2Q26 Municipal Bond Market Overview

Municipal bonds continued to demonstrate resilience in the second quarter amid ongoing interest rate volatility and record-setting new issuance.

After a challenging March, muni indexes quickly got back on track in April to kick off a productive quarter. The S&P Municipal Bond High Yield Index gained 3.3% in the second quarter, outpacing the 2.3% gain of the S&P Municipal Yield Index, which includes bonds across the quality spectrum, as well as the 1.9% gain of the S&P Short Duration Municipal Yield Index. For context, the Bloomberg US Aggregate Bond Index advanced 0.7% during the period.[1]

The market's ability to absorb another quarter of record new issuance was impressive, supported by investor demand as strong fundamentals provided a steady backdrop for municipals. Despite the outperformance of munis relative to Treasuries, we believe tax-equivalent yields for munis—near the top quartile of their 10-year range—are still attractive, with high yield municipals offering an even more compelling yield.[2]

KEY TAKEAWAYS

- After a weak March, municipals rebounded in the second quarter, outperforming Treasuries in the face of ongoing interest rate volatility and higher short-term US interest rate expectations.
- The municipal market remains on pace for another record year of issuance as strong demand has continued to absorb issuance amid a supportive backdrop.
- Issuer fundamentals remain healthy as state and local governments continue to benefit from growing tax revenues, disciplined budgeting, record rainy-day reserves and improving pension funding.
- Despite this outperformance, tax-equivalent yields for munis are near the top quartile of their 10-year range and high yield municipals offer an even more compelling yield.[3]

1,2,3. Source: FactSet; data as of June 30, 2026.

Muni Technicals Remain Supportive

Despite consecutive years of record new-issue volume in 2024 and 2025, investor appetite for municipal bonds has remained unsated in 2026. While first-half issuance of $299 billion—including a record-setting $163 billion in the second quarter—has the market on track to set another annual high-water mark, this paper continues to be met by strong demand across vehicle types, including municipal bond exchange traded-funds (ETFs), tax-exempt mutual funds and separately managed accounts, as well as direct holdings by individuals.[4]

One notable aspect of first half issuance has been the prevalence of prepaid gas bonds issued to finance the upfront purchase of energy supplies by municipal utilities, which are up more than 130% year over year. While these bonds typically have a 30-year maturity, most newer issues are structured with mandatory tender dates at five to seven years.[5]

The quarter saw a pronounced shift higher in short-term US interest rate expectations even as those for other major economies generally moderated. One reason for this has been the appointment of Kevin Warsh as chair of the Federal Open Market Committee, replacing Jerome Powell. While Warsh's nomination for the role in March initially had some observers questioning his ability to lead the central bank independent of President Trump's rate-cutting influence, sentiment regarding his credibility has since shifted markedly. While it remains to be seen if Warsh's credibility is merely enjoying a honeymoon period to begin his term, his consistently hawkish tone has helped push two-year yields higher. Yields on two-year Treasuries broke above 4%, a level not seen consistently since early 2025. Longer maturities, in contrast, were less responsive; 30-year Treasury yields were largely unchanged during the second quarter, while 10-year yields advanced 14 basis points.[6]

Year-to-date, tax-exempt benchmark yields have declined on the short and long ends of the curve while increasing in the belly. The resulting substantial outperformance caused muni/Treasury ratios to decline across the yield curve.[7] Despite the recent pullback, tax-equivalent yields for munis are near the top quartile of their 10-year range; high yield municipals offer an even more compelling yield.[8]

While we view rate hikes as possible based on Warsh's rhetoric, the deliberate lack of formal Fed guidance under the new regime makes policy trajectory difficult to assess. Further, as credible as Warsh may be, he doesn't have the same degree of policy flexibility that many of his predecessors had given today's fiscal situation. The ability to increase interest rates meaningfully in the face of inflationary pressures is likely constrained by the government's need to continually roll over its very large primary deficit at prevailing higher interest rates.

Strong Fundamentals Persist

Issuer fundamentals continue to be supportive, even as they normalize from the stimulus-fueled conditions of the pandemic years. Though state general fund revenue has fallen off the record pace of fiscal 2021 and 2022, it has continued to grow. Fiscal 2026 collections are on track to exceed original estimates, driven by better-than-expected personal income tax receipts; and modest revenue gains are expected in fiscal 2027, which would reflect the fifth consecutive year of expansion. Recommended budgets for fiscal 2027 suggest flat general fund spending next year, and most states plan to continue bolstering their rainy-day funds—many of which are already at nominal highs—in anticipation of future needs.[9]

Another sign of fiscal strength can be found in improved pension funding. The funded ratio of the country's 100 largest public plans, for example, climbed to 89.1% in its latest reading compared to 81.1% a year prior. 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.[10]

These dynamics generally have been supportive of muni bond ratings; 96% of S&P Global's municipal rating universe carries a stable or positive outlook.[11]

4,5. Source: MSRB; data as of June 30, 2026.
6. Source: Federal Reserve; data as of June 30, 2026.
7. Source: MSRB; data as of June 30, 2026.
8. Source: Bloomberg; data as of June 30, 2026.
9. Source: National Association of State Budget Officers; data as of June 4, 2026.
10. Source: Milliman; data as of July 6, 2026.
11. Source: S&P Global; data as of June 30, 2026.

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Past performance is not indicative of future results.

Risk Disclosure

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.

The information is not intended to provide and should not be relied on for accounting or tax advice. Any tax information presented is not intended to constitute an analysis of all tax considerations.

10-year Treasury note is a debt obligation of the US government with a maturity of 10 years upon issuance.

30-year Treasury bond is a debt obligation issued by the US government with a maturity of 30 years upon issuance.

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.

High yield municipal bonds are debt securities issued by states, cities, counties and other public entities that offer a higher rate of interest due to their perceived higher risk of default.

Municipal-to-Treasury ratio compares the yield on a AAA rated muni bond to a US Treasury security of the same maturity to assess relative value.

S&P Global Ratings is a nationally recognized statistical rating organization (NRSRO) that assesses the creditworthiness 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. For more information on the S&P Global Ratings' methodology, please visit spglobal.com and select "Understanding Credit Ratings" under About Ratings.

A **separately managed account (SMA)** is a portfolio of securities that is managed by a professional investment firm.

Taxable equivalent yield (TEY) reflects the pretax yield that a taxable fixed-income investment would need to offer to produce the same after-tax yield as tax-exempt security. The TEY shown is calculated based on the most common federal tax bracket(s).

Two-year Treasury yield is the interest rate paid on a US Treasury note with a maturity of two years upon issuance.

A **yield curve** is a graphical representation of interest rates on debt of equal credit quality across a range of maturities.

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 bonds in the S&P Municipal Bond Index that are not rated or whose ratings are below investment grade. 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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