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Treasury Market Volatility's Impact on the Muni Market.

It was quite the week in the Treasury market last week, which was influenced by multiple factors: sticky inflation expectations, the Federal Reserve's (Fed) patient stance, rumors of foreign buyer boycotts, hedge fund deleveraging, portfolio rebalancing from bonds to cash, and overall Treasury market illiquidity. The situation was exacerbated by a notably weak 3-year Treasury auction, where the Treasury Department had to offer higher yields to attract demand — which still fell short of expectations. At its peak, the 10-year Treasury yield surged by over 0.70% last week before partially recovering to end the week "only" 0.60% higher. As is often the case, these Treasury market disruptions quickly rippled throughout the broader fixed income markets.

Conceptionally, non-Treasury bond yields are a function of a Treasury yield component plus a spread component to compensate for additional risks (including credit and liquidity, to name a few important risks). So, as Treasury market volatility erupted last week, most other high-quality fixed income markets were negatively impacted as well, with the muni market, perhaps surprisingly, feeling the brunt of the Treasury market volatility.

While investment-grade corporate bond yields increased by nearly 0.50%, the municipal market saw yields rise by 0.65–0.85% across various points on the curve. Most of the yield increase stemmed directly from Treasury market movements, but municipal bond spreads also widened considerably. Investors appeared to be selling liquid holdings in an attempt to seek refuge in cash until volatility subsided. However, the municipal market's inherent illiquidity and fragmentation made this mass exodus particularly disruptive, amplifying spread widening beyond what might otherwise be expected.

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