expected to slow in November and December, which means competition for high-quality bonds will likely increase.

2. **We Expect Demand (Competition) to Continue to Rise**: More than $1 billion flowed into municipal mutual funds last week alone, bringing total inflows to nearly $8 billion since mid-August. With trillions still parked in money market and other short-term investments, many investors are seeking longer-term yield options before rates fall further.

3. **Credit Fundamentals Remain Strong**: Property tax revenues are supported by rising home values, and overall municipal credit stability persists. However, sector-specific challenges—such as rising K-12 downgrades—require selective positioning.

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Bottom Line

The "moment" we highlighted last week is still here—but it's fragile. Economic cracks are widening, and the Fed is signaling more cuts. Investors who wait for perfect clarity risk "missing the boat" on today's rare combination of still generationally attractive tax-exempt yields and strong credit fundamentals. Investors need to stay proactive. Look to lock in these attractive tax-exempt yields now and prepare for a market where competition for quality bonds will only grow in the last two months of the year.

Recent HilltopSecurities Municipal Commentary

- Intro to the New Era of AI, Infrastructure & Growth, September 18, 2025
- From Budget Issues to Labor Challenges: Insights from the HilltopSecurities 2025 Public Finance Leaders Survey, September 15, 2025
- Labor Pains, Rate Gains, and Why Muni Investors Can't Wait, September 8, 2025
- Fed Signals September Shift and Tax Threat Resurfaces, August 25, 2025
- The Municipal Bond Market's Post-Golden Age Realignment, August 12, 2025

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Readers may view all of the HilltopSecurities Municipal Commentary here.