



Municipal Bond Market Overview: 1Q26

Municipal bonds began the new year on an upbeat note before the outbreak of war in Iran and the accompanying energy supply shock spawned significant volatility in rate markets.

When all was said and done, the strength of January and February was pretty much undone by March's weakness, and muni index returns ended the first quarter wrapped around zero. The S&P Municipal Bond High Yield Index gained 0.3%, while both the S&P Municipal Yield Index, which includes bonds across the quality spectrum, and the S&P Short Duration Municipal Yield Index lost 0.2%. For comparison, the Bloomberg US Aggregate Bond Index was flat during the period.¹

Municipal issuance set another new record with \$119 billion in tax-exempt bonds and \$128 billion in overall issuance.¹ In the face of complicated and rapidly evolving dynamics that included the outbreak of war, spiking energy prices, renewed inflation concerns, whipsawing policy expectations and acute Treasury volatility, the Municipal Credit team was impressed by the municipal market's ability to absorb significant issuance; in our view, it is a testament to steady investor interest in the asset class and the appealing yields on offer.

KEY TAKEAWAYS

- Municipal bond yields mostly followed the trend of Treasuries during the first quarter, easing across the curve early in the year before rising sharply upon the outbreak of war with Iran, which caused longer-term yields to increase more than short-term yields.
- The market's ability to absorb another quarter of record new issuance was impressive in the face of supportive fundamentals.
- Signs of the war's energy supply shock and financial toll have started to trickle into the macroeconomic data, and we believe some level of inflationary pressure is likely to persist even if this conflict ends sooner.
- In the face of uncertainty introduced by the war and challenges facing policymakers, we believe research-driven underwriting can help uncover opportunities in out-of-favor areas with wide dispersions in yields.

1. Source: FactSet; data as of March 31, 2026.

Muni Market Resilient Amid Volatile Conditions

Given the quarter's complicated and rapidly evolving dynamics—including the outbreak of war, spiking energy prices, renewed inflation concerns, whipsawing policy expectations and acute Treasury volatility—the municipal market's ability to absorb \$119 billion of tax-exempt new issuance (and \$128 billion overall) was impressive, in our view, and is a testament to steady investor interest in the asset class and the appealing yields on offer. Tax-exempt new issuance was 13% higher than in the first quarter of 2025, a year that ended up setting a new annual record. As it had been throughout 2025, issuance was predominantly new capital, with less than one-quarter going toward refunding activity.²

Bond demand proved up to the task of absorbing the strong issuance. January and February are historically robust months for flows into municipal bond mutual funds and exchange-traded funds, and 2026 was no different. The strong start to the year helped kickstart total first quarter inflows of close to \$33 billion, nearly tripling those from first quarter 2025.³

Municipal bond yields eased across the curve early in the year before rising sharply in March.

Municipal bond yields mostly followed the trend of Treasuries during the first quarter, easing across the curve early in the year before rising sharply in March as a shock to the global energy supply chain, brought on by the war with Iran sent energy prices sharply higher and raised concerns about renewed inflation. The end result was a bear steepening in which longer-term yields increased more than short-term yields.

Market-indicated federal funds rate expectations have been volatile; while two cuts had been priced in prior to the war, by late March markets were expecting a rate hike, and markets are now more or less flattish. The Fed, in contrast, has been more measured in its response to the ramifications of the war, leaving its policy rate unchanged in its mid-March meeting and continuing to project one rate cut before year end; this caution likely reflects the common practice among central bankers to “look through” energy shocks. That said, Fed board members' median expectation for 2026 core personal consumption expenditures (PCE) inflation increased to 2.7%, from 2.4% previously, and the notably wide distribution of inflation forecasts—from 2.3% to 3.4%—highlights the uncertainty introduced by the war and the challenges facing policymakers.⁴ With some level of inflationary pressure likely to persist even if the war ended today, Fed rate cuts would seem to be a challenge absent much tighter financial conditions or substantial labor market deterioration.

Meanwhile, signs of the war's financial toll have started to trickle into the macroeconomic data, providing some insight of what may lie ahead. The US headline consumer price index for March increased 3.3%, its highest level in nearly two years, driven by skyrocketing gasoline (up 18.9%) and fuel oil (up 44.2%) prices. Though food prices increased a more modest 2.7%, the energy shock is likely to further pressure a US agriculture sector already struggling with the impacts of trade and immigration policy, which may ultimately contribute to higher food prices.⁵

We have yet to see a GDP print for a period encompassing the war—the Bureau of Economic Analysis will release its initial first quarter estimate on April 30—but the latest GDPNow forecast expects growth of 1.3% compared to estimates of around 3% in February.⁶ This would come on the back of a disappointing 0.5% reading for fourth quarter 2025, down sharply from the third quarter's 4.4% growth due in part to the 43-day government shutdown.⁷

2. Source: SIFMA; data as of April 1, 2026.

3. Source: Investment Company Institute; data as of March 31, 2025.

4. Source: Federal Reserve; data as of March 18, 2026.

5. Source: US Bureau of Labor Statistics; data as of April 10, 2026.

6. Source: Federal Reserve Bank of Atlanta; data as of April 9, 2026.

7. Source: US Bureau of Economic Analysis; data as of April 9, 2026.

Steady Fundamentals Persist

Issuer fundamentals continue to be supportive, even as they normalize from the stimulus-fueled conditions of the pandemic years. Overall state budgets for fiscal 2026 reflect a healthy environment, and general fund balances remain well above the historical average. Though state general fund revenue has fallen off the record pace of fiscal 2021 and 2022, it has continued to grow, and modest revenue gains are expected in fiscal 2026. Budgets enacted to date suggest flat general fund spending in 2026, and most states plan to maintain or increase the size of their rainy-day funds—many of which are already at nominal highs—in anticipation of future needs.⁸

Another sign of fiscal strength can be found in improvement in pension funding, as the aggregate median ratio for local-government pensions climbed to 80% in the most recent, fiscal 2024 reading from 78% in fiscal 2022. While this can be attributed in part to market performance, local governments have increased contributions and tweaked their benefit structures, demonstrating improved funding discipline and better long-term sustainability.⁹

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These dynamics have supported muni bond ratings activity, which has remained positive even as the ratio of upgrades to downgrades continued to moderate: positive activity (including both upgrades and favorable outlook revisions) outpaced negative activity at a rate of 1.3x in the first two months of the year, down from 1.9x in 2025.¹⁰ Both defaults and first-time distressed debt remained very low in the first quarter.¹¹

8. Source: National Association of State Budget Officers; data as of November 14, 2025.

9. Source: S&P Global; data as of September 16, 2025 (most recent available).

10. Source: S&P Global; data as of February 26, 2026 (most recent available).

11. Source: BofA Global Research; data as of March 31, 2026.

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All investments involve the risk of loss of principal.

Investments in bonds are subject to interest-rate risk and can lose principal value when interest rates rise, while they typically increase their principal values when interest rates decline. Bonds are also subject to credit risk, in which the bond issuer may fail to pay interest and principal in a timely manner, or that negative perception of the issuer's ability to make such payments may cause the price of that bond to decline.

Municipal bonds are subject to credit risk, interest rate risk, liquidity risk, and call risk. However, the obligations of some municipal issuers may not be enforceable through the exercise of traditional creditors' rights. The reorganization under federal bankruptcy laws of a municipal bond issuer may result in the bonds being cancelled without payment or repaid only in part, or in delays in collecting principal and interest.

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Diversification does not guarantee investment returns and does not eliminate the risk of loss.

A **bear steepener** is the steepening of the yield curve caused by long-term interest rates increasing at a faster rate than short-term rates. A bear steepener is usually suggestive of rising inflationary expectations or a widespread rise in prices throughout the economy.

Consumer price index (CPI) (Price) measures inflation as experienced by consumers in their day-to-day living expenses by capturing the average change over time in the prices paid for a representative basket of consumer goods and services. A price-return index only measures price changes.

A **credit rating** is an assessment provided by a nationally recognized statistical rating organization (NRSRO) of credit worthiness of an issuer with respect to debt obligations, including specific securities, money market instruments, or other bonds. Ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest); ratings are subject to change without notice. Not Rated (NR) indicates that the debtor was not rated and should not be interpreted as indicating low quality.

Exchange-traded funds (ETFs) are listed investment vehicles that seek to provide exposure to a benchmark, index or actively managed strategy.

Federal funds rate is the interest rate at which depository institutions (banks and credit unions) lend reserve balances to other depository institutions overnight on an uncollateralized basis.

GDPNow is a running estimate of real GDP growth based on available economic data maintained by the Federal Reserve Bank of Atlanta. It is not an official forecast of the Atlanta Fed.

Personal consumption expenditures (PCE) price index measures changes in the prices of goods and services purchased by consumers in the US. Core PCE excludes food and energy prices.

Bloomberg US Aggregate Bond Index (Gross/Total) measures the performance of the investment grade, US dollar-denominated, fixed-rate taxable bond market in the US, including Treasuries, government-related and corporate securities, fixed-rate agency MBS (agency fixed-rate and hybrid ARM passthroughs), ABS, and CMBS. A total-return index tracks price changes and reinvestment of distribution income.

S&P Municipal Bond High Yield Index (Gross/Total) measures the performance of fixed-rate tax-free bonds subject to the alternative minimum tax, including bonds of all quality and from all sectors of the municipal bond market. A total-return index tracks price changes and reinvestment of distribution income.

S&P Municipal Yield Index (Gross/Total) measures the performance of high yield and investment grade municipal bonds. A total-return index tracks price changes and reinvestment of distribution income.

S&P Short Duration Municipal Yield Index (Gross/Total) measures the performance of high yield and investment grade municipal bonds with maturities of one to 12 years. A total-return index tracks price changes and reinvestment of distribution income.

Indexes are unmanaged and do not incur management fees or other operating expenses. One cannot invest directly in an index.

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