MUNICIPAL BONDS

Some Negative Trends Call for Defensive Positioning

This report is excerpted from the Third Quarter 2026 Fixed-Income Sector Views.

Tight valuations and poor fundamentals going into the latter half of the third quarter.

Tax-exempt municipal bond valuations remain tight as steady demand from retail investors has more than offset supply growth. The AAA tax-exempt curve flattened by 18 basis points during the second quarter. Tight valuations and a lack of positive credit catalysts makes defensive positioning appropriate.

Sector Commentary

- Tax-exempt/Treasury yield ratios finished the second quarter below where they stood at the end of the first quarter. Ratios are 62/67/86 percent in 5/10/30-year tenors, respectively, a parallel shift downward of 5 percentage points versus March 31 levels. The AAA tax-exempt slope from 1–30 years flattened 18 basis points during the quarter, lagging the 32 basis points of flattening in the Treasury curve, and indicating some marginal relative value in long-dated tax exempts.
- Taxable municipal spreads tightened 4 basis points during the second quarter, failing to keep pace with 6 basis points of tightening in investment-grade corporates. Supply remains low year to date, down 3 percent to $18 billion and comprising just 6 percent of total municipal issuance. The light primary calendar continues to provide a technical tailwind for taxable spreads.

Investment Themes

- Consistent demand from separately managed accounts and steady inflows into mutual funds and ETFs have supported tax-exempt valuations for most of 2026, despite geopolitical events and Treasury volatility. Based on seasonal patterns, technicals turn bearish toward the end of the summer. We believe a defensive posture is appropriate going into the latter half of the third quarter.
- At Standard and Poor's, negative outlook revisions continue to exceed positive revisions, implying more downgrades than upgrades for the next six–12 months. We expect negative credit trajectories to continue.
- The depletion of COVID-era stimulus funding and a decline in school age population have led to large gaps in school district budgets. To date, districts have laid off mostly administrative positions and eliminated unfilled positions. Due to the fixed labor costs, school districts will require supplemental funding at the local level or from other governmental entities to avoid structural deficits.

By Allen Li and Michael Park

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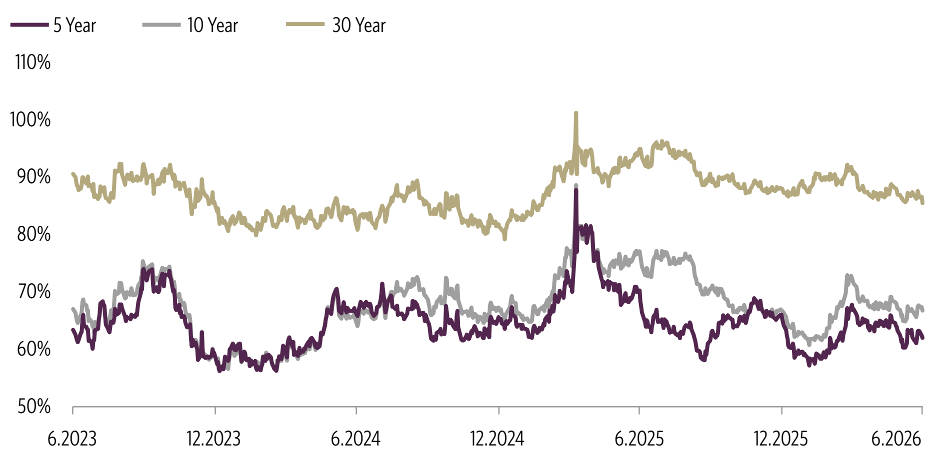
Muni/Treasury Yield Ratios Declined in Q2

AAA Muni/Treasury Yield Ratios



Source: Guggenheim Investments, LSEG. Data as of 6.30.2026.

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One **basis point** is equal to 0.01%.

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