Municipal bond market recap and outlook

FIRST QUARTER 2026

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Overview

- The municipal market's rally paused as geopolitical events drove an increase in interest rate volatility.
- Demand for municipals was strong, with positive investment flows in almost every week of the quarter.
- New issuance rose year over year, as state and local governments sought financing to complete a backlog of capital projects.
- Underlying municipal fundamentals remained supportive, with credit conditions broadly stable.

Municipal bonds delivered mixed results for the first quarter. Performance was strong early on, with municipals generating positive returns of approximately 2% over January and February, supported by favorable market technicals and solid credit fundamentals.[1] Market confidence remained intact even in the face of macroeconomic factors, such as a partial federal government shutdown in early February and shifting economic data that raised questions about the path of Federal Reserve (Fed) policy action. In March, the market's momentum was interrupted by a surge in interest rate volatility, triggered by geopolitical events. Escalating hostilities in the Middle East prompted a broad-based selloff across global capital markets. Municipal bonds declined in sympathy with other asset classes, though their drawdown was relatively modest compared to equities and several other fixed income sectors. In this environment, municipals gave back much of their previous gains. For the quarter overall, investment grade, high yield and taxable municipals returned -0.18%, 0.71%, and 0.43%, respectively.[2]

The Fed maintained a cautious policy stance during the quarter. In January, policymakers paused their easing cycle, leaving the target federal funds rate unchanged. This decision was widely anticipated by the markets, as inflation remained above the central bank's 2% target and labor market conditions appeared relatively stable. Fed Chair Jerome Powell emphasized continued progress on inflation, while acknowledging that price pressures remained somewhat elevated.[3] At the March meeting, the Fed remained on hold, citing mixed inflation signals, softening labor indicators, and external risks that included US trade policy, immigration, and higher energy prices due to the conflict in the Middle East.[4] Nevertheless, the Fed maintained its outlook for one rate cut in 2026.[4]

Surging rate volatility experienced in March caused US Treasury yields to end the quarter higher, as investors pushed out their expectations for near-term Fed rate cuts and even contemplated the possibility of rate hikes. Yields of two-, five-, ten-, and thirty-year Treasury bonds increased 32, 19, 12, and 4 basis points, respectively.[5] This resulted in a Treasury curve that was somewhat flatter than it was at the beginning of the quarter.

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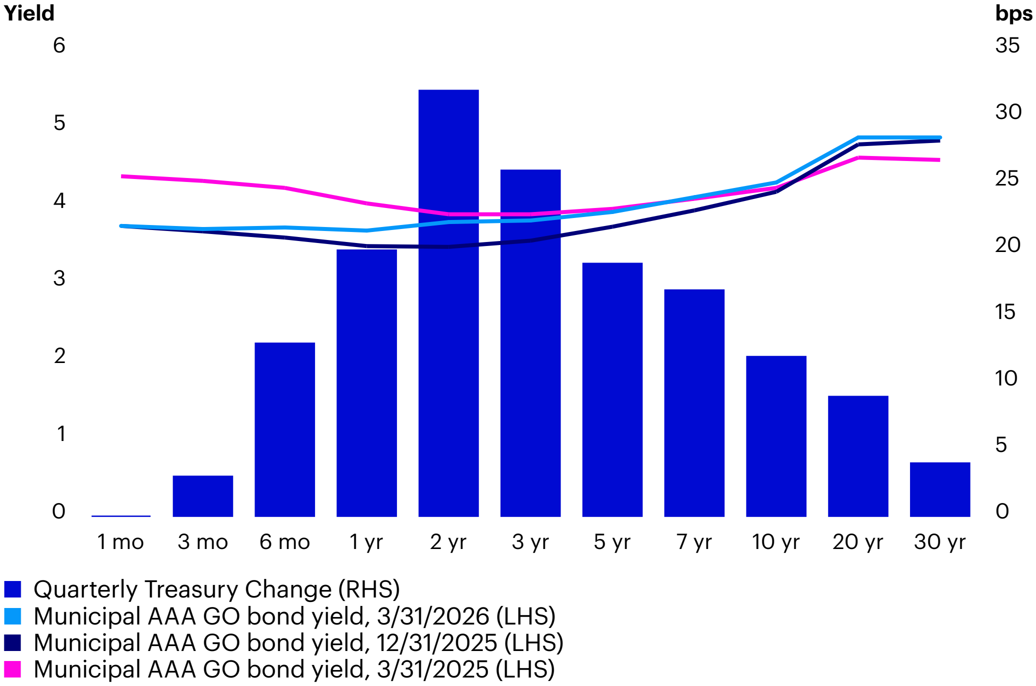
Following two months of falling municipal yields—particularly on the shorter end of the curve—March brought about a reversal. By the end of the quarter, the muni yield curve steepened, with the yields of two-, five-, ten-, and thirty-year AAA general obligation bonds having climbed 3, 26, 36, and 23 basis points, respectively over the period[6] (see Exhibit 1).

Exhibit 1: The municipal yield curve was steeper than the US Treasury yield curve at the end of the first quarter



Source: US Department of the Treasury, Daily Treasury Yield Curve Rates. Data as of March 31, 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 guarantee results.

With yields at multi-year highs, the municipal market grew increasingly attractive from both an income and price appreciation standpoint. Elevated yields can translate into attractive tax-advantaged income streams, which may be particularly appealing for high income investors. Furthermore, periods of high starting yields have historically been associated with stronger forward returns, particularly over longer investment horizons. This is illustrated by a 93% correlation between starting yields and future 10-year returns,[7] as well as the Bloomberg Municipal High Yield Index's cumulative total return of 118.52% since 2011[8] (see Exhibit 2).

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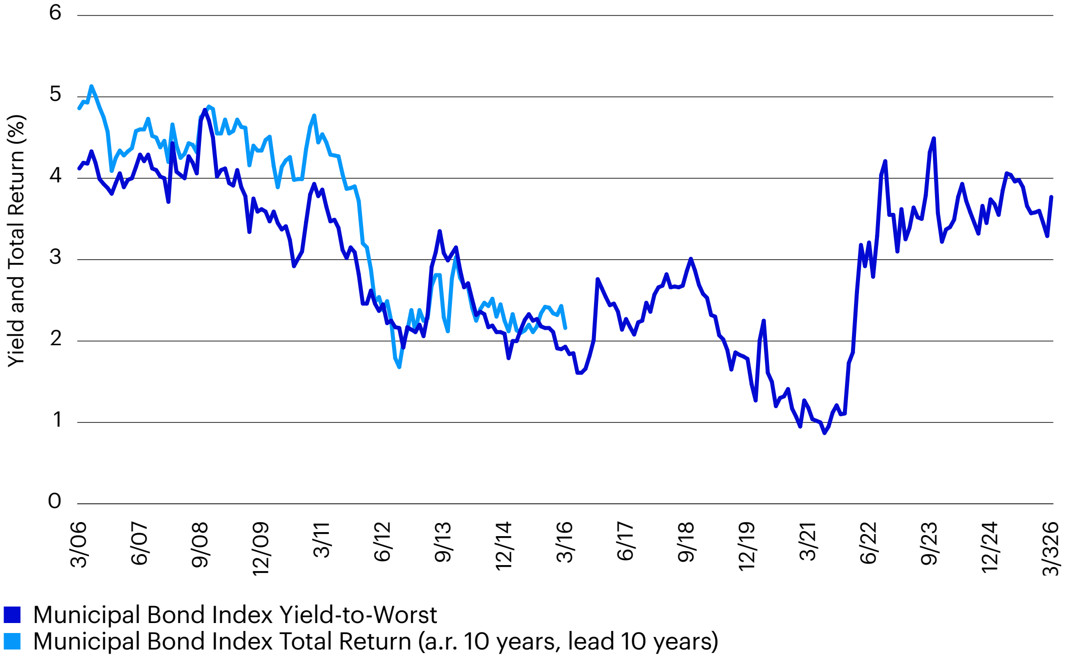
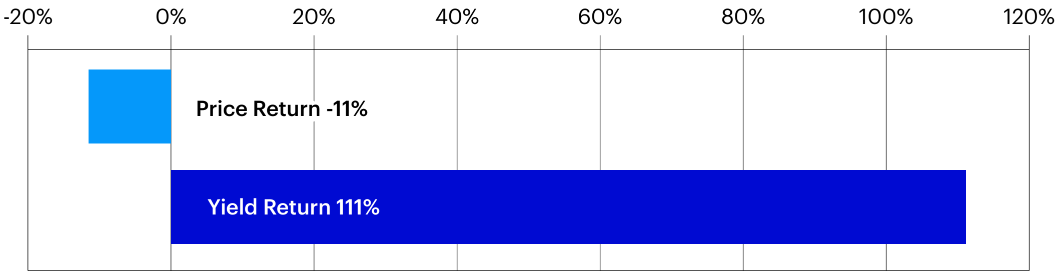
Exhibit 2: Over the long term, yield drives total return[8]

Historical Correlation of ~90% Between Starting Yield and Future 10-Year Returns



Contribution to Cumulative Total Return
March 31, 2011 – March 31, 2026



Bloomberg High Yield Municipal Index Return (%)			
	Price Return	**Yield Return**	**Total Return**
Cumulative	-13.54	132.06	118.52
Annualized	-0.42	5.77	5.35

Source: Morningstar, Bloomberg L.P., data as of March 31, 2026.

The Bloomberg Municipal Bond Index is an unmanaged index considered representative of the tax-exempt bond market. The Bloomberg Municipal Bond High Yield Index is an unmanaged index considered representative of bonds that are non-investment grade, unrated or rated below Ba1. An investment cannot be made directly in an index. Past performance does not guarantee results. Correlation data is a 10-year lag.

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Investor demand was resilient amid record supply

The combination of high absolute yields and potential price appreciation supported individual and institutional demand during the quarter. Overall, municipal ETFs and mutual funds netted approximately $26 billion of investment inflows, just about half of the $52.4 billion recorded in calendar year 2025.[9] Investors generally favored investment grade strategies, with inflows focused on intermediate- to long-term funds.[9] High yield strategies also reported positive flows for the quarter, despite three consecutive weeks of outflows in March.[9]

New municipal issuance was $135 billion in the first quarter of 2026, about 11% higher than in the first quarter of 2025, driven by infrastructure borrowing, higher supply costs, and reduced federal spending.[10] Tax-exempt supply accounted for $128 billion of the total, 13% more than in the first quarter of 2025.[10] As for taxable supply, it was approximately $7 billion, down from the $11 billion that came to market in fourth quarter of 2025.[10] Taxable new issuance may have declined because interest rates were high by historical standards.

Outlook

Recent volatility has been driven by macroeconomic uncertainty and geopolitical events, not credit fundamentals. Although some sectors of the municipal market came under pressure due to reduced federal support and inflation-driven cost pressures, credit fundamentals remained positive during the quarter. State and local government budgets appeared to be on solid footing, with the vast majority maintaining healthy reserves. While there has been a moderate slowdown in credit rating upgrades, they still exceeded downgrades during the first quarter, highlighting the strong underlying fundamentals.[10]

Going forward, we expect to see positive market momentum return, as history has shown that municipal bonds have done well following periods of stress. These episodes have tended to be short lived, with fundamentals ultimately reasserting themselves. In fact, from a historical perspective, current yields suggest a favorable entry point for investors willing to focus on long term outcomes (see Exhibit 3).

Exhibit 3: Municipal Bonds: Drawdown History and Subsequent Performance

Period	Peak Date	Bottom Date	Drawdown	6-month return following bottom
Fed Raising Rates ('04 – '06)	03/17/2004	05/13/2004	-5.29	+6.04
Global Financial Crisis	01/23/2008	10/16/2008	-11.22	+13.24
Fear of Default Crisis*	10/12/2010	01/17/2011	-6.46	+7.53
Taper Tantrum	05/02/2013	09/05/2013	-6.77	+6.17
Trump Election Victory	07/06/2016	12/01/2016	-5.71	+5.50
Covid-19 Pandemic	03/09/2020	03/23/2020	-10.94	+11.97
Inflation Crisis	12/31/2021	10/26/2022	-13.02	+7.98
Liberation Day	04/04/2025	04/09/2025	-5.18	+7.27

*This period refers to the 2010 crisis of confidence sparked by an unfounded fear that hundreds of billions of dollars' worth of municipal defaults were on the horizon.

Source: Bloomberg, as of March 31, 2026. Performance represented by the Bloomberg Municipal Bond Index an unmanaged index considered representative of the tax-exempt bond market. An investment cannot be made directly into an index. Past performance does not guarantee results.

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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 seasoned credit research team to identify market dislocations as we seek to add value for shareholders.

1. Source: Bloomberg, as of February 28, 2026.
2. Source: Bloomberg, as of March 31, 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. Source: Federal Reserve, as of January 28, 2026.
4. Source: Federal Reserve, as of March 18, 2026.
5. Source: US Department of the Treasury, as of March 31, 2026.
6. Source: Thomson Reuters, as of March 31, 2026.
7. Source: Morningstar, Bloomberg, for the period between March 31, 2006 and March 31, 2026. Past performance does not guarantee results.
8. Source: Morningstar, as of March 31, 2026.
9. Source: LSEG Lipper Global Fund Flows, J.P. Morgan, as of April 2, 2026.
10. Source: Bloomberg, as of March 31, 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.

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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