

Q1 2026 REVIEW & OUTLOOK

Tracking Tax-Exempt Paper

A quarterly perspective on the municipal bond market from the MTAM investment team.



Following solid positive total returns posted by the municipal bond market over the first two months of 2026 **(+2.2%)**, tax-exempt debt reversed course in March **(-2.3%)**. We attribute this abrupt shift in municipal market performance toward the end of 1Q26 to a confluence of three factors.

First, heightened geopolitical risks sparked by the US–Iran war rattled the broader rates markets and spilled over to have knock-on effects for municipals. The yield on the 10-year US government benchmark note surged to over 4.4%, its highest level since mid-2025. Municipal yields followed higher at a rapid pace: the benchmark 10-year tax-exempt municipal yield crested 3% toward the end of March for the first time in over six months, finishing the month at 3.06%—up nearly 60 basis points from the end of February.

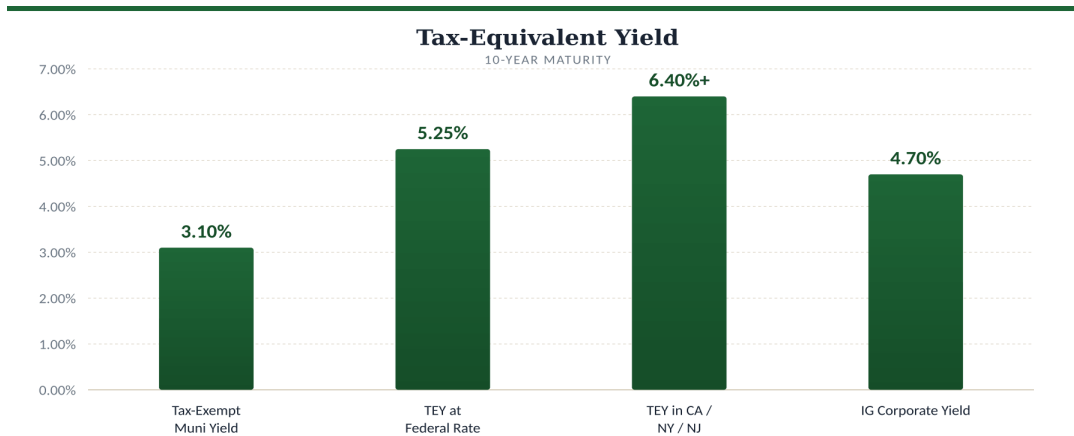
Second, higher oil prices renewed inflationary concerns, placing downward price pressure on fixed income assets, particularly long-dated bonds, including tax-exempt municipals. As a result, the municipal curve steepened.

And third, supply/demand dynamics for the municipal market became less favorable in March, consistent with historical seasonal patterns. As the month progressed, some high-profile issuers reduced deal sizes amid increased market volatility.

TEYs Top of Mind

Now that the April 15 tax filing deadline is behind us, we expect the higher yield environment in the tax-exempt space to garner attention. Munis are now more attractive versus taxable debt at the 10-year maturity point and beyond than they were earlier in 2026—providing better relative-value opportunities for investors.

At present, a **3.1% 10-year AA-rated municipal bond** has a tax-equivalent yield of **5.25%**, reflecting a top marginal individual income tax rate of 40.8%. For investors residing in high-tax states such as California, New York, and New Jersey, the TEY on high-grade municipals at the 10-year maturity can exceed **6.4%**. By comparison, high-quality taxable corporate bonds sit at roughly 4.7%—suggesting municipal TEYs remain compelling.



Sources: Bloomberg; Fidelity

OUR VIEW

“With the April tax deadline behind us and 10-year AA munis yielding north of 3%, tax-equivalent yields of 5.25%—and 6.4%+ in high-tax states—offer compelling relative value versus high-grade corporates.”

Credit Quality Stays Strong, Despite Rising Risks

Despite ongoing geopolitical tensions and economic uncertainty, overall municipal credit quality remains strong. Payment default rates remain very low. As a point of reference, the payment default rate on the par amount of debt in safe sectors (excluding Puerto Rico) sits at only **0.02%**. The overall municipal default rate—including the riskier sectors—is less than 1% and has been falling, based on recent data from Municipal Market Analytics.

That said, technical defaults are showing an uptick, and rating trends have begun to turn negative. These risks on our radar reinforce the importance of careful credit selection within municipal bond portfolios.

Against that backdrop, we prefer high-grade, investment-grade municipals in quality sectors. State governments, water and sewer, electric utilities, and sales tax revenue make that list. By contrast, we remain cautious on the higher-risk segments of the marketplace—bonds issued by not-for-profit hospitals and private higher-education systems face greater credit challenges, as examples.

Key Takeaways

- Municipal returns turned in March after a solid start to the year, driven by higher rates, renewed inflation concerns, and seasonal supply/demand.
- With benchmark 10-year AA munis near 3.06%, tax-equivalent yields of roughly 5.25% (and over 6.4% in high-tax states) look attractive versus ~4.7% on high-grade corporates.
- Overall credit remains healthy—default rates stay below 1%—but a pickup in technical defaults and negative rating trends warrants active, research-driven selection.
- MTAM continues to favor high-grade essential-service sectors and to avoid the more challenged corners of the market.

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Joined MTAM in 2026 as a member of the Investment Committee. Kathleen has four decades experience in the municipal industry, including 16 years as Senior Municipal Strategist at UBS, responsible for strategy, market analysis, and relative-value work. Previously at Lehman Brothers and Smith Barney.

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