U.S. Municipal Bond Market

The Return of Higher Yields Rewards Investors and Tests Borrowers

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Summary

- Higher yields offer greater income opportunities for fixed-income and municipal bond investors who are ready to put new investment dollars to work.
- Higher yields also mean higher borrowing costs which could slow consumer spending, business investment, housing activity, and hiring. Those effects could weaken tax revenue growth and pressure municipal credit. Therefore, higher yields make disciplined credit selection even more important.
- State and local governments and other public entities must now finance infrastructure in a more expensive market. Higher borrowing costs may force them to scale back projects, find additional revenue, or delay investments that could become more expensive over time.

From 1981 to the Summer of 2020

The decline in U.S. interest rates began during the inflation crisis of 1981, when the Federal Reserve under Paul Volcker fought entrenched inflation and the 10-year Treasury yield approached 16%. Nearly four decades later, during the first summer of the COVID crisis, the yield fell to roughly 0.5%. Likewise, the 10-year AAA MMD yield peaked at 11.50% in 1981 and bottomed out at 0.58% in the summer of 2020.

There is no universally accepted definition of a bull or bear market in bonds. Equities have a widely used benchmark. An equity bear market is generally defined as a decline of at least 20% from a recent high, while a bull market is commonly associated with a rise of at least 20%. Long-term bond cycles are more often identified through sustained movements in interest rates.

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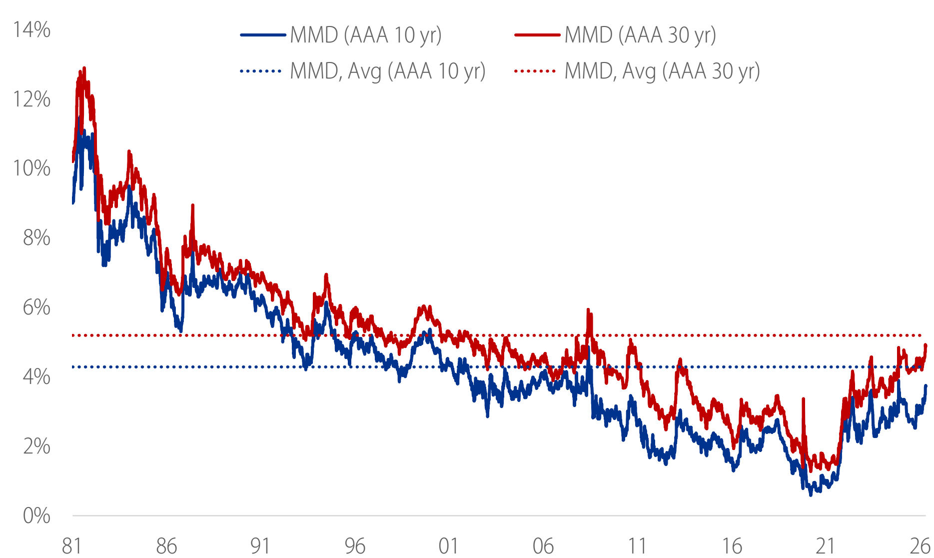
Higher Municipal Yields Return After Four Decades of Decline



Source: Refinitiv and HilltopSecurities.

Higher Yields Bring Uneven Consequences

Investors and observers can debate whether a new bond bear market has begun. There should be less debate about the practical consequences of higher yields. The effects on investors, the broader economy, and the public sector will not be evenly distributed.

Credible fiscal changes could ease investor concerns, but inflation, economic growth, monetary policy, Treasury supply, and other forces also affect yields.

For the Federal Debt and Policymakers

Stanley Druckenmiller captured the scale of the policy challenge facing federal officials and the public in his Wall Street Journal commentary, Let the Bond Market Speak. Druckenmiller criticized efforts to suppress long-term Treasury yields through expanded buybacks, arguing that federal officials risked interfering with signals from a functioning market.

The broader fiscal consequence is that federal debt maturing in a higher-rate environment will likely be refinanced at greater cost. Interest payments could then consume more of the federal budget, leaving less capacity for other priorities. Credible fiscal changes could ease investor concerns, but inflation, economic growth, monetary policy, Treasury supply, and other forces also affect yields. We examined how mounting federal debt could affect infrastructure and public finance in How $40 Trillion of Federal Debt Could Reach U.S. Infrastructure and Public Finance.

For Investors

For fixed-income and municipal bond investors putting new money to work, higher yields can create opportunity, particularly in the tax-exempt municipal market. We wrote about that opportunity last week in The Bond Market Selloff Is Making Attractive M/T Ratios the New Municipal Opportunity of 2026. **This opportunity remains.** Municipal to Treasury ratios (M/T ratios) remain attractive, but credit selection has become more important, especially in the K-12 education, higher education, and health-care sectors.

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Rising rates strengthen the case for even closer credit analysis. It has been decades since many public entities have had to finance capital projects in a persistently higher-rate environment. Some borrowers have the financial capacity, revenue flexibility, and management discipline to adjust. Others are less prepared, so this is an important potential pressure to watch going forward.

Higher Borrowing Costs Reach the Economy

Higher rates are intended to change economic behavior. That was one reason the Federal Open Market Committee (FOMC) raised its target rate by 25 basis points last week. Inflation has remained above target, while financial conditions have been more accommodative than what monetary policymakers would prefer (see the line chart on page two).

Higher borrowing costs reach consumers and households through mortgages, auto loans, credit cards, and other forms of credit. Homeowners with existing fixed-rate mortgages generally retain their current payments, while first-time homebuyers and other new borrowers face prevailing rates. As debt payments consume more income, households have less money available for other purchases.

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Businesses may postpone investment or hiring as financing becomes more expensive. Higher mortgage rates could further weaken housing demand, while higher financing costs can slow construction and limit new housing supply. Over time, weaker spending, investment, and employment growth could restrain state and local tax revenue and place pressure on municipal credit.

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Higher yields therefore offer investors greater income while also testing economic activity and the fiscal capacity of public entities.

Higher Rates Could Mean Harder Infrastructure Choices

Higher rates increase the cost of financing schools, roads, water and sewer systems, and other public assets. For state and local governments and other public entities, higher borrowing costs can mean less infrastructure for the same amount of debt capacity.

Public entities facing higher borrowing costs could:

- Absorb the additional cost
- Raise taxes, fees, or other revenue
- Reduce the scope of the project
- Postpone the infrastructure investment

Each potential choice carries a cost. Reducing a project's scope may leave a sponsor without the capacity or infrastructure it needs. Raising taxes, fees, or user charges may be difficult. Delaying the investment could preserve near-term budget flexibility, but it could also increase construction and deferred maintenance costs while residents and businesses wait longer for needed infrastructure.

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Recent HilltopSecurities Municipal Commentary

- The Bond Market Selloff Is Making Attractive M/T Ratios the New Municipal Opportunity of 2026, September 14, 2026
- Warsh Calls on the Fed to Meet the Moment as Rate Hike Odds and Municipal Yields Rise, September 2, 2026
- The Market Thought Lower Rates Were Coming, August 27, 2026
- How $40 Trillion of Federal Debt Could Reach U.S. Infrastructure and Public Finance, August 20, 2026
- The Transition from Credit Momentum to Credit Selection, Public Finance Enters a More Demanding Phase, August 18, 2026

Readers may view all of the HilltopSecurities Municipal Commentary here.