EAGLE INCOME TEAM

Municipal Market 2026 Mid-Year Review and Outlook

July 2026

EAGLE | Asset Management

Executive summary

- **Municipal bonds were the best-performing fixed income sector during the first half of 2026, with the Bloomberg US Municipal Bond Index returning 2.32% year to date.**
- **Municipal issuance reached $299 billion through June – 6% above 2025's record pace and 40% above the 10-year average.**
- **Investor demand has remained exceptionally strong, with $53.3 billion of net inflows year to date – the second-highest first-half total on record.**
- **Municipal credit fundamentals have remained broadly healthy, but rising sector divergences reinforce the importance of active credit selection.**

Review and outlook

The municipal bond market delivered an impressive first half of 2026, overcoming a series of macroeconomic and geopolitical challenges that typically would pressure fixed income returns. Higher US Treasury yields, persistent inflation, shifting US Federal Reserve (Fed) expectations, record municipal issuance, and heightened geopolitical tensions all created a difficult backdrop. Yet despite these headwinds, municipal bonds emerged as the best-performing fixed income sector, generating returns of more than 2% through the first half of the year. Attractive tax-adjusted yields, resilient investor demand, and more favorable starting valuations allowed the asset class to outperform in this challenging environment.

We remain constructive on the municipal market, though we expect the second half of the year to be more volatile than the first. Elevated absolute yields have provided attractive after-tax income opportunities, drawing unusually keen investor demand. Municipal bond funds attracted $53.3 billion of net inflows during the first half of 2026 – the second-highest first-half total on record. We expect these inflows to continue to provide an important technical tailwind as the market absorbs another year of historically elevated issuance.

While broad credit fundamentals have remained healthy, sector dispersion has grown as fiscal pressures and federal policy changes have created winners and losers. The ratio of upgrades to downgrades, which has been contracting significantly over the last two years, is evidence of this trend. We continue to favor essential-service sectors such as water and electric utilities, and we advocate for greater selectivity in health care, higher education, transportation, and certain general obligation issuers facing demographic and funding challenges. In this environment, we believe disciplined security selection, rigorous credit analysis, and a focus on intermediate- and longer-duration bonds should be the key drivers of attractive tax-efficient income and competitive total returns through the remainder of 2026.

Returns – Resilience amid headwinds

It's hard to imagine many investors would have predicted a strong year for municipals. The market has had to digest a war between the US and Iran, higher Treasury yields, stubborn inflation, a Fed that shifted from expecting several interest rate cuts to considering hikes, and another record-setting year for municipal issuance. Normally, these circumstances would be a recipe for headwinds.

[1] Unless otherwise indicated, all data cited is sourced from Bloomberg as of June 30, 2026.

[2] Any forecasts, figures, opinions, or investment techniques and strategies set out are for informational purposes only. There is no assurance any estimate, forecast or projection will be realized.

Instead, we have seen two key factors support the resilience of the municipal sector:

1. Higher tax-adjusted income: As the tax-exemption has a multiplier effect, it has become more valuable since yields reset higher in 2022. For investors in the highest tax bracket, few asset classes have been able to compete with municipal bonds on a tax-adjusted basis.
2. More attractive valuations: While not at historically cheap valuations, municipals started 2026 at a more attractive relative value than other asset classes. Following the pressure of heavy supply and tax-policy concerns, municipals entered the year with more room for recovery than other sectors.

We continue to have a favorable outlook on the municipal market. We believe the asset class is well positioned to generate positive returns through the remainder of the year but we expect investors to navigate a more challenging environment than earlier in the year. Record levels of issuance, ongoing uncertainty surrounding the path of interest rates, and valuations that are less attractive than they were at the beginning of 2026 could create periods of volatility.

Geopolitical risks also remain on the radar. Tensions between the US and Iran are ever-fluid and could periodically unsettle financial markets. Even so, the municipal market demonstrated impressive resilience through the first half of the year. Barring a significant change in the macroeconomic backdrop, we believe municipals remain on track to deliver another year of positive returns for investors.

Supply – An evolving landscape

State and local governments sold $299 billion in the first half of 2026, outpacing the record-breaking supply of 2025 by 6% and issuing 40% above the 10-year average. Supply contracted post-COVID, but, as we've noted previously, began to expand at a record-setting pace in 2024. This was driven by four primary factors:

1. Deferred maintenance: Issuers have postponed capital projects while waiting for a decline in interest rates that increasingly appears unlikely. Meanwhile, inflation has driven cumulative costs sharply higher for both new projects and the maintenance of existing infrastructure. Research shows that the average project cost was 29% higher in 2025 than in 2019.
2. A return to the debt market: COVID-related funds are exhausted, and a substantial portion of the Biden administration's infrastructure funding has been clawed back. As a result, municipalities are returning to traditional debt financing for new construction projects and ongoing operations.
3. Declining expectations of lower rates: Issuers have been postponing capital projects, patiently waiting for rates to decline, but there has been a growing acceptance that significantly lower rates do not seem likely in the near term.
4. Federal policy changes: Potential policy shifts could increase funding needs across various issuers. Impacted areas may include climate-related programs, particularly if the Federal Emergency Management Agency is phased out or curtailed; higher education due to federal funding restrictions; and health care, as hospitals may need to issue more debt to offset cuts to Medicaid.

Coming into 2026, opinions on municipal bond supply were largely divided. Some investors expected the elevated issuance from the second half of 2025 to continue, with forecasts calling for more than $630 billion in new issuance. We, on the other hand, viewed last year's surge as more of a one-time idiosyncratic event and expected issuance to ease back toward more normal levels.

We're halfway through the year and the market has landed somewhere in the middle. Issuance got off to a stronger start than in 2025 but moderated late in the second quarter. At the current pace, full-year issuance is on track to finish slightly above last year's record totals. The increased supply would push net issuance to the $250 billion to $260 billion range.

Demand – Why it may not let up

Drawn by attractive yields and municipals' defensive characteristics amid recent market volatility, investor demand for municipal bonds has been one of the strongest on record. Year-to-date net inflows totaled $53.3 billion through June. It's the second-highest level on record for this point in the year – surpassing 2019 and trailing only 2021. We expect inflows to remain supportive in the second half of 2026. We believe absolute municipal bond yields continue to offer attractive tax-adjusted value compared to any other fixed income sector.

Credit – Selectivity is key

Credit quality has remained healthy, with upgrades still outnumbering downgrades. However, the gap has narrowed noticeably from the past few years. This suggests the credit environment is becoming less favorable than it has been recently.

While we believe credit fundamentals should remain strong in the near term, emerging sector-specific challenges in 2026 will demand heightened analytical precision. Fiscal pressures and shifting federal support require rigorous credit analysis in health care, higher education, transportation, and general obligation bonds. While many states and municipalities maintain healthy reserves, others face tighter budgets and increased reliance on capital markets

Sector outlook – Areas of concern

LOCAL GO (SCHOOL DISTRICTS)

Local school districts are under pressure as pandemic aid expires and costs rise. Demographic shifts and competition from charter and private schools are driving enrollment challenges.

HIGHER EDUCATION

Higher education faces a demographic cliff following a peak in high school graduates in 2025. This is compounded by US federal policy changes and reduced research funding.

HEALTH CARE

Health care margins have improved since 2023 but remain vulnerable to Medicaid cuts and policy changes in safety-net hospitals and rural facilities under the One Big Beautiful Bill Act.

TRANSPORTATION

Mass transit and other transportation systems continue to struggle with declining ridership and rising costs amid reduced US federal support. Ports, airports, and toll roads remain relatively stable.

Conclusion

Given these dynamics, we will maintain our disciplined approach that's focused on intermediate-to-long maturities where value persists. We remain overweight to water and electric utilities and other essential-service sectors, while exercising caution in the sectors highlighted earlier. Rigorous credit monitoring will guide adjustments as fiscal and policy developments unfold.

Disclosures

Investing involves risk, including risk of loss. Past performance does not guarantee future results.

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Risk information

Risks associated with Fixed Income investing: Many investors consider bonds to be “risk free” investment vehicles. Historically, bonds have indeed provided less volatility and less risk of loss of capital than has equity investing. However, there are many factors that may affect the risk and return profile of a fixed-income portfolio. The two most prominent factors are interest-rate movements and the creditworthiness of the bond issuer. Bonds issued by the U.S. government have significantly less risk of default than those issued by corporations and municipalities. However, the overall return on government bonds tends to be less than these other types of fixed-income securities. Investors should pay careful attention to the types of fixed-income securities that comprise their portfolio, and remember that, as with all investments, there is the risk of the loss of capital.

Not every investment opportunity will meet all of the stringent investment criteria mentioned to the same degree. Trade-offs must be made, which is where experience and judgment play a key role.

Income earned from investments in municipal bonds, while exempt from federal taxes, may be subject to state and local income taxes. All capital gains, as well as income earned from other sources, are subject to taxation. Income from municipal securities may also be subject to the Alternative Minimum Tax. Municipal securities typically provide a lower yield than comparably rated taxable investments in consideration of their tax-advantaged status. Investments in municipal securities may not be appropriate for all investors, particularly those who do not stand to benefit from the tax status of the investment. Please consult an income-tax professional to assess the impact of holding such securities on your tax liability.

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Index

The Bloomberg Municipal Bond Index is a rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market.

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