Market Insights

As of April 23, 2025

Municipal Market: Near-Term Volatility May Present Long-Term Opportunity

April has been quite a month so far, as evidenced by these Bloomberg headlines.

- Muni Bonds Jump on Haven Rally After Trump Tariffs Hit Markets (4/3/2025)
- Municipal Bonds Extend Rally as Investors Seek Tariff Haven (4/4/2025)
- Muni Rout Drags on After Market Sees Worst Day in 31 Years (4/8/2025)
- Muni Bond Rout Deepens Even More as Investors Panic Sell (4/9/2025)
- Munis Stage Biggest Rally Since 2020 After Trump Tariff U-Turn (4/10/2025)

Following a safe-haven rally in early April, tariff uncertainty spread to the municipal bond market, sparking levels of volatility not seen since March 2020. Historically, March and April tend to be challenging for municipal returns due to unfavorable technicals driven by lower reinvestment capital and tax-related selling. The tariffs announcement worsened an already unfavorable environment, and rates sharply sold off, driven mainly by

- greater uncertainty
- potential for higher inflation
- increased selling (particularly municipal ETFs) due to redemptions
- ongoing review of the tax exemption on municipal securities
- the risk of funding cuts, which might negatively impact certain municipal sectors

This turbulent environment resulted in the worst week (April 7) of performance for investment-grade and high-yield municipal bonds since March 2020.[1] While uncertainty is by nature unsettling, we believe that volatility can offer opportunity for long-term investors. Let's examine the potential opportunity with municipals and why the long-term outlook is positive to us.

Yields are historically high

Municipals are typically sought by investors for their quality and income, and yields are now historically high. As of April 18, the yield of the investment-grade municipal market was 4.14%,[2] significantly higher than the 10-year average of 2.44%. Even more impressive, on a tax-equivalent basis, the yield rises to 6.57% at the 37% federal tax rate, or 5.59% at the 24% federal tax rate. For comparison, the yield of the investment-grade corporate market was 5.34% prior to the impact of taxes.[3] Not only do municipal bonds potentially offer a higher yield on a tax-equivalent basis, but they also offer higher credit quality.

Fundamentals are generally strong

While the lack of policy clarity and the implementation of tariffs are likely to be growth-depleting if sustained, municipal fundamentals are entering this period in a position of strength. Municipal borrowers have benefited from years of economic growth and resulting increases in tax revenues, property valuations and debt service coverage while exercising the discipline to build balance sheet reserves. Active management and selection are likely to increase in importance as a slowing economy would impact the most vulnerable borrowers, and potential cuts to federal funding may be aimed at certain sub-sectors or individual borrowers, requiring operational adjustments. The strong starting point of municipal fundamentals, however, may help ensure credit quality broadly remains intact, and our analysts remain focused on identifying issuers with favorable through-cycle fundamental performance.

Inflows should return

Historically, municipal flows have been highly correlated with volatility and returns. The initial 10 weeks of 2025 saw strong demand, which followed a period of relatively low volatility and strong returns. Then, volatility spiked and returns turned negative, spurring six consecutive weeks of outflows through April 17. Periods of extreme volatility are very challenging when they happen but tend to be short lived. We believe, as economic and tax policies are clarified, stability and inflows should return as investors refocus on the relatively attractive levels of yield and solid fundamentals of the municipal asset class.

What to consider

So where does this volatility leave us? During moments of panic, the market has tended to overshoot. We believe this current period of volatility, which has caused a spike in yields, may offer a very attractive entry point for long-term investors. However, as mentioned above, selectivity is critical.

To see where MFS is finding opportunity in the municipal market, contact your MFS sales representative.

Endnotes

[1] Source: Bloomberg PORT. Yield-to-worst (YTW). The investment-grade municipal market is represented by the Bloomberg Municipal Bond Index.

[2] Source: Bloomberg PORT. Yield-to-worst (YTW). The investment-grade municipal market is represented by the Bloomberg Municipal Bond Index.

[3] Source: Bloomberg PORT. Yield-to-worst (YTW). The investment-grade corporate market is represented by the Bloomberg US Corporate Bond Index.

Investments in municipal instruments can be volatile and significantly affected by adverse tax or court rulings, legislative or political changes, market and economic conditions, issuer, industry-specific (including the credit quality of municipal insurers), and other conditions. Because many municipal instruments are issued to finance similar projects, conditions in certain industries can significantly affect the portfolio and the overall municipal market.

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