FRANKLIN TEMPLETON

Municipal Bond Market

Q3 2025

Market Review

- The municipal (muni) bond market, as measured by the Bloomberg Municipal Bond Index, posted a return of 3.00% for the third quarter of 2025 (Q3). After suffering losses in July, the muni bond market picked up momentum and delivered the strongest return of the year in September. In the United States, gains were driven by greater clarity on tariff policy, a resilient economy and a more dovish US Federal Reserve (Fed). Early in the quarter, the United States reached trade deals with the United Kingdom, European Union and Japan, while extending tariff negotiations with China. Although Q2's gross domestic product growth was strong—fueled by consumer spending—the job market slowed during Q3. In September, the Fed cut rates by 25 basis points (bps) to 4.00% to 4.25%, with projections suggesting two more cuts by year end. The benchmark 10-year US Treasury yield fell by eight bps to 4.15%.

Outlook

- Muni bond valuations continue to appear 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. Muni bond issuance exceeded historical averages in Q3 as issuers, who had been reluctant to issue new bonds under the looming threat to their tax-exempt status, came to market. Positive fund flows into the asset class were not able to keep up with the supply. The muni bond yield curve continues to steepen with longer-maturity bond valuations cheapening somewhat.

- Muni fundamentals remain broadly stable, however, as the economy slows and inflationary pressures ease, tax revenue growth at the state and local level is expected to moderate, placing greater importance on credit selectivity going forward. Our base case is for a modest slowing of the US economy, but this will not be uniform. Changes to US government spending will disproportionally 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 issuances 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 distinctive insights are important to every stage of our muni bond investment process, including sector and issuer selection and risk management.

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IMPORTANT INFORMATION