



As long as inflation expectations remain well anchored, CIO expects the Fed to view this inflation as transitory and to respond to a weakening labor market with 75-100bps of rate cuts in 2025. (UBS)

Munis sell off and underperform as yields surge

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Investment grade (IG) tax-exempt munis experienced a steep sell-off and have significantly underperformed in 2025, as muni yields surged. Munis generally exhibit lower volatility, but this year volatility has trended higher. The recent sell-off has seen muni volatility spike to levels last seen during the pandemic and has far exceeded the volatility of IG corporates. Weak technicals stemming from high muni supply and reduced demand from redemptions (typical during the March-May period), increasing investor concerns around the muni tax-exemption, and federal policy uncertainties drove increased volatility and upward pressure on muni yields even prior to the sharp sell-off in rates. Following 2 April, AAA muni yields have risen in tandem with Treasuries but much more uniformly across the curve. We expect technicals to improve in the June-July period, as coupon payments increase redemption demand. In the very near term, rate volatility and technicals may continue to pose headwinds.

Muni total return performance during 2025 has been disappointing, and the high volatility is unnerving. That said, market dislocations bring potential opportunities for investors with longer investment horizons to lock in elevated yields. Long maturities look especially appealing given the steeper yield curve and cheaper relative valuation (higher m/T ratios). Tax-equivalent yields offer a compelling opportunity for investors in the highest tax brackets to achieve solid total returns over the next 12 months.

Treasury rates outlook

The risk-off sentiment that gripped the market in early April initially sent investors to the perceived relative safety of Treasuries. This dynamic quickly reversed soon thereafter as equity markets marched lower while Treasury yields moved sharply higher. This sudden and sharp increase in Treasury yields has confounded investors. In our view, a confluence of factors, not one individual culprit, explains the move higher in rates. Portfolio managers sold Treasuries to raise cash to cover fund redemptions, hedge funds unwound the basis trade, and primary dealer balance sheets became a bit full. Selling by foreign holders seems less likely, in our view, as most central banks concentrate their Treasury holdings in the front end.

We expect 10-year yields to rise toward 4.5% in the near term and wouldn't rule out a further move higher amid current low liquidity. Since we expect the 10-year yield to end 2025 around 4% at year-end, we would consider adding interest rate exposure between 4.5% and the year to date high of 4.8%. As muni yields have risen more than Treasury rates, relative value has significantly improved, as muni-Treasury (m/T) ratios have moved higher across the curve.

Economic outlook and muni credit spreads

The economy slowed in early 2025, with consumer spending softening after a strong 4Q holiday shopping season. We expect growth to weaken throughout 2025 due to tariff hikes, tighter immigration policy, and government spending cuts, which have already caused a sharp drop in both business and consumer sentiment. While softer demand may help constrain price increases, tariffs could lift inflation to around 4% by year-end. As long as inflation expectations remain well anchored, we expect the Fed to view this inflation as transitory and to respond to a weakening labor market with 75-100bps of rate cuts in 2025. The muni sell-off so far has been about rates and technicals, not credit. However, in this backdrop of a weakening economy, we urge caution on lower-rated munis. BBB and HY spreads are still tight and may increase significantly should economic growth decline more than we expect. The likelihood of that scenario has risen materially in our view.

Tariff policy uncertainty to persist

The 90-day tariff pause was a relief, but predictability to support consumer, business, and investor sentiment remains a long way off. It's also not clear what a deal with countries who have expressed a desire to negotiate would look like and what would sway decision making. That said, the focus appears to be clearly on China now. Although the weighted average tariff after the pause with other countries and escalation with China is still very high, we may be past peak uncertainty, so downside risks are lower from here than they were prior to 2 April.

Tax concerns weigh on muni investor sentiment

Increased investor concerns about the muni tax-exemption may have played a role in the selloff. Total elimination of or a cap on the tax exemption with retroactive effect (both of which would negatively impact muni bond prices), although possible, are low probability outcomes in our view. Although some deals were pulled during the latest selloff, concern around the tax-exemption has actually worsened technical, by boosting supply. We believe Private Activity Bonds and the higher education sector are at greater risk of losing the tax exemption. We expect outstanding bonds will be grandfathered. On a positive note, bipartisan support for Tax-exemption seems to be growing. Also, there now seems to be some possibility of raising the top marginal tax rate to 40%, a positive for tax-exempt muni demand. We expect more clarity by June, as negotiations on the reconciliation bill advance.

Original report: [**Municipal Market Guide: Dislocation brings opportunities, 14 April 2025.**](#)

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