

It's prime time to consider municipal bonds

July 8, 2025 | Shannon Rinehart, CFA, Senior Municipal Portfolio Manager; William (Bill) L. Callagy, Senior Municipal Portfolio Manager

Focus on opportunities driven by decade high yields and strong fundamentals.



After a challenging start to the year, the municipal bond market is showing signs of a turnaround. A confluence of technical, seasonal and legislative factors is creating what we believe is an attractive entry point for investors seeking high-quality income. Municipal credit quality remains robust and tax-equivalent yields are near 15-year highs. We explore the dynamics shaping the market and identify opportunities with compelling yield that are supported by strong fundamentals.

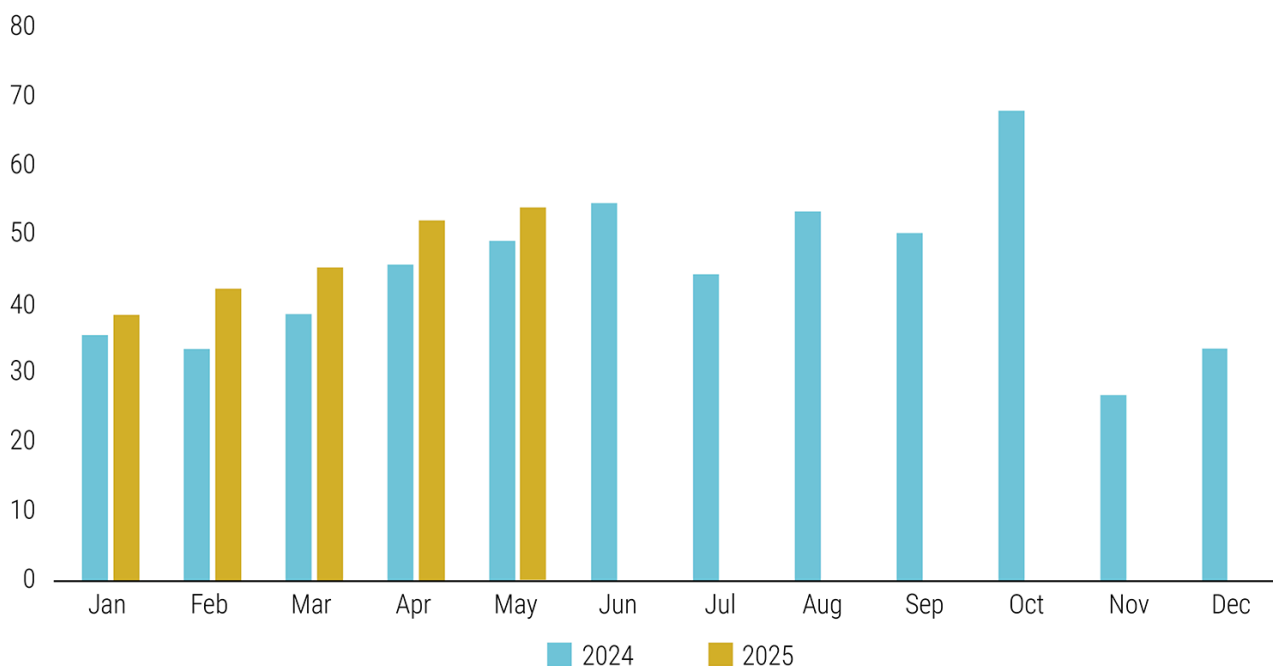
A technically driven sell-off, not a structural weakness

Municipal bonds have lagged so far in 2025, but the reasons are largely technical (supply/demand dynamics) rather than fundamental. A surge in issuance – up over 15% year over year and 55% higher than the 10-year average – was largely driven by fears over potential changes to federal funding and the tax-exempt status of municipal bonds. While the full elimination of the municipal tax exemption was viewed as unlikely, issuers of private activity bonds faced outsized pressures. The assumption was that any changes to the tax-exempt status would be on a go-forward basis and issuers in these segments could face higher borrowing costs in the future. These concerns created a pull-forward of supply as issuers rushed to market to retain their favorable tax treatment.

After months of political whiplash, municipal policy fears have largely abated. While the proposed One, Big, Beautiful Bill generated a lot of headlines, the municipal market was left largely unscathed. The most disruptive elements feared by the municipal market – such as the elimination of the tax exemption and a significant reduction of support for state and local governments – are unlikely to materialize. This has reduced the urgency for municipalities to issue debt and has helped stabilize the market.

Policy uncertainty drove a surge in issuance

Monthly muni gross issuance (\$ billions)



Source: Barclays, as of June 24, 2025.

Moreover, the summer months are historically favorable for municipal bonds due to the seasonality of principal and interest payments, which lead to stronger demand. In June, bond maturities are expected to total \$30 billion, with an additional \$12 billion in coupon payments. Much of this capital is poised to be reinvested, creating a strong demand tailwind. This seasonal reinvestment cycle typically contributes to stronger performance and reduced volatility in the market.

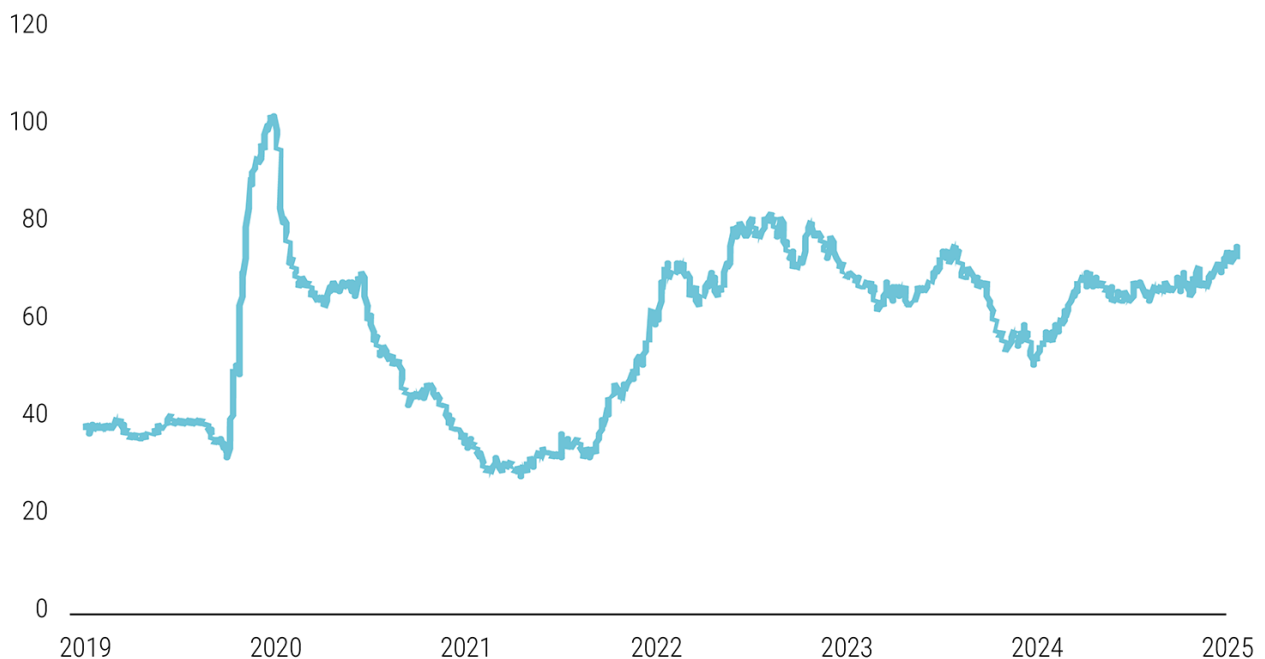
The legislative fog lifts, clearing the way for munis

The political landscape, while initially a source of volatility, is starting to provide more clarity. The Senate has moved in sync with the House on key provisions impacting the municipal bond market. One element of focus for our portfolios has been the permanent extension of the Alternative Minimum Tax (AMT) exemption that was temporarily enacted by the 2017 Tax Cuts and Job Acts (TCJA).

While many ETFs avoid AMT paper due to structural constraints, active managers can capitalize on the yield premium – currently 65 to 75 basis points (bps) over comparable non-AMT bonds. The TCJA significantly reduced the number of taxpayers subject to AMT from about five million to 200,000, which increased the demand base for AMT paper. Spreads on bonds subject to AMT have recently widened due to concerns that the expiration of TCJA at the end of 2025 would lead to more investors subject to AMT and, as a result, less demand for AMT issuance. Our view is that the risk of a demand drop-off for AMT bonds is being generously compensated and is a unique opportunity for yield enhancement that is not dependent upon going down in credit quality.

Active managers can capitalize on the yield premium of AMT bonds

AMT vs. non-AMT bonds (basis points)



Source: Bloomberg L.P. and Columbia Threadneedle Investments, as of May 30, 2025. Past performance is no guarantee of future results.

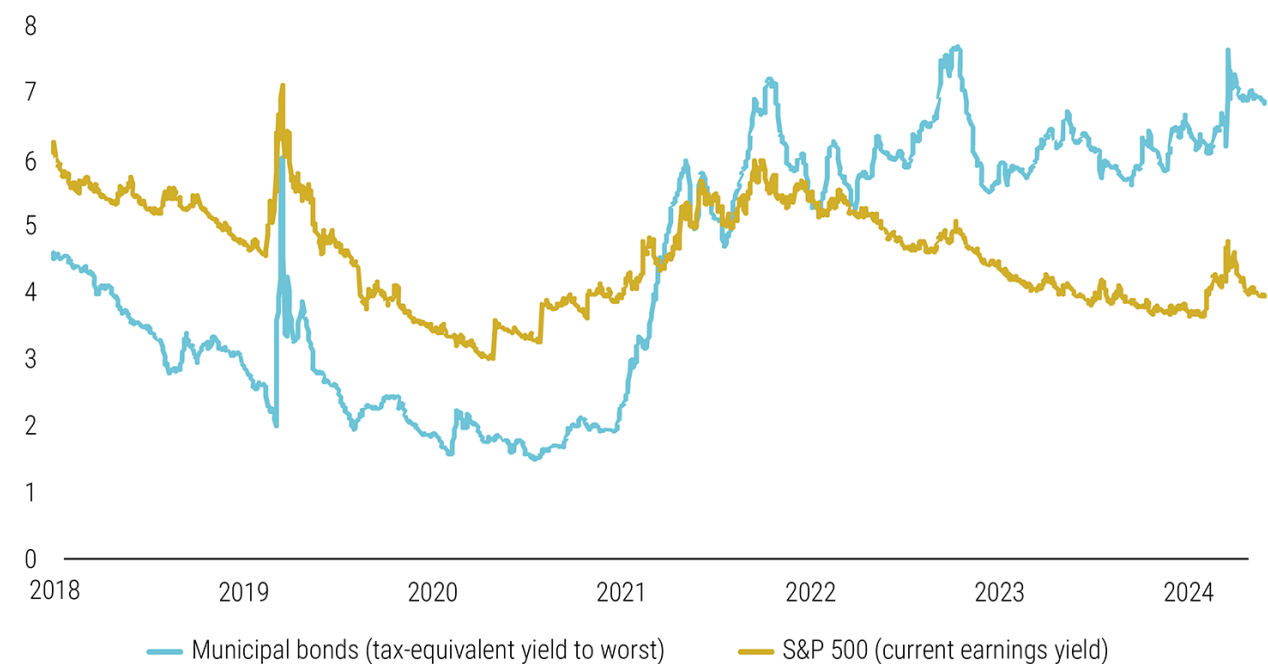
The proposed tax legislation also includes changes to the state and local tax (SALT) deduction and higher taxes on endowments and private foundations. While increasing the SALT deduction could reduce demand for municipal bonds in some cases, the impact is expected to be limited. The deduction phases out in the top tax brackets who own the bulk of tax-exempts. Our expectation is that strong demand will continue, particularly for bonds issued in higher tax states like California and New York.

Compelling yield advantage (even relative to equity)

Perhaps the most compelling reason to consider municipal bonds today is the yield environment. Tax-equivalent yields on high-quality munis are now higher than the earnings yield on the S&P 500. The steep yield curve offers a substantial yield pick-up in the intermediate and long portions of the curve. For example, the longer maturity (10–30 year) yield slope is 120 bps wider than its 10-year average.

Munis offer compelling yield advantage versus equities

(%)



Source: Bloomberg L.P., as of June 24, 2025. Municipal bonds are represented by the Bloomberg Municipal Bond Index. It is not possible to invest directly in an index. Tax-equivalent yield (TEY) is calculated using a 40.8% tax bracket, which includes a 37.0% top federal marginal income tax rate and the 3.8% net investment income tax to fund Medicare. Actual tax rates may vary based on individual circumstances. The TEY does not account for state or local taxes, the Alternative Minimum Tax (AMT), or other tax considerations. Past performance is no guarantee of future results.

Active management and research drive opportunities

The current environment underscores the critical role of research and active management in the municipal bond market. While volatility around April's "Liberation Day" saw massive ETF outflows, we adopted a disciplined approach, deploying cash across the muni market, targeting high-quality bonds that were being indiscriminately sold below their fundamental value.

With spreads tight and volatility elevated, the ability to identify value through rigorous credit analysis is more important than ever:

- **Health care.** In the health care sector, we are selectively investing in hospital systems with dominant market positions, strong financials and favorable payer mixes.
- **Continuing care retirement community (CCRC).** In the CCRC space, demographic tailwinds and stable home prices are creating opportunities.
- **Higher education.** In higher education, headline risks have caused some spread widening, but the underlying credit quality of top institutions remains strong.

The bottom line

Municipal bonds are currently offering attractive tax-adjusted yields that are backed by strong fundamentals. With the easing of policy uncertainty and favorable seasonal conditions, this could represent an attractive entry point for investors seeking high-quality, tax-advantaged income to increase their allocation to municipal bonds within a well-diversified portfolio.

SENIOR MUNICIPAL PORTFOLIO MANAGER**Shannon Rinehart, CFA**

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