

Municipal Bonds

Coupon Income to Anchor Q1 Municipal Bond Returns

This report is excerpted from the *First Quarter 2026 Fixed-Income Sector Views*.

Constrained municipal issuance supports favorable market dynamics.

Municipal bond performance will likely be driven by coupon income, with limited price appreciation potential at current valuations. We expect state budget discussions around federal Medicaid to pick up pace late in the second quarter.

Sector Commentary

- After reaching one-year highs in April, tax exempt/Treasury yield ratios began 2026 near the low ends of their three-year ranges. Ratios in the five- and 10-year maturities sit in the low-60s, versus a three-year range of 55–88 percent. Notably, the 30-year ratio has rallied to 87 percent compared to a three-year range of 79–101 percent despite retail investors' focus on front-end paper. Continued curve flattening has steadily reduced the attractiveness of long-dated munis.
- Taxable municipal spreads tightened during the fourth quarter, beginning 2026 approximately 22 basis points tighter than IG corporates at the index level. Supply remained low for 2025, totaling \$33 billion and down 14 percent from 2024. Other than state housing agencies, most municipalities are unlikely to issue taxable debt given current relative valuations between exempts and taxables. Thus taxable muni spreads are likely to follow IG corporate spreads for most of the year.

Investment Themes

- The first quarter typically sees strong reinvestment demand from principal and interest (P&I) payments, and we expect \$152 billion of principal and interest for the first quarter, up slightly from \$149 billion for the same period last year, providing support for new issuance.
- Current valuations leave few obvious sources of outperformance. Yield ratios are hovering around three-year averages, and the municipal slope has flattened significantly since the summer, outperforming the Treasury slope.
- Cuts to federal Medicaid funding enacted by the OBBBA will take effect at the end 2026, after the midterm elections. A couple of states have made small changes around eligibility and benefit levels, but we have not seen wholesale changes in most states. The majority have a June fiscal year end, so we expect state budget discussions around Medicaid to pick up in May or June for fiscal 2027.

By Allen Li and Michael Park

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Yield Ratios Are Hovering Around Three-Year Averages

AAA Muni/Treasury Yield Ratios



Source: Guggenheim Investments, LSEG. Data as of 1.2.2026.

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One **basis point** is equal to 0.01%.

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