

Municipal bond market recap and outlook

THIRD QUARTER 2026



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Overview

- Municipal bonds posted losses during the third quarter, as interest rate volatility drove benchmark municipal yields to their highest levels since at least 2011.[1]
- Credit fundamentals stayed healthy overall, with ratings upgrades continuing to outpace downgrades.
- New issuance remained at record levels and quarterly investment flows were positive, though demand weakened in September amid volatility caused by sharply rising yields.
- Higher starting yields have been associated with stronger long-term forward returns, which can potentially benefit investors who actively reposition their portfolios into higher-yielding municipals.

Municipal performance was broadly negative during the third quarter, driven by extreme interest rate volatility across global bond markets. Municipal yields rose sharply, following the trend in the US Treasury market, as inflation concerns, fueled by the continuing US-Iran conflict, led investors to anticipate a more hawkish policy stance from the Federal Reserve (Fed). These factors overshadowed the positive credit outlook, as financial conditions remained generally sound across states and municipalities, and credit ratings upgrades continued to outpace downgrades. Investment grade, high yield, and taxable municipals returned -6.35%, -5.55% and -4.39%, respectively, during the third quarter, wiping out the gains of the first half of 2026.[2] Higher-quality credits generally underperformed lower-quality credits.

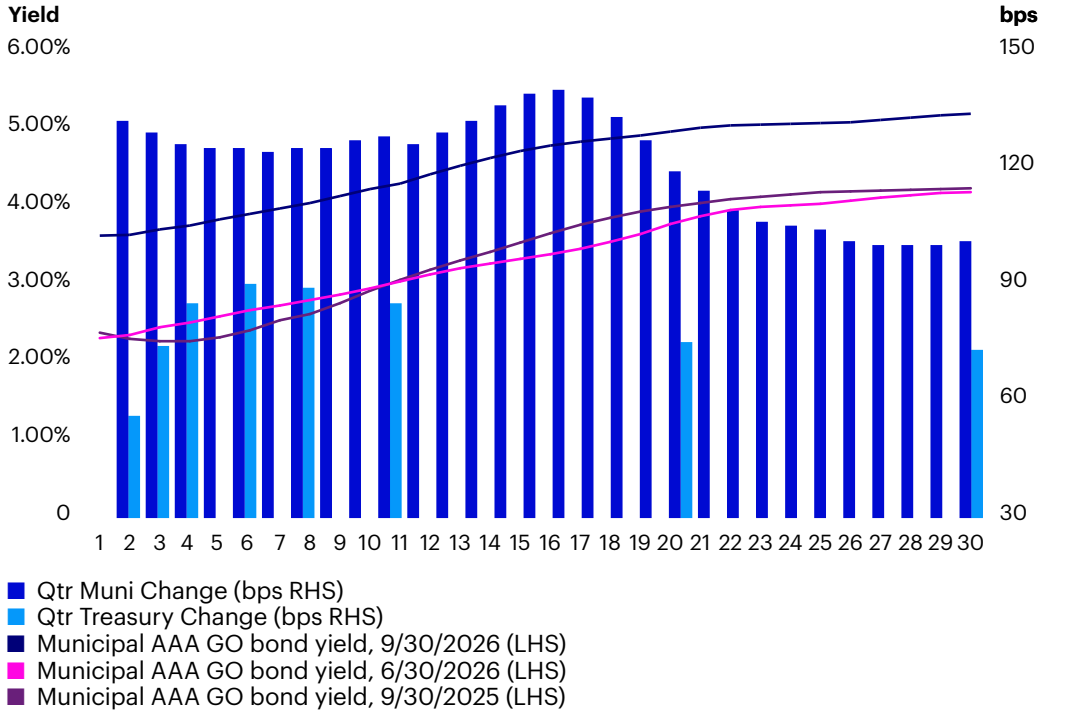
The broad US economy remained resilient, supported by consumer spending, business investment, productivity, and a relatively stable labor market. However, persistent inflation led the Fed to adopt a more restrictive policy stance during the quarter. After holding interest rates steady in July, the Federal Open Market Committee (FOMC) voted unanimously to raise the federal funds rate by 25 basis points in September—the first increase since 2023—to a maximum target of 4.00% from 3.75%.[3] Fed Chair Kevin Warsh put it bluntly at the press conference: "[t]he plain fact is inflation is too high and has been for too long."[3] He framed the rate hike as a way to "support a timelier return"[3] to the Fed's 2% inflation target. The Fed also said that "uncertainty remains elevated, owing, in part, to geopolitical developments."[3] Sixteen of the FOMC's 18 members penciled in at least one more rate hike before the end of 2026, with a few forecasting additional hikes during 2027.[3] Warsh's promise was that the FOMC "will deliver price stability,"[3] which—along with maximum employment—is half of the Fed's dual mandate.

As investors anticipated near-term Fed rate hikes, US Treasury yields rose along the curve. Yields of two-, five-, ten-, and thirty-year Treasury bonds increased 74, 90, 85, and 73 basis points, respectively.[4] Municipal yields rose by more than Treasurys, with most of the activity occurring in September. For the quarter overall, the yields of two-, five-, ten-, and thirty-year

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AAA general obligation bonds climbed 129, 125, 128, and 101 basis points, respectively.[4] The municipal yield curve flattened, as shorter- and intermediate-term yields rose more than longer-term yields (see Exhibit 1).

Exhibit 1: The municipal yield curve flattened but remained steeper than the Treasury yield curve at the end of the third quarter

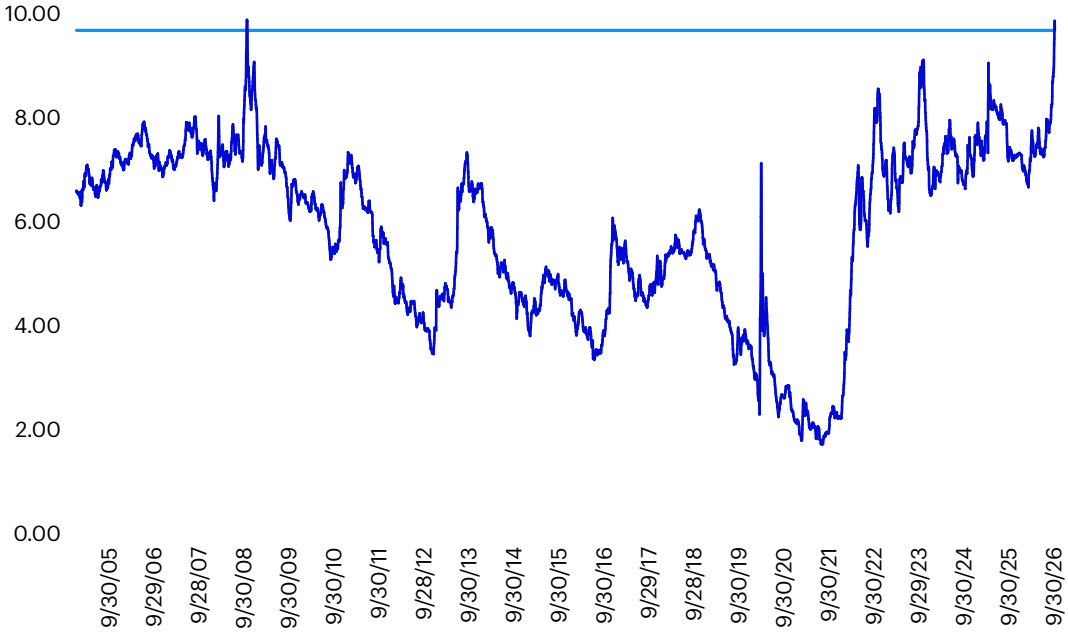


Source: US Department of the Treasury, Daily Treasury Yield Curve Rates. Data as of September 30, 2026. A yield curve is a curve showing several yields to maturity or interest rates across different contract lengths for a similar debt contract. The Municipal AAA GO bond yield is represented by the Municipal 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.

The rise in municipal yields followed a pattern seen several times since the global financial crisis. The 2013 taper tantrum, the 2016 election period, the 2020 pandemic shock, and the 2022 transition in Fed monetary policy were all periods when significant moves in interest rates contributed to weakness in the municipal market.[5] In most of these episodes, selloffs were largely driven by interest rate volatility, not deteriorating credit conditions.[5] This was the case in the third quarter of 2026. As municipal issuers continued to demonstrate solid credit quality and meet their obligations to bondholders, a surge in interest rate volatility pushed municipal yields to their highest levels since at least 2011.[1] Tax-equivalent municipal yields rose to highs not seen since the 2008 global financial crisis (see Exhibit 2).

Municipal bond market recap and outlook Third Quarter 2026

Exhibit 2: The tax-equivalent yield for an investor in the top tax bracket climbed to its highest level since the global financial crisis



Tax-Equivalent Yield (%)
Current Tax-Equivalent Yield (%)

Source: Bloomberg Municipal Bond Index, as of September 30, 2026. Assumes a federal tax rate of 35% from 2004 to 2012, 39.6% from 2013 to 2017, and 37% from 2018 to 2026. Also assumes an additional 10% state income tax and 3.8% Net Investment Income (NIIT) tax as of 2013. Indexes are unmanaged, do not incur management fees, costs and expenses and cannot be invested in directly. Past performance is no guarantee of future results.

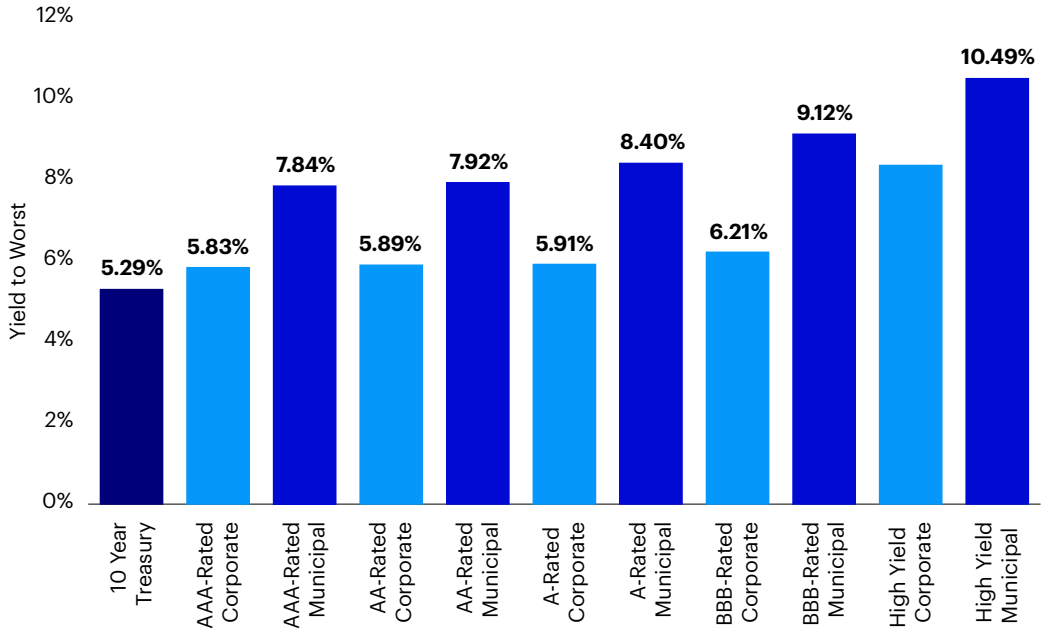
As municipal yields increased, the relative value proposition of the municipal market changed. When the quarter began, strong demand for municipals and substantial reinvestment flows kept municipal/Treasury (M/T) ratios relatively compressed. As the quarter progressed, municipal yields rose more than Treasury yields. By the end of September, five-, ten-, and 30-year M/T ratios reached 73.5%, 77.5%, and 91%, respectively, compared to 62%, 66.7% and 85.5% at the beginning of the quarter, respectively.[5] Higher M/T ratios indicate relative value in municipal bonds compared to US Treasury securities.

Additionally, the tax-equivalent yields offered by municipal bonds grew more attractive relative to taxable corporate bonds (see Exhibit 3).

Municipal bond market recap and outlook Third Quarter 2026

Exhibit 3: Municipal bonds grew more compelling on a tax-equivalent basis compared to US Treasurys and corporate bonds

Tax-equivalent Yields at 40.8%* for fixed income municipal bond indices



Source: Bloomberg, as of September 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 for single taxpayers with more than $200,000 in taxable income or couples with more than $250,000.

Market technicals shifted as the quarter progressed

Municipal supply remained at record highs during the third quarter, with $170 billion of new municipal issuance bringing the 2026 year-to-date total to $476 billion.[1] Issuance was near the same level as second quarter, but it was 8.5% higher than the same period in 2025.[1] Tax-exempt supply accounted for $162 billion of the new issuance, an increase of 9% over the third quarter of 2025.[1] Taxable new issuance remained comparatively modest over the period, at roughly $8 billion, for a 2026 year-to-date total of $29 billion.[1]

Regarding demand, the third quarter began on a strong note, with significant investment inflows into municipal bond mutual funds during July and August. However, flows moderated in September as investors grew more cautious amid the potential for additional interest rate-driven volatility. Despite the late-quarter slowdown, overall flows were positive, totaling approximately $21.6 billion, and bringing year-to-date inflows to $74.1 billion, the second highest level on record.[6]

Outlook

The third quarter's selloff in municipal bonds was unpleasant, but it may look better in hindsight, given that it has potentially improved the market's risk-return profile. We believe the pullback in prices has created investment opportunities across the board—in investment grade, high yield, and taxable municipals. Investors who actively manage their portfolios have the opportunity to take advantage of price declines to engage in tax-loss harvesting to offset capital gains realized elsewhere. The opportunity also exists for investors to reposition their portfolios into higher-yielding municipal bonds, a starting yield reset, as the rise in municipal yields has increased the potential for higher tax-exempt income.

Looking ahead, uncertainty about interest rates, inflation, and US fiscal policy may fuel further volatility, but higher starting municipal yields could provide a cushion against possible weakness while also enhancing total return potential. Historically, periods of higher starting yields have been associated with stronger forward returns, with a 93% correlation between starting yields and future 10-year returns.[7] For example, the Bloomberg Municipal Bond Index was yielding 3.15% on December 31, 2013, with an average annual total return of 3.03% over the following 10 years.[7]

Overall, we continue to see compelling opportunities in municipal bonds. Steady new issuance and ongoing demand for tax-exempt income, combined with high absolute yields and solid credit fundamentals, support a favorable investment environment, in our view. We maintain a positive outlook for credit fundamentals. Although various sectors have come under pressure due to reduced federal government support and inflation-driven cost pressures, we continue to rely on our extensive bottom-up research capabilities to identify strong credits with attractive yields. 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.

1. Bloomberg, as of September 30, 2026.
2. Bloomberg, as of September 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. An investment cannot be made into an index. Past performance does not guarantee results.
3. Federal Reserve, as of September 16, 2026.
4. Thomson Reuters, as of September 30, 2026.
5. Barclays Municipal Research, as of October 5, 2026.
6. Lipper, as of October 1, 2026.
7. Morningstar, Bloomberg L.P., data as of September 30, 2026.

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.

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.

A basis point is equal to one one-hundredth of a percent.

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.

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.

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