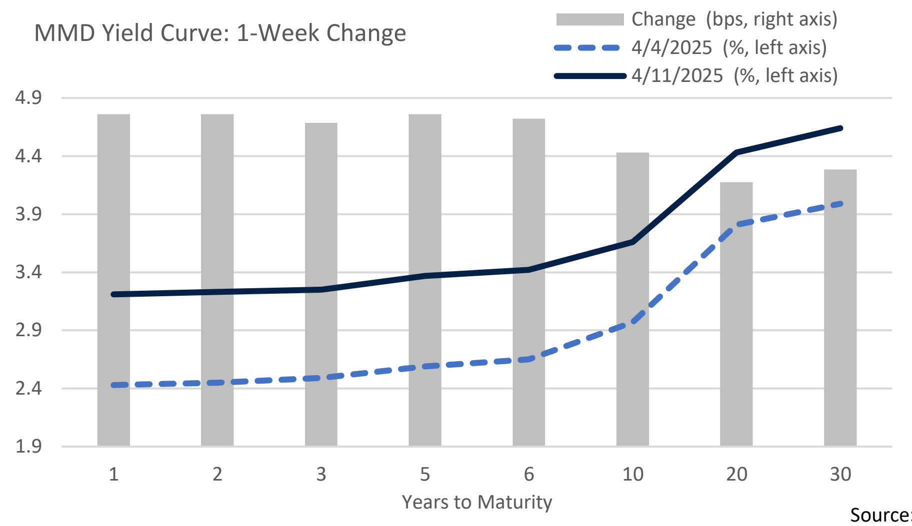
WHAT'S BEHIND MUNICIPAL MARKET DISLOCATION?

APRIL 14, 2025

The high-grade tax-exempt markets are typically characterized by relative price stability, particularly when contrasted with lower grade credits, let alone equities. But it's been anything but the case so far in April, as **extreme volatility has driven up municipal yields** at an unusual pace.

Advisors and investors are understandably looking for answers, and we aim to provide some below. **The primary driver of this turbulence is a liquidity crunch, which has been exacerbated by the factors noted below.**



Source: MMD

Roots of the Sell-Off:

Liquidity appears to be the fundamental culprit as a series of worrisome trade policy announcements on "Liberation Day" and the days that followed prompted a "risk-off" capital markets reaction. The S&P 500 recently suffered its 7th fastest 10%+ decline since 1929, an indication of how unsettled conditions have become.

Diminished liquidity prompted a surge in municipal ETF and fund sales that was not met with adequate demand due to seasonal metrics. According to JP Morgan, ETFs saw their largest outflows since municipal ETFs began reporting in 2006 over the week of April 4th, as investors pulled out $1.4billion on a net basis. Municipal mutual funds also recorded $1.9billion of net outflows over the week ending April 7th, according to LSEG Lipper data.

Municipal market weakness has also simultaneously been impacted by tax-related selling pressure, elevated supply (Q1 issuance was 15% above the same period of 2024, a record year), and lower seasonal reinvestment volume. **In aggregate, this created an exceptionally weak technical environment**.

A surge in bid list volume provides a tangible illustration of the highly atypical selling pressure the municipal market has recently experienced. As reference points, dealers informally reported $3billion+ in bid lists on April 4th, $5.7billion on April 7th, and another $5.4billion on April 14th. These volumes are not at peak 2020 COVID levels but are exceptionally high and uncharacteristic of the municipal market.

Of significant note, **there are no tangible signs that credit concerns are behind high levels of tax-exempt selling**. Despite growing tariff-related recession fears, municipal credit, by and large, remains in a strong position, and we see no indication of credit deterioration. In fact, municipal credit spreads have remained intact despite the market turmoil. AA, A and BBB spreads have stayed constant YTD through April 11th at 11bps, 35bps and 83bps, respectively.

We Believe Municipals Offer Considerable Value at Today's Yields

While it is difficult to predict how quickly stability will return, capitalizing on recent dislocation by adding exposure to client accounts seeking tax-exempt income may be warranted. Appleton Intermediate Municipal's yield-to-worst of 3.62%[1] equates to what we feel is a very attractive tax-equivalent yield of 6.11%[2], particularly for a strategy with an average credit quality of AA+. Furthermore, **the 10-year AAA yield of 3.66% is the highest it has been since 2008**.

Municipals lagged Treasuries throughout most of March, raising the 10-year AAA Muni/UST ratio to 77.4% by quarter-end. In a "risk-off" environment, ratios have subsequently increased further into the low 80s in early to mid-April trading, levels not seen since November 2022. **On a relative value basis, this, too, may be appealing to municipal investors.**

as of 4/11/24	AAA Muni/ Treasury	AA Muni/ Treasury
2 Year	81.57%	82.32%
5 Year	81.20%	82.17%
10 Year	81.70%	84.15%
30 Year	95.67%	100.21%

Source: MMD, Bloomberg

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The prospects of looser monetary policy have also increased, given a considerable decline in growth expectations. The Atlanta Fed's GDPNow Q2 estimate has fallen to -3.7%, although we don't expect the actual figure to be that low. Nonetheless, the markets are now pricing in 3-4 Fed Funds cuts in 2025, the first expected to come as early as June. **Looser monetary policy would likely be supportive of municipals.**

Lastly, **market dislocations of this magnitude are rare but have often historically been followed by non-traditional buyers (pension funds, sovereign wealth, taxable funds) entering the market** with block size transactions. We have not yet seen this but would not be surprised if it materializes and, as such, drives yields lower due to increased demand for the asset class.

1. As of April 11, 2025
2. Tax-Equivalent YTW is based on the YTW and the highest marginal federal income tax rate of 37% plus 3.8% tax on net investment income (40.8% total). This calculation is intended for illustrative purposes only to demonstrate the effect of tax-free treatment of municipal bonds on yields.

Accessibility and communication are important in any environment, although these attributes are especially valuable during uncertain and volatile times. Appleton Partners is committed to sharing our market and portfolio management perspectives as developments unfold. We hope these briefs are helpful and also invite you to reach out to us directly and/or visit www.appletonpartners.com/Insights for additional commentary and insights.

ONE POST OFFICE SQ. BOSTON, MA 02109 TEL. 617.338.0700 WWW.APPLETONPARTNERS.COM