Municipal bond market recap and outlook

FOURTH QUARTER 2025

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Overview

- Municipal bonds experienced positive returns during the fourth quarter and for the full 2025 calendar year, with the bulk of the return coming from yield.
- New issuance hit a new record high in 2025, as issuers continued to tap into the municipal market for financing.
- Demand remained strong over the quarter, as investors sought to capture higher yields, and contributed to positive investment flows in 10 out of 12 months of the year.
- Credit fundamentals remained resilient, with most state and local governments maintaining fiscal balance.

The municipal market delivered steady, positive returns during the fourth quarter, despite record levels of new issuance and the longest federal government shutdown in history. Investment grade, high yield, and taxable municipal bonds returned 1.42%, 1.11%, and 1.05%, respectively.[1] Longer-duration municipals performed particularly well in October, helping to offset some of the underperformance seen earlier in the year, although the momentum slowed in November and December. For 2025 overall, investment grade, high yield, and taxable municipal bonds generated positive returns of 4.25%, 2.46%, and 7.89%, respectively.[1] Higher quality municipal credits generally outperformed lower quality municipal credits in the fourth quarter and the calendar year.

The Federal Reserve (Fed), which had resumed its easing cycle in September, cut interest rates twice during the fourth quarter—by 25 basis points (bps) in both October and December—for a total of three rate cuts in 2025.[2] Although economic growth was solid, inflation remained persistent and the employment outlook weakened. Fed policymakers reiterated their commitment to balancing maximum employment with a 2% inflation target.[3]

Against this backdrop, the US Treasury yield curve steepened with falling short-term yields and rising long-term yields. During the fourth quarter, the yields of two- and five-year Treasury bonds dropped 13 bps and 1 bp, respectively, while ten- and thirty-year Treasury yields rose 2 and 11 bps, respectively. For the year overall, yields of two-, five-, and ten-year Treasury bonds fell 78, 65, and 40 bps, respectively, while thirty-year Treasurys rose 6 bps.

The story was somewhat different along the municipal yield curve, which flattened slightly in the belly, or middle, of the curve. In the fourth quarter, the yields of two- and five-year AAA general obligation bonds each rose 9 bps, while the 10-year yield fell 16 bps, and the thirty-year was unchanged. For the 2025 calendar year, the municipal yield curve steepened significantly as two-, five-, and ten-year AAA general obligation bond yields fell 43, 46, and 30 bps, respectively. Longer dated bonds rose over the same period, with thirty-year AAA general obligation bond yields climbing 34 bps. As a result of the steeping, the municipal yield curve steepened relative to the US Treasury yield curve over the year, as well. (see Exhibit 1).

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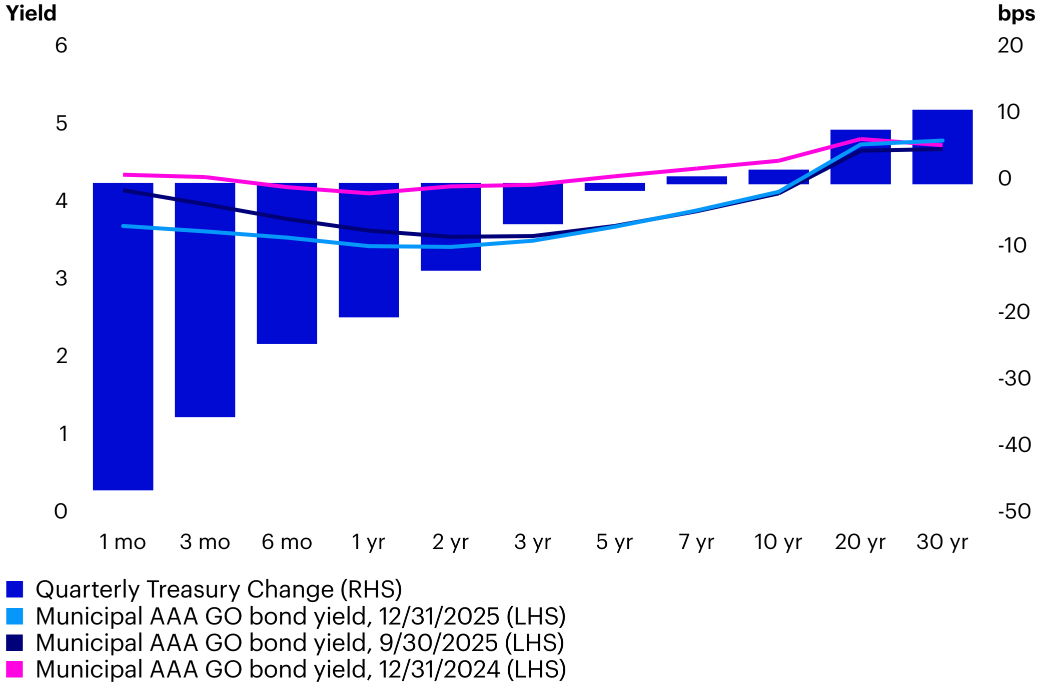
Exhibit 1: The municipal yield curve steepened relative to the US Treasury yield curve during 2025

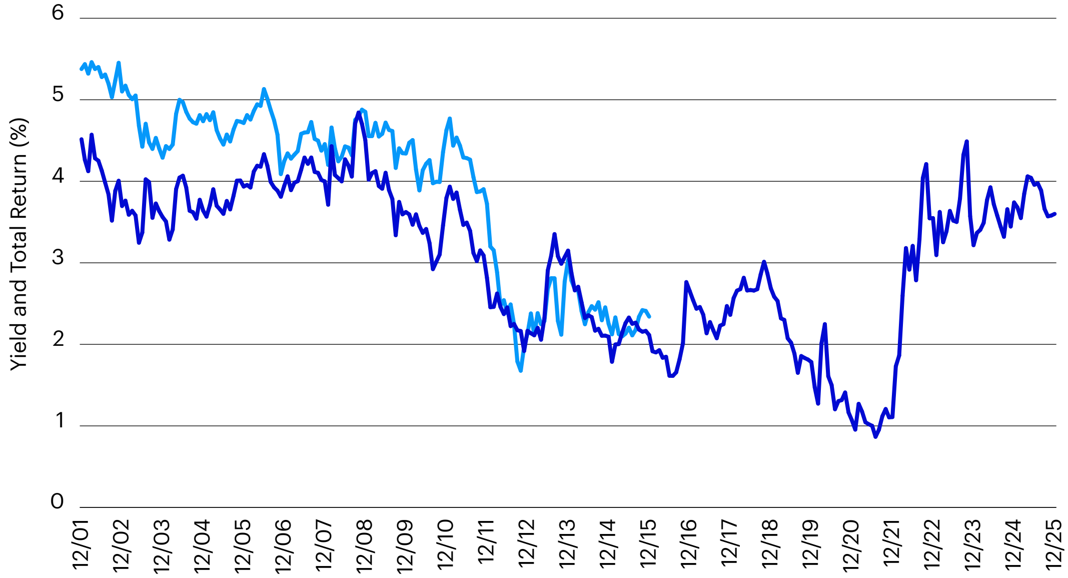


Source: US Department of the Treasury, Daily Treasury Yield Curve Rates. Data as of December 31, 2025. A yield curve is a curve showing several yields to maturity or interest rates across different contract lengths for a similar debt contract. The Municipal AAA GO bond yield is represented by the Municipal 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.

Although longer-term municipal yields declined slightly in the fourth quarter, they ended the year near historically high levels.[4] Many investors, particularly those in higher income tax brackets, view this as positive, since elevated yields have the potential to provide attractive tax-advantaged income opportunities. Notably, there is a strong correlation— approximately 90%—between starting yields and subsequent 10-year returns.[5] Since 2010, higher yields have consistently been a key contributor to total return performance, with the Bloomberg Municipal High Yield Index achieving a cumulative total return of 116.34% through the combined effects of yield and price appreciation (see Exhibit 2).

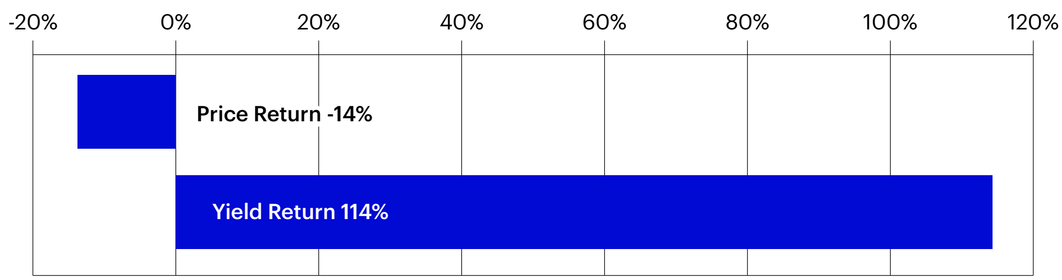
Exhibit 2: Over the long term, yield drives total return[6]

Historical Correlation Up to 90% Between Starting Yield and Future 10-Year Returns



■ Municipal Bond Index Yield-to-Worst
■ Municipal Bond Index Total Return (a.r. 10 years, lead 10 years)

Contribution to Cumulative Total Return
December 31, 2010 – December 31, 2025



Bloomberg High Yield Municipal Index Return (%)			
	Price Return	**Yield Return**	**Total Return**
Cumulative	-16.74	133.07	116.34
Annualized	-0.52	5.80	5.28

Source: Morningstar, Bloomberg L.P., data as of December 31, 2025.

The Bloomberg Municipal Bond Index is an unmanaged index considered representative of the investment grade tax-exempt bond market. The Bloomberg Municipal Bond High Yield Index is an unmanaged index considered representative of noninvestment grade and non-rated municipal bonds. An investment cannot be made directly in an index. Past performance is not a guarantee of future results. Correlation data is a 10-year lag.

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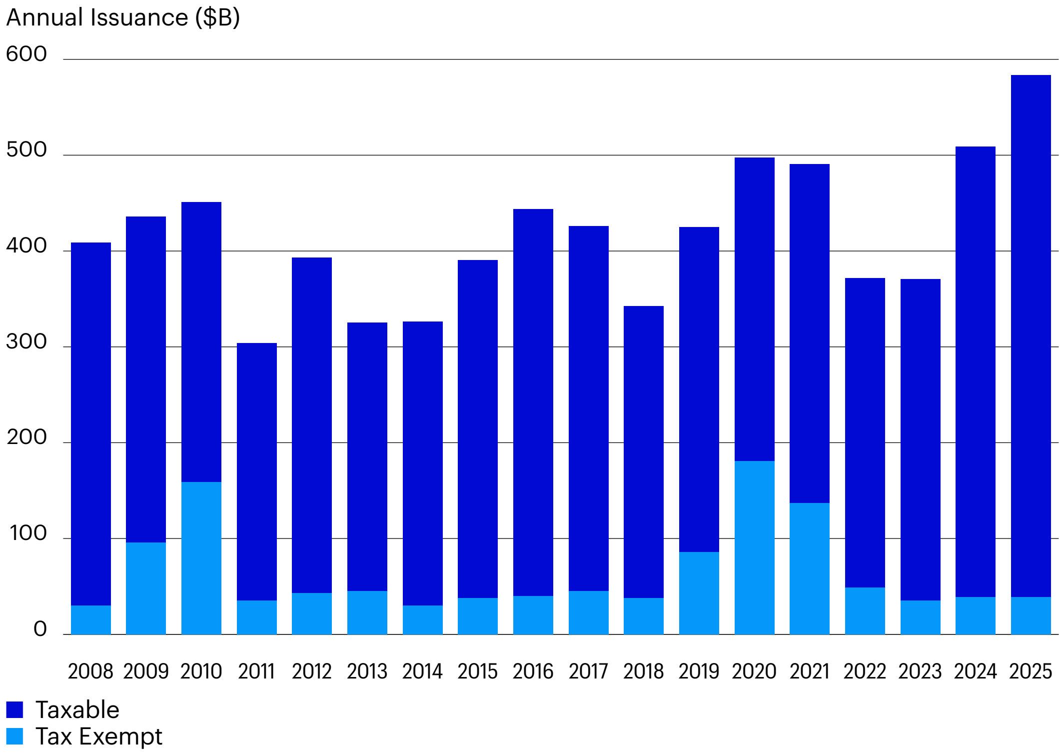
Record supply was met with strong demand

Municipal supply totaled $143 billion in the fourth quarter,[1] continuing the trend of heavy new issuance that began in 2024. Calendar year 2025 saw a new record, with $584 billion in new deals brought to market,[1] surpassing the previous record of $509 billion[7] set in 2024 (see Exhibit 3). Shifting Fed interest rate policies, political uncertainty, and the rising cost of starting new projects and maintaining existing infrastructure may have encouraged many issuers to come to the municipal market in search of capital.

Exhibit 3: Municipal market supply sets another new record in 2025



Source: Bloomberg Financial L.P., as of December 31, 2025.

Tax-exempt supply accounted for $132 billion of the total new issuance in the fourth quarter,[1] 16% higher than in the fourth quarter of 2024.[7] In 2025 overall, tax-exempt new issuance was approximately $544 billion,[1] significantly higher than the $470 billion of tax-exempt new issuance in calendar year 2024.[7] For context, tax-exempt new issuance has averaged about $365 billion annually over the last decade.[1]

As for taxable supply, new issuance was approximately $11 billion during the fourth quarter,[1] up from the $9 billion that came to market in third quarter.[8] Total calendar year new issuance was $39 billion,[1] about the same as the amount issued in 2024.[7] Taxable new issuance spiked in 2020 and 2021, due in part to the elimination of tax-exempt advance refunding under the Tax Cuts and Jobs Act.

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Demand remained strong, with positive investment flows in each month of the quarter. Total net inflows to municipal bond mutual funds and municipal bond ETFs totaled approximately $17.5 billion and ended the year with a total of $52.4 billion.[1] Investment flows were only negative in two months of the year, with the tariffs imposed on "Liberation Day" having the biggest impact on outflows from municipal bond mutual funds during April.[9] Investors shifted their focus to longer-duration municipals at the beginning of the fourth quarter, as shorter-term maturities appeared more vulnerable to reinvestment risk due to the resumption of the Fed's easing cycle.[10] However, that enthusiasm for longer munis faded in the last two months of the year, as investors harvested losses for tax purposes.

Credit picture remained bright

The municipal market continued to benefit from strong credit fundamentals, as most state and local governments maintained healthy reserves. For instance, the median state has enough rainy day funds to operate for nearly 50 days without additional revenue.[11] While only a few states had reserves insufficient to cover a 5% revenue decline in fiscal year 2026, others, are well positioned to withstand a revenue drop of 25% or more.[12] Furthermore, many states planned to increase the size of their rainy day funds in both absolute terms and as a percentage of expenditures during the 2026 fiscal year.[11]

The long-term liabilities and fixed cost metrics of many state and local governments have also continued to improve.[13] The risk of pension losses, for example, has decreased, as pension and other post-employment benefit liabilities fell and revenue grew modestly.[14]

Credit upgrades demonstrated these strong fundamentals and continued to outpace downgrades in 2025.[15] Through the third quarter of 2025, Moody's Ratings and S&P Global Ratings had a combined upgrade/downgrade ratio of 1.7 to 1.[16] The municipal default rate also remained low.[15]

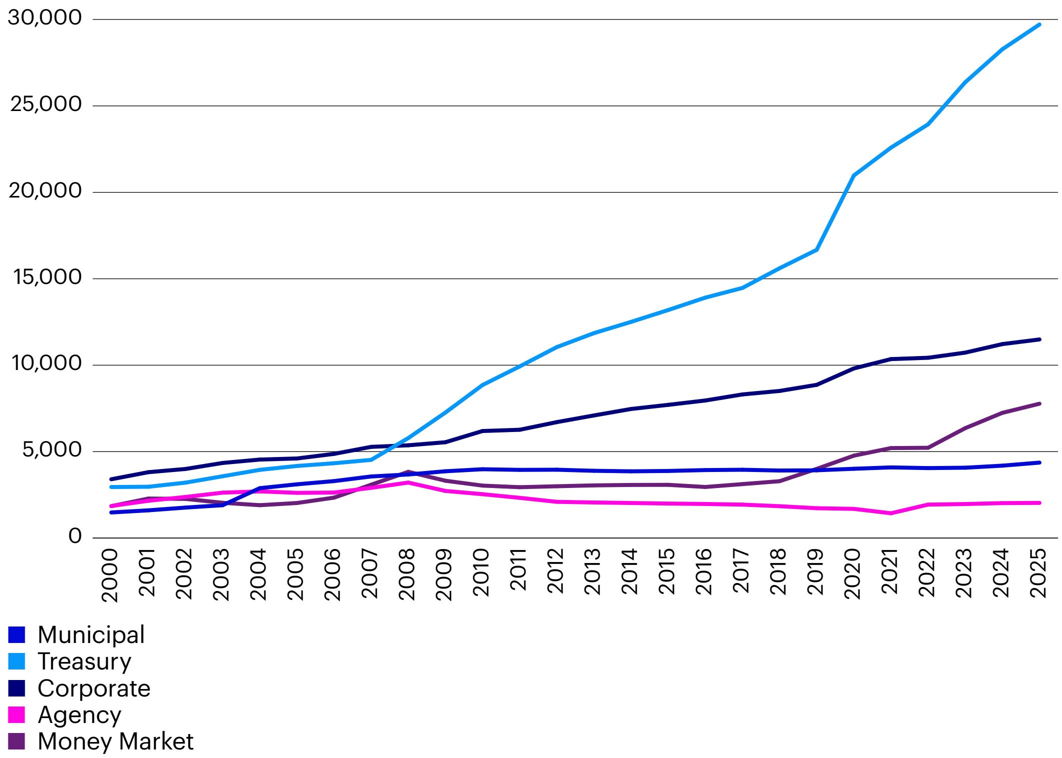
Outlook

Looking ahead, we see attractive opportunities in municipal bonds. With prospects for more Fed interest rate cuts, steady issuance, and ongoing demand for tax-exempt income, we believe high absolute yields and solid fundamentals make municipals a compelling investment choice.

Overall, we expect market technicals to move in favor of munis during 2026. Although many analysts have forecasted another record year—with $600 billion or more of new supply,[17] we believe issuance should normalize and drop toward more historically normal levels. For 2026, we expect to see about $575 billion in new supply,[18] as state and local governments continue to bring debt to market. As for demand, some analysts have forecasted principal redemptions and coupon payments totaling as much as $701 billion,[16] which would eclipse supply forecasts. Depending on how much of that money is reinvested, net supply could be between -$61 billion and +$120 billion in 2026.[16] At the same time, more than $7.7 trillion was invested in taxable and tax-exempt money markets at the end of 2025,[19] money that still may be deployed to municipal bonds if short-term interest rates continue to fall (see Exhibit 4).

Exhibit 4: Municipal market supply sets another new record in 2025

Annual Issuance ($B)



Source: SIFMA as of 9/30/2025, latest data available.

Meanwhile, based on the data, the credit environment is likely to remain stable and resilient, in our view. Accordingly, we do not expect an uptick in defaults in 2026. Although various sectors have faced pressure due to reduced federal support, inflation-driven cost pressures and negative political headlines, we continue to rely on our extensive bottom-up research capabilities to identify strong credits with attractive yields.

As always, we will remain focused on our time-tested process, taking a long-term view without reacting to short-term events. Our seasoned credit research team will continue to seek out market dislocations, and uncover potential opportunities as we seek to add value for shareholders.

1. Source: Bloomberg, as of December 31, 2025. Investment grade municipal bonds are represented by Bloomberg Municipal Bond Index. High yield municipal bonds are represented by Bloomberg Municipal High Yield 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.
2. Source: Federal Reserve, as of December 31, 2025.
3. Source: Federal Reserve, as of December 10, 2025.
4. Source: Standard & Poor's, Bloomberg, Bankrate.com, as of January 14, 2026. Over the past 15 years, 10/30/2023 marks the highest tax-equivalent yield (9.14%) seen in the past 15 years through 12/31/2025. Past performance does not guarantee results. An investment cannot be made into an index. Tax-equivalent yield is the pretax yield a taxable bond needs to equal that of a tax-free municipal bond. The maximum tax rate of 40.8% (the 2026 maximum tax bracket and 3.8% health care tax) was used to calculate the tax-equivalent yield.
5. Source: Macrobond, Bloomberg. L.P. Data as of June 30, 2025. Past performance does not guarantee result. Correlation data is a 10-year lag.
6. Source: Morningstar, as of December 31, 2025.
7. Source: Bloomberg, as of December 31, 2024.
8. Source: Bloomberg, as of September 30, 2025.
9. Source: Strategic Insight, Bloomberg, as of December 31, 2025.
10. Source: Lipper, as of January 5, 2026.
11. Source: National Association of State Budget Officers, , as of November 21, 2025.
12. Source: S&P Global Ratings, BofA Global Research, as of November 21, 2025.
13. Source: Bureau of Labor Statistics, September 2025.
14. Source: Moody's Ratings, as of September 19, 2025.
15. Source: Standard and Poor's, as of September 30, 2025, latest data available.
16. Source: BofA Global Research, as of December 4, 2025.
17. Source: Bloomberg, as of December 5, 2025.
18. Source: Invesco Municipal Bond Team, as of December 18, 2025.
19. Source: Investment Company Institute, as of January 14, 2026.

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

The Bloomberg Municipal High Yield 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.

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.

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

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

Market technicals include supply and demand for a security and how it can affect changes in price, volume, and volatility.

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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