

Municipal Tax-Free Income Update

Commentary | June 30, 2025

Market review

The municipal (muni) bond market, as measured by the Bloomberg Municipal Bond Index,¹ posted a return of -0.12% for the second quarter of 2025 (Q2). After suffering losses in April, the muni bond market recovered as investors returned to the sector following progress on President Donald Trump's "One Big Beautiful Bill" spending package that affirmed the tax-exempt status of muni bonds. In the US, first quarter 2025 gross domestic product (GDP) contracted by 0.5%, but this was fully attributed to an increase in imports (a drag on GDP growth) as businesses pulled forward supply ahead of increased tariffs. The benchmark 10-year US Treasury yield moved two basis points higher, finishing the quarter at 4.23%.

Outlook & Strategy

Muni bond valuations are still attractive. Despite positive returns in the past two months, munis still lag other fixed income sectors year-to-date. This is not surprising given that munis historically are more stable than the rest of the fixed income sectors and lack the day-to-day volatility seen in other asset classes. Current absolute and relative yields continue to offer investors opportunities.

Strong tailwinds from favorable technical conditions continue to be a major support for the sectors. Maturity and coupon payments will increase in June and July, and that money will need to be invested. This will be met with lower issuance as the pull forward effect will limit overall net new issuance over the next few months.

Muni fundamentals remain strong. Expectations are that tax receipts—income, and sales taxes—will moderate as they are susceptible to a slowing US economy. Our base case is for a modest slowing of the US economy, but this will not be uniform. Changes to US government spending will disproportionately affect those states and local general obligation issuers with a higher concentration of federal government revenue. Areas with large government employment could also see economic contraction. While we see this as manageable for most issuers, we are keeping a close eye on issuers with high concentrations to government outlays. The need for strong credit research cannot be overstated. Even issuance from the same legal entity may not have identical credit profiles due to the call on assets and cash flows. Our dedicated research department has decades of experience managing multiple economic cycles. Their unique insights are important to every stage of our muni bond investment process including sector and issuer selection and risk management.

¹ The **Bloomberg Municipal Bond Index** is a broad measure of the municipal bond market with maturities of at least one year. Source: Bloomberg Indices. Important data provider notices and terms available at www.franklintempletondatasources.com. All data is subject to change.

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