Invesco

Municipal bond market recap and outlook

SECOND QUARTER 2026

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Overview

- Municipal bonds delivered positive second-quarter returns, led by high yield municipals and lower-quality credits in general.
- Despite heavy new issuance, particularly a May supply surge, investor appetite was strong enough to digest record supply.
- Municipal yields remained near historic highs, creating compelling income opportunities versus other fixed income assets on both a tax-equivalent and absolute basis.
- The senior living municipal bond sector stands to benefit from favorable demographics, limited new supply, improving occupancy, and a rather stable credit outlook.

Municipal bonds generated positive returns during the second quarter, supported by steady demand for tax-exempt income, healthy credit fundamentals, and attractive yields. Investment grade, high yield, and taxable municipals returned 2.50%, 3.35%, and 0.74%, respectively.[1] Higher-quality credits generally underperformed lower-quality credits.

The quarter opened on a strong note, with municipals demonstrating notable resilience in the face of a heavy new-issue calendar. Although the elevated pace of issuance periodically tested valuations, particularly during a supply surge in May, investor demand remained strong enough to absorb the added volume, which helped sustain municipal gains through the end of the quarter.

Municipal bonds outperformed most other segments of the fixed income market,[1] as macro uncertainty led investors to reprice their expectations for Federal Reserve (Fed) monetary policy. While US consumer activity and labor conditions held up better than many expected, energy-related price pressures and geopolitical turmoil kept inflation elevated relative to the Fed's long-term objective, reducing the urgency for near-term monetary policy easing.

Accordingly, Fed officials left interest rates unchanged, emphasizing that economic activity continued to expand, job gains remained sufficient to keep unemployment broadly stable, and inflation was still above target, partly because of supply shocks in energy-sensitive categories.[2] The Federal Open Market Committee's (FOMC) dot plot projections also signaled a less accommodative stance. In June, the median dot for year-end 2026 moved to 3.8%, up from 3.4% in March – a hawkish flip from a projected cut to a hike.[3] Nine of the 18 FOMC members submitted dots that penciled in at least one hike in 2026, eight saw no change, and only one still called for a cut.[3]

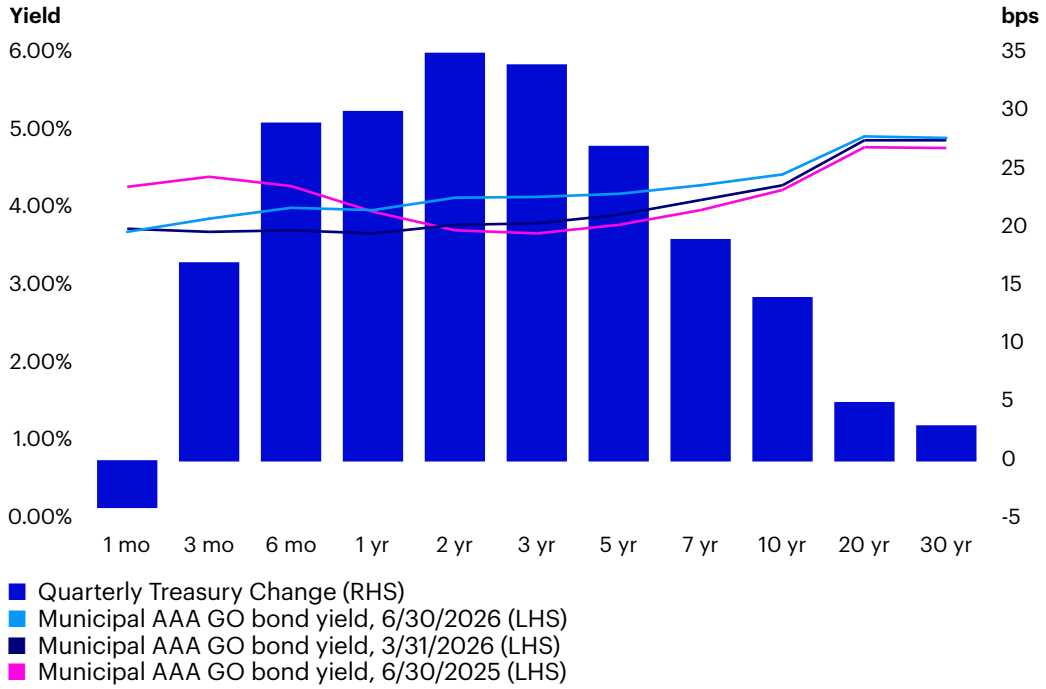
Against this backdrop, US Treasury yields rose, with shorter-term yields increasing significantly. The US Treasury yield curve flattened as the yields of two-, five-, ten-, and thirty-year Treasury bonds climbed 35, 27, 14, and 3 basis points, respectively.[4]

In contrast, municipal yields fell during the quarter. Yields of two-, five-, ten-, and thirty-year AAA general obligation bonds dropped 7, 8, 17, and 28 basis points, respectively.[4] As a result,

Not a Deposit Not FDIC Insured Not Guaranteed by the Bank May Lose Value
Not Insured by any Federal Government Agency

the municipal yield curve remained relatively steep compared to the US Treasury yield curve, particularly beyond the 10-year maturity range (see Exhibit 1).

Exhibit 1: The municipal yield curve was steep at the end of the second quarter, while the US Treasury yield had flattened

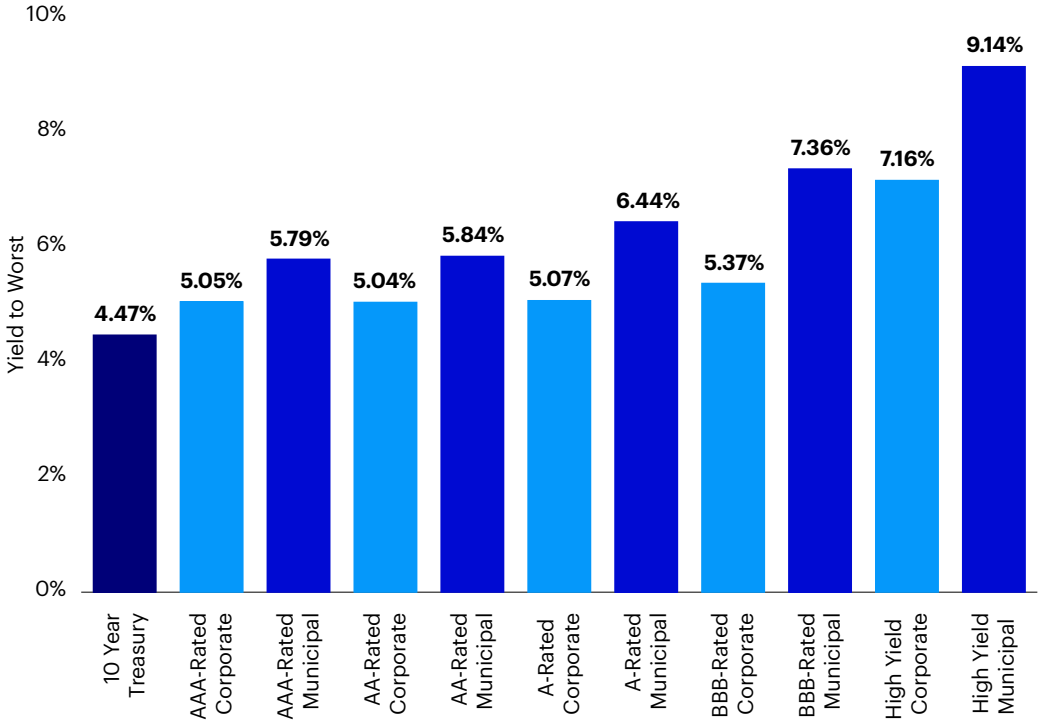


Source: US Department of the Treasury, Daily Treasury Yield Curve Rates. Data as of June 30, 2026. A yield curve is a curve showing several yields to maturity or interest rates across different contract lengths for a similar debt contract. The Municipal AAA GO bond yield is represented by the Municipal Market Data proprietary yield curve of AAA-rated state obligation bonds, based on the institutional block size of $2 million-plus market activity in both the primary and secondary bond market. Past performance does not predict future returns.a

Although municipal yields declined during the quarter, they remained near historically high levels of tax-advantaged income streams, particularly for high-income investors in high-tax states. High yield municipals offered even more attractive yields than investment grade municipals on both an absolute and tax-equivalent basis (see Exhibit 2). The steepness of the municipal yield curve also increased the relative value of municipal bonds, offering investors incremental yield by extending duration.

Exhibit 2: Municipal bonds offered compelling tax-equivalent yields compared to US Treasuries and corporate bonds

Tax equivalent yields at 40.8%* for selected fixed income municipal bond indices



Source: Bloomberg, as of June 30, 2026. AAA-rated municipal is represented by the Bloomberg Municipal Bond AAA Index. AA-rated municipal is represented by the Bloomberg Municipal Bond AA Index. A-rated municipal is represented by the Bloomberg Municipal Bond A Index. BBB-rated municipal is represented by the Bloomberg Municipal Bond BBB Index. High Yield Municipal is represented by the Bloomberg High Yield Municipal Bond Index. AAA-rated corporate is represented by the Bloomberg U.S. Corporate Bond AAA Index. AA-rated corporate is represented by the Bloomberg U.S. Corporate Bond AA Index, A-rated corporate is represented by the Bloomberg U.S. Corporate Bond A Index. BBB-rated corporate is represented by the Bloomberg U.S. Corporate Bond BBB Index. High yield corporate is represented by the Bloomberg U.S. Corporate High Yield. An investment cannot be made directly into an index.

*Assuming a top tax rate of 40.8%, 37% federal tax rate and 3.8% net investment income tax (NIIT), effective Jan. 1, 2026. Irs.gov, as of October 9, 2025. Top marginal tax rate for single taxpayers with more than $640,600 in taxable income or couples with more than $768,700. NIIT is the net investment income tax investment income for single taxpayers with more than $200,000 in taxable income or couples with more than $250,000.

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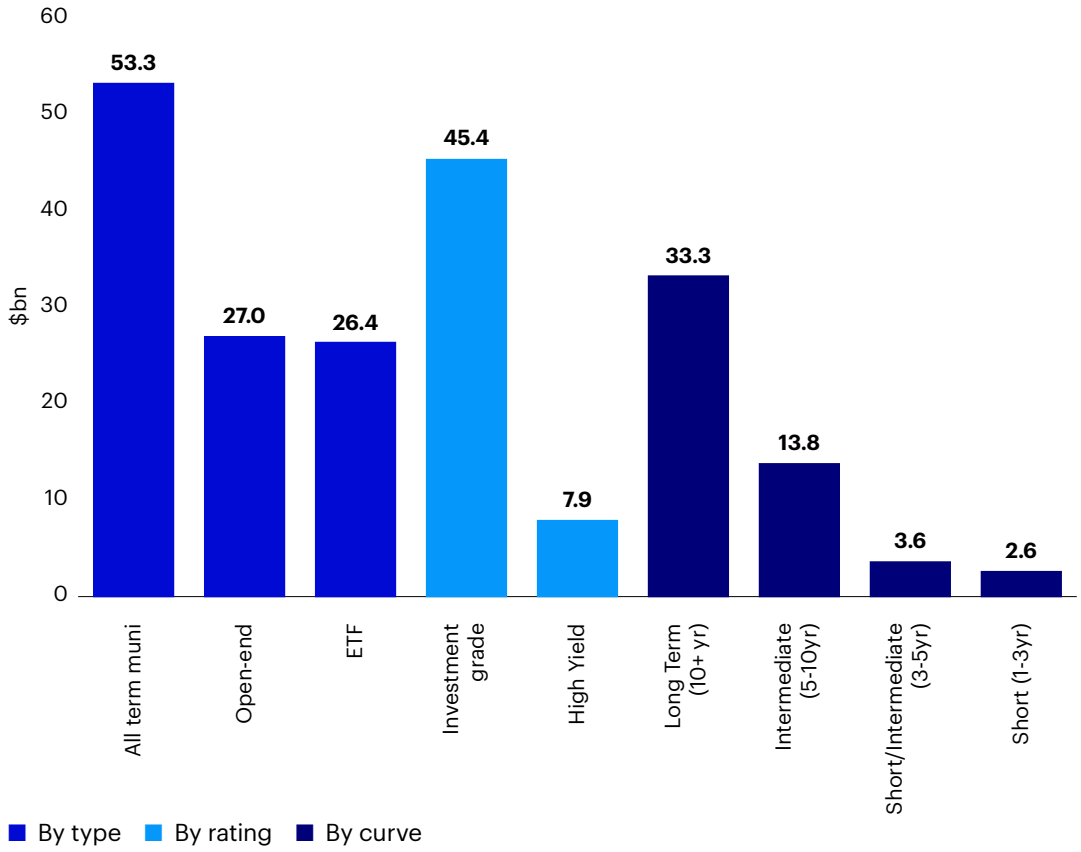
Steady demand helped absorb heavy new issuance

Demand for municipal bonds was strong and persistent as elevated absolute yields attracted both retail and institutional buyers. Municipal fund net flows were positive for the quarter, totaling approximately $27.3 billion,[5] driven primarily by inflows to long-term and investment-grade mutual funds and ETFs.[6] The market only saw two weeks of outflows, largely due to tax season-related selling in April.[6] For the 2026 year to date, inflows totaled $53.3 billion, the second highest level on record[6] (see Exhibit 3).

Exhibit 3: Investment flows were concentrated on investment-grade and long-term funds and ETFs



Source: LSEG Lipper Global Fund Flows, J.P. Morgan, as of July 2, 2026. Note: Figures shown in this table are weekly reporters only.

New municipal issuance was $170 billion in the second quarter, which brought the 2026 year-to-date total to $305 billion – 8% higher than the first half of 2025.[7] The rate of growth, however, slowed relative to 2024 and 2025.[7] Tax-exempt supply, much of it investment grade, accounted for $157 billion of Q2 issuance, an increase of 4% over the first quarter of 2026, for a year-to-date total of approximately $285 billion.[7] Taxable supply remained relatively light at approximately $14 billion, up from the $7 billion that came to market in first quarter of 2026.[7] Taxable new issuance has been fairly modest in historical terms, perhaps due to tight spreads and high absolute yields.

Credit conditions stayed broadly positive

State and local government budgets remained on solid footing, with the vast majority maintaining healthy reserves. Rainy Day funds were still near historic highs, giving government officials room to manage rising costs and prepare fiscal 2027 budgets.[8] Credit rating downgrades ticked higher during the second quarter, but first-time payment defaults were down more than 50% in the 2026 year to date compared to the same period in 2025.[8] That said, dispersion across sectors increased as investors evaluated the impact of higher borrowing costs, federal policy shifts, and cost pressures on issuers with narrower financial flexibility. We believe any problems that emerge are likely to be confined to individual credits, like the Nassau County Tobacco Settlement Corporation's recent default. We do not anticipate broad deterioration in credit conditions.

Sector Spotlight: Senior living municipal bonds

The senior living municipal bond sector presents a compelling risk-adjusted investment opportunity. The sector consists primarily of tax-exempt fixed-rate revenue bonds issued on behalf of not-for-profit senior living operators, including life plan communities and continuing care retirement communities. These bonds are repaid through resident entrance fees, monthly service fees, and operating cash flows rather than tax revenues.

The investment case for the sector is supported by favorable long-term demographics. The population aged 75 and older is projected to increase by 11.5 million between 2025 and 2035, as baby boomers enter the prime age range for senior living.[9] Demand may further be supported by shifting family dynamics, as 22% of baby boomers have no children, 37% have no grandchildren, and middle- and high-income boomers are less likely to live near family members. These are all factors that increase the likelihood of seeking senior-oriented housing.[9]

At the same time, new supply remains constrained by high construction costs, tighter lending standards, labor shortages, and regulatory complexity. This creates a favorable supply-demand dynamic for established operators with strong market positions. Operating fundamentals have also strengthened. Senior housing occupancy has improved for 17 consecutive quarters, generally reaching record levels in late 2025.[9] Pricing power appears to be intact, supported by rent and fee increases. Additionally, discounting has moderated, which has contributed to stronger margins and greater revenue visibility. Credit fundamentals have likewise stabilized.

While the sector continues to face challenges, including labor pressures, affordability concerns, and campus-specific execution risks, senior living municipal bonds offer exposure to long-duration cash flows and essential-service assets. As a result, the senior living sector warrants continued consideration, particularly when combined with disciplined underwriting and careful issuer selection.

Outlook

Seasonal market dynamics could prove supportive of municipals, particularly if issuance moderates. Net tax-exempt supply for July and August is expected to be around $4 billion, which is roughly $9 billion lower than the same period in 2025.[8] At the same time, investment inflows are expected to pick up as investors seek to reinvest interest and returning principal payments. Historically, July has tended to be strong for munis, with the Bloomberg Municipal Bond Index delivering positive returns in 18 of the past 20 years. August has been less consistent but has still produced positive returns in 13 out of the last 20 years.[10]

In the near term, we expect interest rate volatility to continue amid persistent inflationary pressures and as Fed officials remain divided on monetary policy action. Such volatility reinforces the importance of disciplined credit research and active security selection, which may help identify opportunities across market environments.

Overall, the current municipal market may offer investors an opportunity to earn meaningful income while navigating a period of continued monetary policy uncertainty. Tax-exempt yields are attractive, especially for higher-tax investors who may want to lock in longer-term, high-quality tax-advantaged income. Along the municipal yield curve, 16- to 20-year maturities appear attractive from an income and total return perspective, while 18- to 23-year segment may offer a favorable balance of carry and roll-down potential over a multi-year investment horizon. For investors with shorter or intermediate time horizons, the 7- to 10-year portion of the municipal curve could be attractive. A barbell approach may be appropriate for those seeking to balance income opportunity with interest-rate risk, pairing shorter maturities that may provide greater stability with longer maturities that offer enhanced yield and potential price appreciation should the yield curve flatten over time.

Looking ahead, we see compelling opportunities in municipals. Steady issuance and ongoing demand for tax-exempt income, combined with high absolute yields and solid fundamentals, support a favorable investment environment. We remain committed to our time-tested, long-term investment approach, leveraging our experienced credit research team as we seek to actively capitalize on market dislocations that we believe can enhance shareholder outcomes.

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1. Bloomberg, as of June 30, 2026. Investment grade municipal bonds are represented by Bloomberg Municipal Bond Index. High yield municipal bonds are represented by Bloomberg Municipal High Yield Bond Index. Taxable municipal bonds are represented by the Bloomberg Taxable Municipal Index. For second quarter, the Bloomberg Municipal Bond Index returned 2.50%; the Bloomberg Taxable Municipal Index returned 0.74%; the Bloomberg U.S. Treasury Index returned 0.32%; the Bloomberg U.S. Corporate Index returned 1.40%. An investment cannot be made into an index. Past performance does not guarantee results.
2. Federal Reserve, as of June 17, 2026.
3. Federal Reserve Board Summary of Economic Projections, dated June 17, 2026.
4. Thomson Reuters, as of June 30, 2026.
5. Lipper, as of July 1, 2026.
6. LSEG Lipper Global Fund Flows, J.P. Morgan, as of July 2, 2026.
7. Bloomberg Financial, L.P., as of June 30, 2026.
8. J.P. Morgan, as of June 23, 2026.
9. Invesco, as of June 30, 2026.
10. Bloomberg, as of June 30, 2026. Investment grade municipal bonds are represented by Bloomberg Municipal Bond Index. An investment cannot be made into an index. Past performance does not guarantee results.

Fundamentals refer to the forces of supply and demand in determining price.

The Bloomberg Municipal Bond Index is an unmanaged index considered representative of the tax-exempt bond market.

The Bloomberg Municipal High Yield Bond Index is an unmanaged index considered representative of bonds that are non-investment grade, unrated or rated below Ba1.

The Bloomberg Taxable Municipal Index measures the US municipal taxable investment grade bond market.

AAA-rated municipal is represented by the Bloomberg Municipal Bond AAA Index, an unmanaged index considered representative of bonds that are rated AAA.

AA-rated municipal is represented by the Bloomberg Municipal Bond AA Index, an unmanaged index considered representative of bonds that are rated AA.

A-rated municipal is represented by the Bloomberg Municipal Bond A Index an unmanaged index considered representative of bonds that are rated A.

BBB-rated municipal is represented by the Bloomberg Municipal Bond BBB Index, an unmanaged index considered representative of bonds that are rated BBB.

High Yield Municipal is represented by the Bloomberg High Yield Municipal Bond Index, an unmanaged index considered representative of bonds that are non-investment grade, unrated or rated below Ba1.

The Bloomberg U.S. Corporate Index is an unmanaged index considered representative of fixed-rate investment-grade taxable bond debt.

The Bloomberg U.S. Treasury Index is an unmanaged index of public obligations of the US Treasury with remaining maturities of one year or more.

AAA-rated corporate is represented by the Bloomberg U.S. Corporate Bond AAA Index, an unmanaged index considered representative of the US corporate bond market that are rated AAA.

AA-rated corporate is represented by the Bloomberg U.S. Corporate Bond AA Index, an unmanaged index considered representative of the US corporate bond market that are rated AA.

A-rated corporate is represented by the Bloomberg U.S. Corporate Bond A Index, an unmanaged index considered representative of the US corporate bond market that are rated A.

BBB-rated corporate is represented by the Bloomberg U.S. Corporate Bond BBB Index, an unmanaged index considered representative of the US corporate bond market that are rated BBB.

High yield corporate is represented by the Bloomberg U.S. Corporate High Yield, is an unmanaged index considered representative of the US high-yield, fixed-rate corporate bond market.

An investment cannot be made directly in an index.

US Treasurys is represented by the public obligations of the US Treasury. Treasurys are backed by the full faith and credit of the US government as to the timely payment of principal and interest, while legislative or economic conditions could affect a municipal securities issuer's ability to make payments of principal or interest.

A credit rating is an assessment provided by a nationally recognized statistical rating organization (NRSRO) of the creditworthiness of an issuer with respect to debt obligations, including specific securities, money market instruments or other debts. Ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest); ratings are subject to change without notice. NR indicates the debtor was not rated and should not be interpreted as indicating low quality. For more information on rating methodologies, please visit the following NRSRO websites: www.standardandpoors.com and select 'Understanding Credit Ratings' under Rating Resources 'About Ratings' on the homepage.; https://ratings.moodys.io/ratings and select 'Understanding Ratings' on the homepage.; www.fitchratings.com and select 'Ratings Definitions Criteria' under 'Resources' on the homepage. Then select 'Rating Definitions' under 'Resources' on the 'Contents' menu.

Dot plot is a chart that shows how the Fed's top policymakers think the Fed will change short-term interest rates over the next few years.

A barbell strategy pairs lower-risk credits with higher-risk credits while avoiding the middle of the risk spectrum.

About Risk

Municipal securities are subject to the risk that legislative or economic conditions could affect an issuer's ability to make payments of principal and/or interest.

Junk bonds involve greater risk of default or price changes due to changes in the issuer's credit quality.

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested. The values of junk bonds fluctuate more than those of high quality bonds and can decline significantly over short time periods.

All fixed income securities are subject to two types of risk: credit risk and interest rate risk. Credit risk refers to the possibility that the issuer of a security will be unable to make interest payments and/ or repay the principal on its debt. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa.

Municipal bonds are issued by state and local government agencies to finance public projects and services. They pay interest that is typically tax-free in their state of issuance. Because of their tax benefits, municipal bonds usually offer lower pre-tax yields than similar taxable bonds.

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

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Past performance does not guarantee future results.

Diversification does not guarantee a profit or eliminate the risk of loss.

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There is no guarantee the outlooks mentioned will come to pass. These opinions may differ from those of other Invesco investment professionals.