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OUTLOOK THIRD QUARTER 2026

Munis prove their worth at halftime

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Halfway through 2026, the municipal bond market looks meaningfully different than it did a year ago. The volatility that weighed on the asset class in 2025 has given way to attractive yields, strong demand and improving relative value. In our view, the conditions driving the first-half rally remain firmly in place — and we believe the recovery has further to run.

Key takeaways

- **Munis have recaptured roughly 170 basis points of 2025 underperformance, and taxable-equivalent yields remain near historical highs. The case for remaining invested is strong.**
- **The steepest yield curve in years rewards extending maturity. Moving from 10 to 20 years captures 83 basis points of additional yield — more than double the historical Treasury spread.**
- **Federal policy is creating winners and losers across muni sectors. Disciplined credit research can uncover compelling opportunities where spread widening has outpaced fundamentals.**
- **The five themes we identified at the start of 2026 remain intact: Cash rotation, record reinvestment demand, a steep curve, federal policy divergence and historic reserve levels continue to shape the market.**

Munis deliver a resilient first half

Municipal bonds proved resilient in the first half of 2026, despite persistent macro and geopolitical uncertainty. A 2.52% total return in the second quarter brought year-to-date returns to 2.32% — impressive considering 10-year Treasury yields increased 30 bps during that time. Long duration and high yield municipals led the way, driven by a steep yield curve and constrained high yield supply against a backdrop of surging inflows.

Since the third quarter of 2025, municipals have staged a meaningful comeback against broad taxable fixed income. Last year, munis underperformed the Bloomberg U.S. Aggregate Bond Index by more than 450 basis points (bps) at the bottom — a degree of underperformance seen only four times in the past 20 years.

In each prior instance, munis rebounded sharply and went on to outperform the aggregate by more than 400 bps. With the asset class recapturing roughly 170 bps year-to-date, we believe we are in the early innings of that recovery. Attractive absolute taxable-equivalent yields, a steep curve and compelling relative valuations provide a solid foundation for the rally to continue.

> **Portfolio implication:** Near term volatility may present an attractive entry point. For invested clients, we think staying the course — or adding on weakness — remains prudent.

Demand momentum shows no signs of slowing

Near-record inflows drove positive performance and compressed spreads through the first half of the year. Investors directed nearly $50 billion into muni funds and exchange-traded funds — up 150% year-over-year — mainly into long duration and high yield strategies.

History supports continued optimism. Municipal performance is highly correlated to fund flows, and when flows are positive, returns have followed more than 70% of the time. When first-half flows have been positive, second-half performance has matched that trend more than 80% of the time dating back to 1993.[1]

The yield advantage is striking. Even with the U.S. Federal Reserve on hold, money market yields for investors in the 24% tax bracket hover near 2.75% — barely positive after inflation. By contrast, taxable-equivalent yields (TEY) for munis sit in the top quartile of their 10-year history.[2]

The broad municipal index offers a TEY of 6.04% versus 4.73% for the Bloomberg U.S. Aggregate Bond Index. For investors in the 37% tax bracket, a 20-year muni bond yielding 3.78% is equivalent to a taxable bond yielding 6.39% — well above current investment-grade corporate bond yields.

Tax policy developments add a meaningful demand tailwind. As midterm elections approach, state ballot measures targeting high earners through wealth or millionaires' taxes are likely to increase the appeal of tax-exempt income.

Washington and Rhode Island have already enacted new marginal rates on income over $1 million, and California voters will weigh a one-time wealth tax on billionaires in November. The One Big Beautiful Bill Act preserved federal income tax rates established under the 2017 Tax Cuts and Jobs Act, but as local tax burdens trend higher, demand for tax-efficient income solutions will only grow.

> **Portfolio implication:** As more states raise marginal tax rates, state-specific municipal strategies can meaningfully amplify the value of tax-exempt income.

Record supply is being absorbed with discipline

New issue volume accelerated in the second quarter, rising 25% from the first quarter. Total supply stands just under $300 billion year-to-date, and we maintain our full-year expectation of approximately $600 billion.

The heavy volume has been well-absorbed given the strength of inflows, and both deal size and deal count have grown relative to historical norms — providing ample opportunity to deploy cash at attractive yield levels.

Long duration and high yield supply have lagged demand despite surging investor appetite. Bonds maturing in 20 years or longer account for 34% of year-to-date supply — running 9% below the trailing five-year average. High yield and non-rated issuance fell 8% year-over-year through the first half. Strong new deals repriced at tighter spreads; weaker ones struggled to find buyers. We view this market discipline as a healthy sign for credit conditions ahead.

Hospitals, public power, water-sewer and housing each saw new issue volumes grow more than 20% year-over-year, yet investor demand pushed many deals to five to ten times oversubscribed and spreads tightened accordingly. Richer valuations do shift the risk/reward trade-off, but absolute yields remain attractive and rigorous credit research can still surface compelling opportunities within these sectors.

Reinvestment cash flows — from maturities, calls and coupons — are up year-over-year, but have fallen short of market estimates for close to $700 billion for the year. July call estimates have risen meaningfully, and July coupon payments are the highest on record for that month.

> **Portfolio implication:** Elevated redemptions should persist through year end, sustaining a net negative supply environment and supporting continued positive returns.

The yield curve still rewards extending duration

The municipal curve flattened during the second quarter as yields rallied, rewarding long-duration investors. Ten-year muni yields fell 17 bps while 20-year yields declined 34 bps to 3.78% — equivalent to 6.39% on a taxable-equivalent basis.

Investors who extend from 10 to 20 years capture an additional 83 bps in yield. Stretching to 30 years adds 124 bps. At current levels, that income compounds meaningfully over time and serves as an effective buffer against market volatility.

The comparison to Treasuries strengthens the case for munis at longer maturities. Treasury yields have risen sharply — particularly in the short and intermediate segments — as markets price in near-term Fed rate hike risk. The Treasury 10s/30s slope stands at 47 bps, trailing muni steepness by 77 bps. Historically that differential has averaged closer to 41 bps, suggesting further room for compression and reinforcing our preference for duration in munis over Treasuries.

Municipal-to-Treasury yield ratios have moved to richer levels as rates have diverged year-to-date. 10-year and 20-year ratios currently stand at 66% and 76%, respectively.

That said, relative value metrics alone do not tell the full story. We believe absolute starting yields are the more consequential consideration. Over the past three years, 10-year and 20-year muni ratios averaged 67% and 80% — against tax-exempt yields of 2.82% and 3.67%. Yet investors who put cash to work in the broad municipal index since June 2023 have earned an average annual taxable-equivalent return of 9.34% over the three-year period.

> **Portfolio implication:** The steep muni curve and Treasury spread differential reinforce our preference for extending duration in munis over Treasuries.

Credit divergence is creating selective sector opportunities

Federal policy shifts are pressuring the municipal market unevenly, drawing sharper distinctions between credits equipped to navigate the current environment and those facing genuine headwinds. In this landscape, disciplined security selection backed by robust credit research is critical.

We continue to find compelling opportunities in affordable housing, water-sewer and public power. Elevated new issue supply in these sectors has produced attractive concessions despite largely stable and strong underlying credit quality.

Affordable housing demand remains robust, underpinned by a shortage of more than 7 million units nationwide and growing congressional momentum for housing legislation.

Water-sewer systems — natural essential service monopolies — show healthy metrics, with average days cash on hand of 543 days as of fiscal year 2025 and average debt service coverage of 2.3x. Supply is up 20% year-over-year, meaning these steady, high-quality credits are coming to market at attractive yields. Capital needs tied to deferred maintenance and forever chemical (PFAS) remediation should keep issuance levels elevated.

Public power utilities face mounting pressure to expand capacity as electricity demand from data centers grows rapidly. We do not expect that demand to abate, and issuance should remain elevated as states debate how to allocate the cost of new build-out between ratepayers and the hyperscalers driving it.

State and local governments remain the bedrock of the asset class. Median rainy day fund balances are on track to reach 14% of expenditures by fiscal year end 2026 — nearly double the pre-pandemic average of 8%. State and local tax collections grew 5.7% year-over-year in the first quarter of 2026, with both income and sales taxes rising.

Budget season is underway, and revenue forecasts reflect broad-based conservatism. Revenues and expenditures are projected to grow roughly 2% in fiscal year 2027, reflecting expectations of slower economic growth and continued federal policy uncertainty. Revenue-raising capacity and expenditure flexibility support credit resilience across tax-backed sectors, even amid headline volatility. We favor general obligations and tax-backed credits as core portfolio holdings.

Headlines are obscuring solid state and local credit

Budget headlines often overstate fundamental credit risk. Investors who look past the noise can avoid selling into weakness and may find opportunities to add to strong credits when spreads widen without cause.

New York extended its budget deadline as expected, a procedural matter with no financial significance. Governor Hochul resisted income tax increases, and the final budget includes modest additional support for New York City. Mayor Mamdani preserved reserve levels and avoided property tax increases — a constructive outcome.

Illinois continues to manage structural fiscal challenges, but an improved reserve position and demonstrated willingness to address long-term liabilities support a stable credit outlook for now.

Several state ballot measures have direct implications for muni demand by raising the after-tax value of federal tax-exempt income for high earners.

California: Governor Newsom rejected a union-backed compromise on the proposed billionaire's tax, with a November ballot appearance now certain.

Rhode Island: A new surtax on income over $1 million is already enacted as part of the fiscal year 2027 budget.

Washington: Higher marginal rates on high earners are now law.

Florida: Voters face a proposed residential property tax reduction that could constrain local revenues, with smaller issuers reliant on residential property taxes more exposed than those with diversified tax bases and strong reserves.

Colorado: Proposed income tax changes could carry local revenue implications that warrant close monitoring.

> **Portfolio implication:** Budget driven spread widening may create opportunities in strong credits. State-specific strategies may enhance after-tax returns for high earners.

Outlook: We see a window to act

For investors holding excess cash, the next few months present a meaningful window to put it to work. We favor longer-maturity bonds — particularly 20-year-plus maturities — along with water/sewer, housing and select health care and higher education credits where spread widening has outpaced fundamental deterioration.

As credit dispersion widens, security selection matters more. Fundamentals are sound, demand is strong and today's yields offer a meaningful income advantage over similarly rated corporate bonds. We believe the rally likely has further room to run.

Sector fundamentals diverge amid shifting federal policy

The muni sector scorecard shows our views on credit fundamentals, momentum and valuations for major municipal sectors.

Muni sector scorecard

+ Positive = Neutral — Negative

SECTOR	CREDIT FUNDAMENTALS	CREDIT MOMENTUM	KEY TAKEAWAY
State & local governments	=	=	Steady tax revenue growth and strong reserves provide cushion against possible economic slowdown and federal policy uncertainty.
Education	=	—	Declining demographics, affordability and federal policy changes are pressuring revenue at the same time inflation is increasing expenses. Large universities will be able to navigate, smaller colleges likely to struggle.
Transportation	+	=	Airport cash balances are healthy and passenger demand remains well above pre-pandemic peak levels, providing a cushion again emerging uncertainty driven by higher oil prices that could impact travel. Capital investment needed to expand capacity.
Housing	+	=	Need for affordable housing bolsters demand. Labor supply constraints due to immigration policy shifts may delay projects.
Water & sewer utilities	+	=	Essential service, monopolistic providers with robust liquidity will continue to require significant capital investment.
Health care	=	=	Elevated labor and supply costs are normalizing. Most hospitals will adapt to federal Medicaid policy changes coming in 2027. Smaller, rural hospitals may struggle.

Data source: Nuveen, 31 May 2026. Certain statements may be deemed forward-looking statements. Please note that any such statements are not guarantees or intended to constitute a prediction of any future performance; actual results or developments may differ materially from those projected.

Our 2026 themes remain intact

	What's happening?	Progress report	Actions to consider
Low money market rates unlock cash rotation	$7.5T in sidelined cash may move toward higher-yielding assets	Inflows materialized, but money market assets continue at record highs. We expect a return to Fed easing in 2027 and remain confident that muni demand will stay elevated.	Position in high-quality munis; lock in yields, particularly with call-protected longer-duration bonds
Record supply wave meets surging reinvestment demand	2026 issuance is projected at a record ~$600B and reinvestment flows may surge 50%	Supply expectations are intact. Any brief softness from accelerated issuance should create attractive entry points for investors with cash to deploy.	Capitalize on potential new issue concessions; apply rigorous credit research to identify value
Steepest yield curve in years rewards duration extension	20-year munis offer an attractive yield pickup over 5- and 10-year bonds	The steepest yield curve in years favors longer maturities. Long duration has outpaced front-end strategies on a quarter-to-date and year-to-date basis.	Extend duration; add exposure to 15- to 30-year municipal bonds
Federal policy shifts create differentiation opportunities	The One Big Beautiful Bill Act reduces federal support for states, hospitals, universities and utilities	Reduced federal support will pressure hospitals, higher education and public power unevenly. The municipal tax exemption survived intact. Credit selection matters more than ever.	Selectively add top-tier health care and higher education credits; monitor spread volatility
Record reserve levels anchor credit resilience	Most municipal borrowers enter 2026 with reserves at historic highs and recession-tested revenue sources	Record rainy day fund balances and rising tax revenues support our conviction that municipals are well-positioned even in a recessionary scenario.	Focus on state/local GOs, water/sewer utilities; favor select charter schools and land-secured in high yield

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For more information, please visit nuveen.com.

Endnotes

1 Data source: Morningstar and Bloomberg, L.P.

2 Data source: Bloomberg, L.P., using the Bloomberg Municipal Bond Index and applying the maximium tax rate applicable at the time.

Sources

All market and economic data from Bloomberg, FactSet and Morningstar.

Gross Domestic Product: U.S. Department of Commerce. Treasury Yields and Ratios: Bloomberg (subscription required). Municipal Bond Yields: Municipal Market Data. Open-end fund flows: Investment Company Institute. Municipal Issuance: Siebert Research. Defaults: Municipals Weekly, Bank of America/Merrill Lynch Research. State Revenues: The Nelson A. Rockefeller Institute of Government, State Revenue Report. State Budget Reserves: Pew Charitable Trust. Global Growth: International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD). Standard & Poor's and Investortools: http://www.invtools.com/. Flow of Funds, The Federal Reserve Board: https://www. federalreserve.gov/releases/z1/default.htm. Payroll Data: Bureau of Labor Statistics. Bond Ratings: Standard & Poor's, Moody's, Fitch. New Money Project Financing: The Bond Buyer. State revenues: U.S. Census Bureau.

NASBO Fall 2025 Fiscal Survey; CMS.gov; New York City February 2026 Financial Plan.

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Taxable-equivalent yields are based on the highest individual marginal federal tax rate of 37%, plus the 3.8% Medicare tax on investment income. Individual tax rates may vary. Inflation rate used is the PCE Deflator, which is removed from the after tax income of the 3 month T-bill yield, resulting in an after tax and after inflation rate for cash.

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