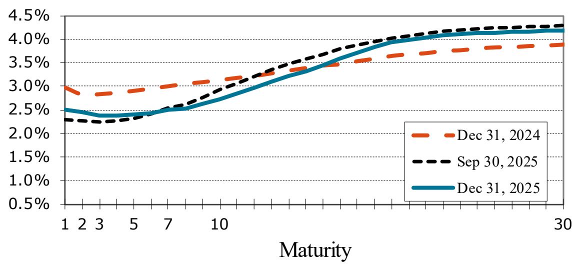
Baird Advisors
Municipal Fixed Income Market Commentary
2025 Review and 2026 Outlook

2025 Municipal Market Review

2025 was a year marked by a steepening yield curve, record new issue supply and modest widening of credit spreads. Short and Intermediate yields fell the most, as illustrated by the 10yr AAA yield ending December at 2.73%, its lowest point for the year, down 40 bps year-over-year and down 109 bps from the post-Liberation Day high of 3.82% reached on April 9th. 2yr yields finished the year down 38 bps, and the 5yr yield finished down 51 bps year-over-year. In contrast, the 30yr yield finished the year **up** 32 bps. The first half of the year was shaped by policy decisions stemming from the new Trump administration. Implementation of tariffs in April combined with uncertainty surrounding the status of the municipal tax-exemption in the One Big Beautiful Bill (OBBB) contributed to the steepening of the yield curve and underperformance of municipals relative to Treasuries through August. This underperformance, however, created very attractive tax-exempt valuations, boosting investor demand for the municipal market. This led to a reversal of fortunes over the last four months of the year as municipal yields fell more than Treasuries across most of the curve. Over the year, investors absorbed a record $585B of total municipal issuance (up 17% over 2024), $531B tax-exempt and $54B taxable, with the heaviest supply coming in 1H'25 as issuers attempted to get ahead of any potential tax changes implemented in the OBBB. The combination of appealing tax-free yields and improved cross-market valuations helped sustain positive net flows into municipal funds/ETFs. Total net fund/ETF inflows of $51B for the year, up from $41B in 2024, helped to digest the steady stream of supply. Of course, the Fed moving to an easier monetary policy provided a favorable backdrop for the bond market as the Fed lowered its target for the Fed funds rate by 75 bps between September and December. Providing cover for the Fed rate cuts was relatively stable inflation and a slowing labor market.

AAA Municipal Yields



Maturity	12/31/24	9/30/25	11/30/25	12/31/25	1Mo Chg	Q4 Chg	2025 Chg
1	2.97%	2.30%	2.52%	2.49%	-0.03%	0.19%	-0.48%
2	2.82%	2.27%	2.47%	2.44%	-0.03%	0.17%	-0.38%
3	2.83%	2.25%	2.40%	2.38%	-0.02%	0.13%	-0.45%
5	2.90%	2.31%	2.41%	2.39%	-0.02%	0.08%	-0.51%
7	3.00%	2.54%	2.51%	2.50%	-0.01%	-0.04%	-0.50%
10	3.13%	2.92%	2.74%	2.73%	-0.01%	-0.19%	-0.40%
30	3.87%	4.30%	4.11%	4.19%	0.08%	-0.11%	0.32%

Cash Flows and Yield Curve Slope

2025 was marked by a pronounced steepening of the municipal yield curve, with the 2s30s slope ending the year at +175 bps, 70 bps steeper than its +105 bps starting point. The curve's path was far from linear as long-end issuance surged to record levels, tax policy uncertainty lingered and demand along the curve varied, the slope widened dramatically to a peak of +244 bps on August 25 before retracing into year-end. The very steep curve enhanced the opportunity for investors to boost returns through roll-down strategies on a positively sloped curve. Historically, steeper curves have correlated with stronger municipal fund flows, as investors are incentivized to extend duration—whether via direct bond purchases or allocations to intermediate and long-term municipal funds. At year end, all but the short end of the curve was positively sloped, as short-term tax-exempt cash rates remain elevated relative to intermediate yields, reflecting the lagged effect of Fed policy.

Strong, but Changing Credit Backdrop

The backdrop for municipal credit remained fundamentally resilient throughout 2025, though signs of a shift back toward more typical conditions emerged. Stable economic growth and healthy tax collections—particularly income and sales taxes—continued to support state and local government revenues, while property tax receipts also rose modestly. According to year-end data from the National Association of State Budget Officers (NASBO), aggregate state reserve balances remain robust at roughly 21% of expenditures, and median rainy day fund balances are expected to be 14% of expenditures, well above historical norms, providing a meaningful cushion against future economic volatility. This strength underpinned investor confidence, but the tone shifted from the peak credit environment of prior years toward a more balanced posture. Rating agency upgrades still outpaced downgrades, yet the pace moderated: S&P and Moody's combined upgrade to downgrade rates YTD through 3Q25 stand at 1.4:1, down from 2.2:1 in 2024 and 4.1:1 in 2023. Inflationary pressures and rising operating costs increasingly weighed on municipal budgets, forcing issuers to make tougher choices on spending and reserves. Credit spreads reflected these dynamics – while high-grade paper remained firm, the trend for BBB and high-yield credit spreads was wider as investors built in more yield protection, particularly in more vulnerable sectors such as charter schools and higher education. Overall, municipal credit fundamentals remain strong, but the market has clearly moved beyond its peak, entering a phase where selectivity and forward-looking credit analysis are critical.

Sector Performance

Both General Obligation bonds and the broad Revenue sector performed similarly in 2025 (4.31% and 4.21%, respectively). In the Revenue sector, Prepay gas and other corporate-backed municipal issues (IDR/PCR) were among the leaders, benefiting from tighter credit spreads as counterparties—large banks and strong financial institutions—maintained solid credit profiles and corporate spreads narrowed in the taxable market. The Housing sector also delivered strong results, aided by additional yield and improved technicals as prepayment speeds stabilized and demand for affordable housing remained robust. Multi-family housing bonds, particularly those with federal backing, saw steady investor interest and favorable pricing dynamics. Hospitals were the worst performing group within the Revenue sector, although fundamentals stabilized as operating margins improved, bolstering liquidity and credit metrics. Higher Education was another Revenue sub-sector that lagged, as demographic headwinds persisted, with enrollment pressures intensifying as the number of U.S. high school graduates peaked and began to decline. Smaller, tuition-dependent private colleges faced mounting challenges, including elevated fixed costs for tenured faculty and misalignment between academic offerings and labor market demands. Mergers, acquisitions, and closures accelerated as institutions sought to adapt, while rating agencies signaled further downgrades ahead.

Positive Full-year Returns for 2025

Returns for 2025 were positive across the curve. Intermediate maturities outperformed both shorter and longer dated issues, with longer maturities seeing the most underperformance as long rates rose. Revenue and GO bonds performed similarly for the quarter, but GOs slightly edged Revenues for the year while the Prerefunded sector lagged both Revenue and GOs for the quarter and year. Finally, mid-grade, A-rated issues performed the best for the year, but returns were close across Investment Grade issues. High Yield municipals underperformed IG by 179 bps, as negative headlines hit the sector.

Total Returns of Selected Barclays Municipal Indices and Subsectors

Bloomberg Index/Sector	December	Q4	YTD	2024	*Duration*
Municipal Bond Index	0.09%	1.56%	4.25%	1.05%	*6.74*
General Obligation bonds	0.16%	1.60%	4.31%	0.55%	*6.37*
Revenue bonds	0.06%	1.57%	4.21%	1.22%	*6.94*
Prerefunded bonds	0.28%	0.57%	4.02%	2.08%	*2.54*
Long maturities (22+ yrs.)	-0.33%	1.63%	1.95%	1.40%	*11.23*
Intermediate maturities (1 - 17 yrs.)	0.28%	1.41%	5.18%	0.88%	*4.91*
Short maturities (1 - 5 yrs.)	0.33%	0.47%	4.11%	2.07%	*2.39*

Bloomberg Quality	December	Q4	YTD	2024	*Duration*
AAA	0.11%	1.57%	4.25%	0.33%	*6.94*
AA	0.12%	1.57%	4.21%	0.79%	*6.62*
A	0.01%	1.50%	4.35%	1.78%	*6.71*
BBB	0.06%	1.77%	4.13%	2.87%	*7.58*
High Yield	-0.24%	1.15%	2.46%	6.32%	*7.71*
HY, ex-Puerto Rico	-0.30%	1.07%	2.48%	6.78%	*7.65*

2026 Outlook

The outlook for the municipal market in 2026 is favorable. The year ahead begins with investors continuing to earn attractive tax-exempt income as shown by the yield on the Bloomberg Municipal Bond Index at 3.59%. When municipal yields are tax adjusted, they are even more appealing. Attractive roll-down benefits from the steeper curve should also enhance returns and incentivize investors to extend from cash-like holdings. With the Fed cutting rates by 75 bps between September and December and potential further easing ahead, front-end yields are expected to decline, increasing the appeal of extending along the curve. This should provide a constructive backdrop for fund flows, which were already strong in 2025. We expect supply to remain abundant once again, perhaps achieving a third consecutive year of record issuance in 2026. Although the post-Covid federal stimulus funds which elevated infrastructure investment are now spent, pent up demand and the rising cost of construction projects (in part due to AI-driven data center demand) should encourage robust state and local issuance. As noted above, the credit backdrop is favorable even as the importance of monitoring credits remains paramount. Although credit spreads are modestly wider than a year ago, a relatively neutral credit posture remains appropriate while continuously searching for select opportunities. We will also continue to seek additional yield through structural nuances that the municipal market offers, particularly in the highly rated, single-family and multi-family Housing sector. Yet, investors also recognize some of the uncertainties that lie ahead. The Fed begins 2026 as a body divided with voting governors dissenting in recent meetings, expressing differing views on the dual mandates of labor and inflation, suggesting an uncertain rate path going forward.

Disclosures

Fixed income is generally considered to be a more conservative investment than stocks, but bonds and other fixed income investments still carry a variety of risks such as interest rate risk, credit risk, inflation risk, and liquidity risk. In a rising interest rate environment, the value of fixed-income securities generally decline and conversely, in a falling interest rate environment, the value of fixed-income securities generally increase. High yield securities may be subject to heightened market, interest rate or credit risk and should not be purchased solely because of the stated yield.

The Bloomberg Municipal Bond Index is a broad-based, total-return index. The bonds are all investment-grade, tax-exempt, and fixed-rate securities with long-term maturities (greater than 2 years). They are selected from issues larger than $50 million. The components listed below the Municipal Bond Index (long maturities, intermediate maturities, short maturities, prefunded bonds, general obligation bonds and revenue bonds) are subsectors of the Bloomberg Municipal Bond Index and do not represent separate indices.

The Bloomberg High Yield Municipal Index includes bonds with a par value of at least $3 million and must be issued as part of a transaction of at least $20 million. The maximum rating for inclusion is Ba1/BB+/BB+ using the middle rating.

For more information about the Bloomberg Municipal Bond Index or Bloomberg High Yield Municipal Index, please visit https://index.barcap.com/Home/Guides_and_Factsheets.

Municipal securities investments are not appropriate for all investors, especially those taxed at lower rates. The alternative minimum tax (AMT) may be applicable, even for securities identified as tax exempt. Past performance is not a guarantee of future results.

Ratings are measured on a scale that ranges from AAA or Aaa (highest) to D or C (lowest). Investment grade investments are those rated from highest down to BBB- or Baa3.

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