

## Second quarter 2026 outlook

# Muni bonds have been resilient amid uncertainty

Municipal bonds faced a challenging first quarter of 2026, with gains exceeding 2% in January and February giving way to a rate-driven selloff in March as geopolitical risk escalated. Despite the difficult environment, taxable-equivalent yields remain near historic highs, credit spreads are attractive and fund inflows set a record — and we believe the case for municipals remains strong.

### *Key takeaways*

- **Despite a turbulent first quarter, the steep municipal yield curve may reward investors who extend duration, with 20-year AAA yields above 4.00%.**
- **With reinvestment demand projected to surge 40% and net supply expected to remain negative, technical conditions favor municipal total returns through year end.**
- **Security selection in the health care and higher education sectors presents an opportunity for investors willing to look past current pressures.**

OPINION PIECE. PLEASE SEE IMPORTANT DISCLOSURES IN THE ENDNOTES.

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## Volatility and value define the muni outlook

Munis returned 2.20% through February before a sharp rate-driven selloff in March pushed the quarter to -0.18%.

In our view, investors have not missed the muni rally, and recent weakness in the asset class may offer an opportunity to increase exposure at attractive valuations.

Taxable-equivalent yields (TEY) for munis are in the top quartile of their 10-year history.<sup>1</sup> The broad municipal index offers a TEY of 6.37% versus 4.57% for the Bloomberg U.S. Aggregate Bond Index. Municipal credit spreads are also relatively attractive compared to corporates, with muni spreads in the 70th percentile versus the 15th percentile for investment grade corporates.<sup>1</sup>

Municipals lagged the Bloomberg U.S. Aggregate Bond Index by more than 400 basis points (bps) at various points during 2025 and, while they have since recovered ground, still trail the broader taxable index by 319 bps as of quarter end. History shows that gaps of this magnitude have been followed by rapid recoveries and subsequent outperformance of a symmetrical approximately 400 bps.<sup>2</sup> If history is a guide, current market conditions may represent an attractive entry point for investors positioned to capture the recovery.

## Record demand fuels a powerful market rally

Municipal fund flows surged 113% year-over-year in the first quarter. The market has gathered \$25.3 billion in 2026 through February, the best start to any year on record. Since 1993, positive first quarter flows have signaled net positive annual flows for the calendar year 70% of the time.<sup>3</sup> Investor flows are important because municipal total return is 79% correlated to positive inflows (Figure 1).<sup>4</sup>

We expect demand to continue, supported by ample cash on the sidelines, high starting yields and solid municipal credit conditions. But recent headwinds are worth monitoring, stemming from geopolitical uncertainty and a U.S. Federal Reserve that appears content holding interest rates steady for 2026.

Money market fund assets remain at historically high levels. On average, it has taken 18 to 22 months for sustained money market outflows to materialize following an easing cycle.<sup>5</sup> The end of the first quarter marks

the 19th month since the beginning of the current rate reduction cycle.

The Fed's most recent cut pushed after-tax money market yields below 2.75% for investors in the 24% tax bracket. With inflation hovering near 2.4%, cash is unlikely to cover the growth of living expenses for most investors. Municipal flows for the first quarter have strongly favored longer duration and high yield bonds, suggesting investors are keen to lock in historically attractive yields while credit conditions remain solid.

## A healthy new issue market may reward patient investors

The new issue market is running slightly ahead of the historically high pace set in 2025. Total new issuance of \$142 billion is up 11% year-to-date, though supply has underwhelmed against forecasts for an even more robust calendar.

We expect the pace of issuance to accelerate from the second quarter through year end and believe \$600 billion in new issue supply is attainable (Figure 2). As issuers contend with higher project costs due to inflation, new issue deals are larger than in years past. The result is more attractive valuations on new deals and ample investment opportunities.

New issue deals have historically offered investors a meaningful spread over secondary purchases – a concession that we think should compound into real value and tax savings over time.

General obligation and local school districts were the top two absolute issuing sectors during the quarter. Within revenue sectors, hospitals, higher education and gas-prepay topped the charts. Hospitals and gas-prepay year-over-year issuance was up 66% and 32%, respectively. Higher education – while down 11% from extremely high levels in the first quarter of 2025 due to federal tax policy uncertainty – remained well ahead of its 10-year average issuance.

We expect to see healthy issuance growth in 2026 across the market, as waning fiscal stimulus and federal funding reductions push more projects toward public financing markets than at any point in recent years.

The gas-prepay sector is a nascent and growing segment now comprising more than 5% of the municipal index with

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roughly \$100 billion outstanding. These bonds involve financial services counterparties and complex structures that command higher yields to compensate for additional risk. They are not traditional muni bonds financing essential service monopolies. As such, we are highly selective in this sector and believe these bonds are best suited to well-diversified portfolios.

Despite new supply, reinvestment demand from maturing bonds, callable bonds and coupons is projected to surge 40% compared to last year. Maturity and coupon dates are projected to increase significantly through the third quarter. As reinvestment demand continues to outpace new issuance, we expect the market to remain in a net negative supply environment that should support total returns.

## A steep yield curve rewards duration extension

The 20-year AAA municipal bond yield now tops 4.00%, offering a yield pickup of 1.45% over 5-year AAA bonds (Figure 3). The combination of 20-year municipal yields above 4.00% and a spread between 5- and 20-year municipals of more than 1.25% has occurred less than 5% of the time over the last 15 years.<sup>6</sup>

This asymmetric risk-return profile further supports the case for extension: the Bloomberg Municipal 20-Year Index reflects 13.61% upside potential if rates fall 100 bps, versus -4.72% downside if rates rise 100 bps. Starting yields are 1.30% higher than the 15-year average – meaningful given

that income has historically comprised nearly 84% of municipal total returns.<sup>7</sup>

By comparison, 20-year Treasuries offer a yield pickup of only 0.96% over 5-year bonds, well below the 1.45% available in municipals. We favor extending marginal duration in municipals over Treasuries.

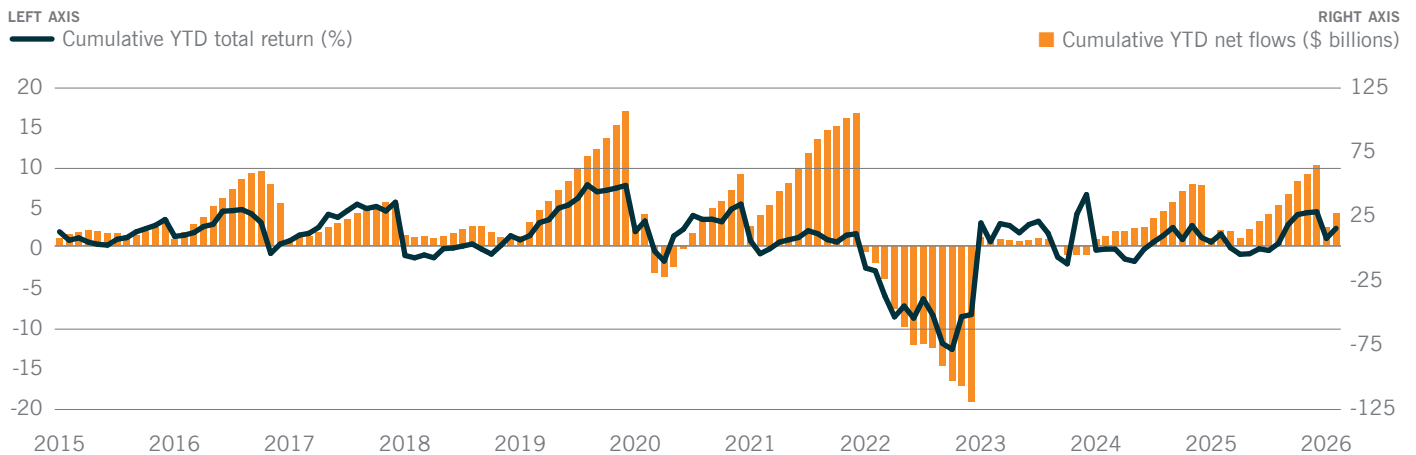
## Credit divergence creates opportunity across muni sectors

Federal policy shifts are creating uneven pressures across the municipal market. For selective investors, that divergence may create opportunity. We see compelling cases for active sector selection in higher education and health care, while strong liquidity and essential service sectors continue to anchor broader credit resilience.

**Colleges and universities** remain vulnerable to federal policy risk on multiple fronts, and current credit spreads across the higher education sector reflect these pressures. The One Big Beautiful Bill Act (OBBBA) limits federal student loan borrowing, which may weigh on enrollment and affordability. Meanwhile, the cancellation of federal research grants constrains university finances and their ability to attract students and faculty.

Even if policy concerns fade, we expect bond issuance to remain elevated, driven by deferred maintenance, heightened competition for students and rising project costs. Elevated issuance and well-publicized headwinds

**Figure 1: Municipal fund flows have been strongly correlated with performance**



Data source: Morningstar Direct, 01 Jan 2015 – 31 Dec 2025, fund flows shown monthly and performance shown annually. Performance data shown represents past performance and does not predict or guarantee future results. Representative index: Bloomberg Municipal Bond Index. Municipals represent the total of all municipal bond open-end funds, including high yield, but excluding exchange-traded funds. Shading represents significant market events.

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have pushed spreads wider, and rigorous credit analysis could help investors capture additional yield.

**Health care** faces mounting pressure from rising costs and shifting federal policy. The expiration of ACA premium subsidies in 2025 contributed to a 5% decline in 2026 enrollment. Beginning in 2027, OBBBA will reshape Medicaid eligibility and is expected to reduce beneficiaries by 11 million, lowering federal matching dollars for states and leaving hospitals to absorb a larger share of uninsured patients.

Our credit team tends to favor health care credits with leading market positions, multi-state operations and strong physician alignment – issuers we believe may offer adequate compensation for the increasingly challenging operating environment.

**State and local governments** maintain robust liquidity, with median rainy day fund balances projected to reach 14% by FYE26, up from a pre-pandemic average of 8%. Total state and local tax revenue increased 5.4% in 2025,

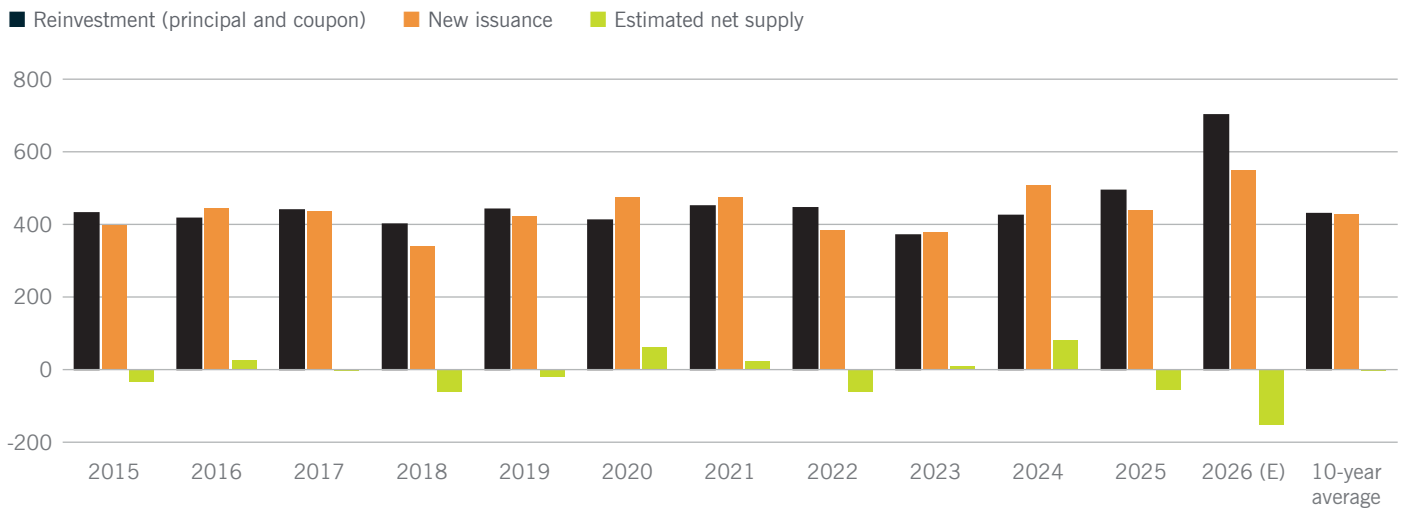
broadly outpacing individual state projections, as most states took a conservative budget approach in anticipation of federal policy and funding uncertainties.

Fiscal year 2027 budget season is well underway. While many proposed state and local budgets reflect deficits, we view these as opening positions rather than final outcomes. Many state and local governments are constitutionally required to pass balanced budgets and have several levers available, including raising tax rates, instituting new taxes, reducing expenditures and drawing down reserves.

New York City’s preliminary FY27 budget illustrates this process well. The mayor identified an initial \$5.4 billion gap and proposed two closing scenarios; the city council will offer an alternative, followed by months of hearings and budget negotiations. A compromise is expected by the early July deadline. Strong liquidity, revenue-raising capacity and expenditure flexibility support credit resilience in tax-backed sectors despite headline volatility.

**Figure 2: Record reinvestment flows exceed new issuance in 2026**

(\$ billions)



Data source: Siebert Williams Shank, 2015 – 2025; Nuveen, Bank of America Merrill Lynch, 2026 estimates, 31 Dec 2025. 2026 estimates include both taxable and tax-exempt municipals.

**Revenue sectors** can be more vulnerable to economic shifts, and we favor those that function as essential service monopolies. Water and sewer, electric utilities, and transportation are prime examples. Water and sewer issuers generally demonstrate strong liquidity and debt service coverage and have rate-setting powers that allow them to adjust user charges over time. We believe sectors that combine operational stability with pricing flexibility are well-positioned to navigate both economic and geopolitical uncertainty.

**Affordability** has become a defining issue across the United States, shaping political discourse and driving election outcomes. Congressional momentum is building around affordable housing, with bills such as the 21st Century ROAD to Housing Act and the Affordable Homes Act pending approval. President Trump recently signed an executive order restricting large institutional investors from buying single-family homes.

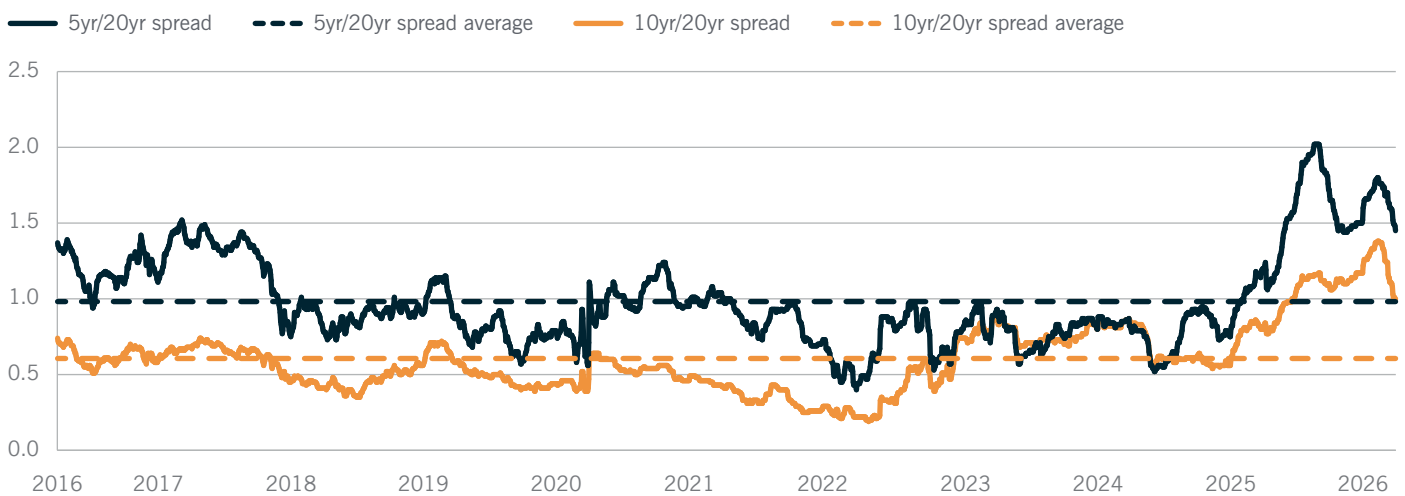
Municipal bonds directly support affordable housing development while offering investors an opportunity for tax-exempt income. However, structural features such as prepayment risk, credit enhancements, collateral and project-level finances can create meaningful differences in risk and return. Rising supply in the sector may create opportunity, and evaluating these structural complexities through thorough due diligence will be essential.

**“We would consider any short-term market dislocations as an opportunity to add exposure at current valuations.”**

### Outlook: Use near-term volatility as a tactical opportunity in 2Q

We suggest investors consider staying invested and use any short-term market dislocations as a tactical opportunity to add exposure at current valuations. The steep yield curve makes extending maturity profiles – particularly into 20-year-plus bonds – an effective way to capture additional yield and long-term value. Selective allocation to higher education and health care bonds may also reward patient investors, as sector-level policy concerns have driven spread widening that we believe overstates the fundamental credit risk in many of these issuers.

**Figure 3: A steep muni yield curve creates duration opportunity**



Data source: Nuveen, MMD Refinitiv, 01 Jan 2015 – 31 Oct 2025. Performance data shown represents past performance and does not predict or guarantee future results. Curve slopes represent the yield spread between the relevant AAA municipal tenors.

## Sector fundamentals diverge amid shifting federal policy

The muni sector scorecard shows our views on credit fundamentals, momentum and valuations for major municipal sectors (Figure 4).

**Figure 4: 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	=	-	Pressure due to increased competition for students and affordability coupled with federal policy changes. Large universities should 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, though emerging uncertainty around higher oil prices could impact travel. Capital investment is 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 should 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, 28 Feb 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.

Five themes are shaping our approach in 2026

	What's happening?	Market implications	Actions to consider
<b>Low money market rates unlock cash rotation</b>	\$7.5T in sidelined cash may move toward higher-yielding assets	Positive flows historically coincided with positive muni returns 79% of the time over the last decade	Position in high-quality munis; lock in yields, particularly with call-protected longer-duration bonds
<b>Record supply wave meets surging reinvestment demand</b>	2026 issuance is projected at a record ~\$600B and reinvestment flows may surge 50%	Elevated supply creates attractive new issue concessions, especially in airports and health care	Capitalize on potential new issue concessions; apply rigorous credit research to identify value
<b>Steepest yield curve in years rewards duration extension</b>	20-year munis offer an attractive yield pickup over 5- and 10-year bonds	The asymmetric risk-return profile of investing in longer duration bonds has markedly improved	Extend duration; add exposure to 15- to 30-year municipal bonds
<b>Federal policy shifts create differentiation opportunities</b>	The One Big Beautiful Bill Act reduces federal support for states, hospitals, universities and utilities	Policy headlines drive volatility; muni tax exemption survived, limiting broad market damage	Selectively add top-tier health care and higher education credits; monitor spread volatility
<b>Record reserve levels anchor credit resilience</b>	Most municipal borrowers enter 2026 with reserves at historic highs and recession-tested revenue sources	Broad credit deterioration is unlikely, but downgrades may rise in policy-exposed sectors	Focus on state/local GOs, water/sewer utilities; favor select charter schools and land-secured in high yield

Data source: Nuveen, 31 Dec 2025. 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.

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#### Endnotes

- 1 Bloomberg L.P., 26 Mar 2026.
- 2 Morningstar Direct, 01 Jan 2015 – 31 Dec 2025. Fund flows and performance are cumulative YTD figures for each calendar year.
- 3 Morningstar Direct, 01 Jan 2015 – 31 Dec 2025.
- 4 Bloomberg, L.P., ICI, Nuveen, 31 Mar 2026. Weekly correlation using ICI municipal bond estimated weekly net new cash flow and the Bloomberg Municipal Bond Index Total Return Index.
- 5 Bloomberg L.P. and ICI, based on trailing 6- and 12-month net money market flows since 2000.
- 6 Nuveen, MMD Refinitive, 31 Mar 2011 – 31 Mar 2026.
- 7 Nuveen, Bloomberg L.P., 31 Dec 2010 – 31 Dec 2025.

#### Sources

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.invttools.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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