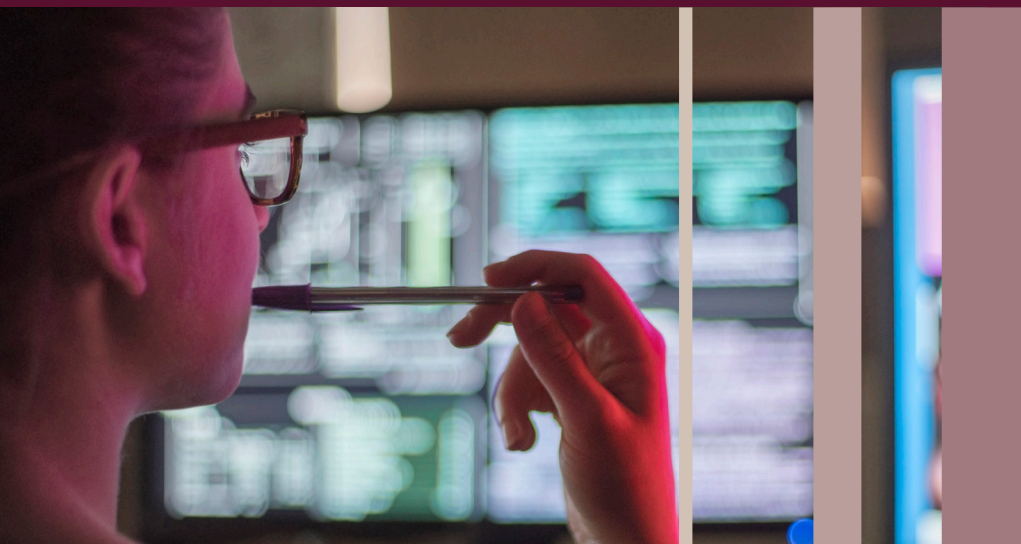




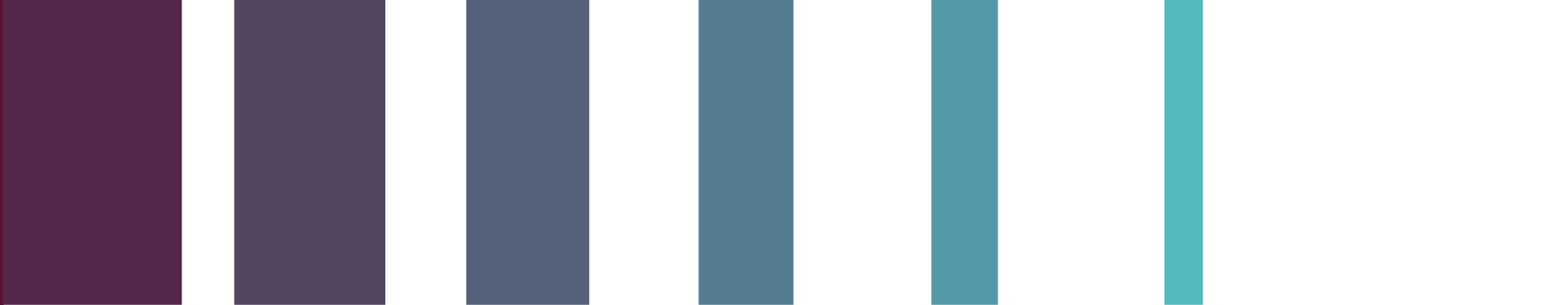
Municipal Fixed Income Team

Municipal Basis Points 4Q 2026

Gauging Municipal Volatility—and Opportunity

- A backup in Treasury yields contributed to a down quarter for municipal bonds.
- Issuance and weaker fund flows added to headwinds, along with investors' need for liquidity.
- We believe yields and relative valuations are at compelling levels, although security selection will likely remain crucial.





Macro and Markets

A tough quarter leaves municipal yields at historically generous levels, while reinforcing the value of security selection.

The third quarter of 2026 was challenging across fixed income markets, with municipal bonds delivering relative underperformance, most of which occurred in September. The catalyst was a continued backup in Treasury rates. The Federal Reserve raised its policy rate at its September meeting, building on the hawkish tone that new Chair Kevin Warsh established at the central bank's July meeting and at the Jackson Hole symposium in late August. The market is now expecting a rate-hiking cycle of roughly three additional 25-basis-point increases.

Reasons for Recent Volatility

September was a particularly challenging month for municipals. Due to the federal tax exemption, municipal yields typically trade with less volatility than Treasury counterparts. So, why did they move so much in September?

In our view, one thing that likely did not contribute to the sell-off was credit quality. Investment grade munis remain among the highest-quality and most resilient fixed income credit segments. Given continued U.S. economic strength, we believe the backdrop for municipal credit quality continues to be favorable. Rather, we believe other factors were at play:

- The increase in Treasury yields naturally pressured municipals.
- Heavy new issue supply weighed on municipal valuations.
- Fund flows, previously a tailwind, moderated due to interest rate volatility.
- September and October typically generate less municipal reinvestment from maturities and coupons than at other times of the year.
- Dealer inventories were heavy.
- Bid-wanted activity ballooned with some investors needing to raise cash and others looking to harvest tax losses.

All in, the Bloomberg Investment Grade Municipal Index returned -4.05% in September, its worst total return month since 2008; the full 3Q return of -5.78% was the second worst for a quarter since 1989.¹

Where We Find Ourselves

Stepping back, the municipal market has experienced—and largely recovered from—other sharp sell-offs over the years, including during the “Taper Tantrum” of 2013, the rate-hiking cycle of 2022 and, most recently, the “Liberation Day” tariff downdraft of April 2025.

Moreover, municipal absolute yields are now at levels not seen in decades.² For example, five-year AAA munis are yielding approximately 3.7%, which is 73% of the equivalent Treasury yield, and 10-year AAA munis are yielding 4.1% or 77% of the 10-year Treasury yield—relative valuations that are far better than recent averages.³ For intermediate investment grade munis,⁴ the yield is 4.49%, which equates to a taxable equivalent yield⁵ of roughly 7.58%—within shouting distance of long-term equity returns—for an AA rated fixed income asset class. In addition, the municipal market now has a significant yield cushion should rates continue to be volatile.

A Value Opportunity

It is hard to predict when Treasury rates could stabilize given uncertainty around the war in Iran. However, given the dramatic rise in yields, we think investors will eventually come to recognize the significant value within the municipal market and, at some point, start to buy tax-exempt securities in a more meaningful way. In the meantime, we favor capitalizing on the higher yield environment, looking for mispriced securities and harvesting tax losses where appropriate in separate accounts. While we recognize how difficult this environment has been for investors, we believe that staying the course is likely to prove rewarding over time, particularly given new opportunities we see in the municipal market.

¹Source: Bloomberg for all data unless otherwise stated, as of September 30, 2026.

²Bloomberg AAA municipal yield.

³Last five years through September 30, 2026.

⁴As measured by the Bloomberg 1-15 Year Municipal Bond Index.

⁵Assumes a 37% marginal tax combined with an ACA tax of 3.8% for a total rate of 40.8%.

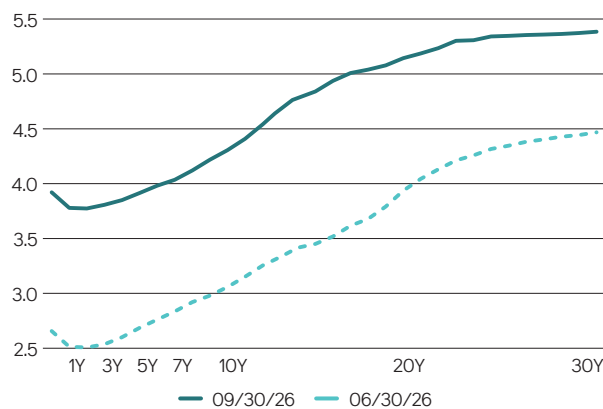
Strategy and Outlook

Yields, valuation and a positive technical turn.

Rising Treasury yields, a hawkish Fed and higher oil prices are keeping inflation worries front and center. Softer reinvestment flows in September and October, and a surge in new municipal issuance have added to the pressure. In the wake of these events, municipal yields are at their highest levels in about two decades.

Fixed Income Yields Have Spiked

AA G.O. Municipal Yield by Maturity (%)



Source: Bloomberg. Data as of September 30, 2026.

Our View: Stay Neutral on Duration

We remain cautious on duration (price sensitivity to interest rate changes), but believe higher yields and heavier new-issue supply may provide attractive opportunities. In this volatile market, we favor actively harvesting losses where appropriate in separate accounts.

Quick Take: What's Behind Higher Yields?

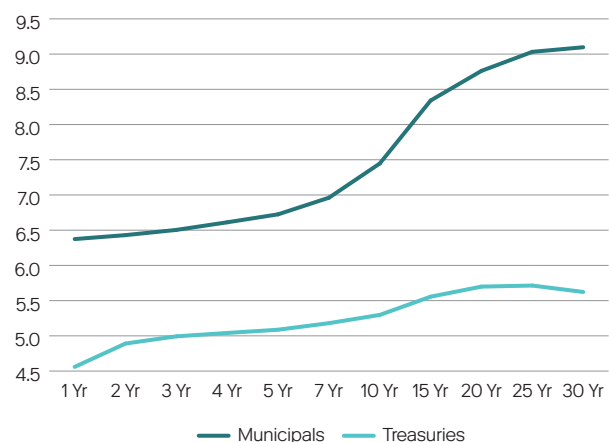
- **Hawkish Fed:** The central bank raised rates 25 basis points in September, and markets are pricing in one or two more hikes this year.
- **Energy spike:** Higher oil prices continue to feed inflation concerns.
- **Resilient economy:** Growth is holding up better than expected, weakening the case for near-term monetary easing.
- **Global tightening:** Other central banks are also raising rates, pushing yields up worldwide.
- **Uncertainty:** The Mideast conflict and midterm election have added to market volatility.

Rationale: Why Consider Munis Now?

- **Real yields:** Investors are receiving more income above inflation than they have in decades. We believe that's a strong starting point for long-term returns.
- **Compelling tax-equivalent yields vs. U.S. Treasuries:** 10-year AA municipals now offer an absolute yield of 4.25% and a 7.18% taxable equivalent yield, compared to the 10-year U.S. Treasury's 5.25% yield.
- **Deeper value:** 10-year AAA municipal yields are up more than 1.25% since June 30, while the municipal/Treasury ratio for 10-year AAA munis has climbed to about 78%, from 67% at midyear.

Mind the Yield Gap

Taxable Equivalent Yield: Munis vs. Treasuries (%)



Source: Bloomberg. Data as of September 30, 2026. Assumes a 37% marginal tax combined with an ACA tax of 3.8% for a total rate of 40.8%. Municipals are AA general obligation bonds.

Technical: Another Support for Municipals

We are likely experiencing higher-than-normal new issuance in October, ahead of the midterms, giving investors a window to put sidelined cash to work. Looking ahead, that supply should fade just as a large wave of reinvestment arrives in December; more money chasing fewer available bonds could support munis going forward.

Drilling Down

Pressure is building across public school districts, but we continue to find well-managed issuers with favorable credit trends.

School districts have long been a healthy corner of the municipal market, supported by local property taxes, state funding and a strong record of meeting debt service on time. However, although credit quality has held up well historically, it is now being tested across the sector. As a result, we believe careful issuer selection matters more than ever, and that districts with sound finances and proactive leadership can still offer compelling opportunities.

Pressure Has Been Building

The primary concern is straightforward. Expenses are growing faster than revenues, as salaries, benefits, special education services and everyday operating costs continue to climb. Temporary federal aid that supported districts during the pandemic has also dropped, and gains in local property taxes and state funding, though meaningful in some places, have not been enough to make up the shortfall.

Falling enrollment is compounding the problem by further weakening revenues. Lower birth rates and immigration are shrinking the pool of school-age children in many communities,⁶ and because most state funding is distributed on a per-student basis, fewer children translates into less revenue.

Families also have more options than before. Charter schools, which are publicly funded but independently

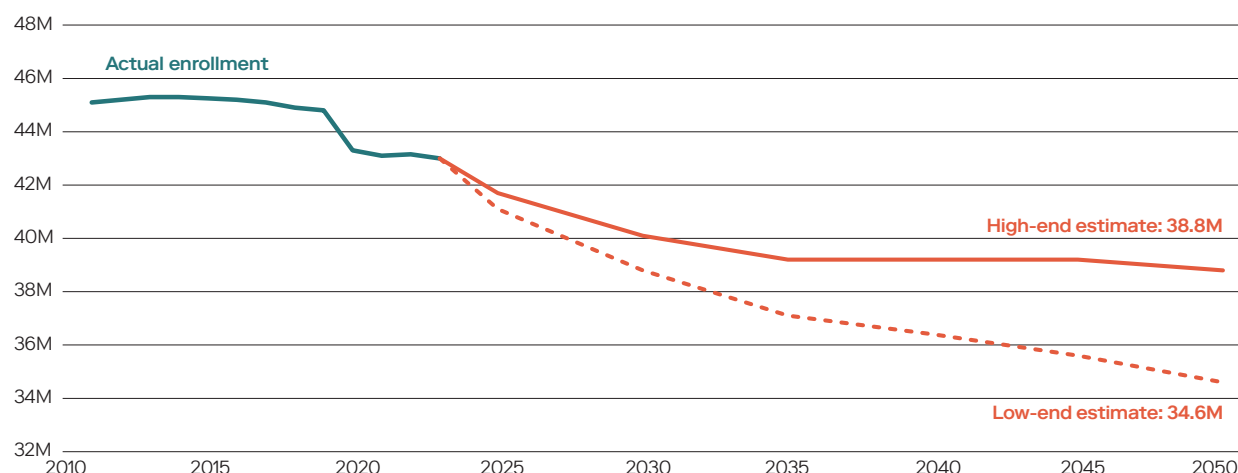
run, are expanding in many states. More states are also offering school choice vouchers, which let families use public dollars for private school tuition, moving both the student and the funding outside the public system. A new federal tax credit could add to this trend by drawing more students away from public schools. The Educational Choice for Children Act, part of the One Big Beautiful Bill Act, funds scholarships that eligible families can use for private or alternative education. Together, these forces are expected to push enrollment lower across the public school system.

Options for replacing lost revenue may be limited. Districts have historically turned to voters for new taxes to close budget gaps, but growing affordability concerns could make approval more difficult. Reserves, which expanded considerably in recent years, have now plateaued, leaving districts with less cushion to absorb shortfalls. Rating agencies have recently downgraded more districts than they have upgraded,⁷ a sign that pressure is spreading.

Fewer Students, Familiar Costs

Fewer students do not automatically mean lower costs. As enrollment declines, districts often keep paying for staff and buildings they no longer need. Teacher salaries and health benefits continue to rise, and facilities built for larger classes still require heating and repairs. Staffing reductions and school closures are the most direct

Public School Enrollment Is Experiencing Secular Decline



Source: National Center for Education Statistics, Brookings Institution. Data as of August 2026.

⁶ Source: Multiple news outlets, such as Reason Foundation, "Latest data shows just 10 states have avoided K-12 public school enrollment decreases," June 16, 2026, and Reuters, "Immigrant student enrollment is dwindling at schools across the US amid immigration crackdowns," November 17, 2025.

⁷ Source: Moody's "Medians" report, September 1, 2026. 1Q 2026 rating actions highlight the trend.

responses, but even closed buildings can be difficult to sell or reuse, leaving the district responsible for upkeep. Because spending cuts trail revenue losses, districts can face short-term budget gaps even when they respond quickly. Cuts take time to plan and implement, and community opposition can stretch that timeline further as families organize quickly to protect neighborhood schools and their teachers. The result is often that revenue follows students out the door while the biggest expenses can stay behind.

With budget pressure mounting across the sector, we believe effective governance matters more than ever. The strongest districts plan ahead, identifying budget gaps before they emerge and making measured spending adjustments early rather than waiting for a crisis. Weaker districts tend to be more reactive, allowing structural deficits to widen and drawing down reserves further.

Windows of Opportunity

Pressure does not affect every district equally and some trends remain favorable despite the sector headwinds. Taxable property values have grown in many communities, lifting tax collections, a core source of school district funding. Reserves have slipped from their recent peak, but the strong growth of prior years has left most districts with adequate cushions, giving them time to address budgetary constraints. Some districts are even bucking the trend, with stable or growing enrollment supporting revenue. Even where enrollment is flat or declining, the strongest districts are those budgeting conservatively and acting early to offset anticipated revenue reductions.

We typically find opportunity where these strengths come together: a stable or growing tax base, healthy reserves and management teams that budget conservatively in the face of enrollment declines. In our view, districts with all three should be well positioned to withstand tighter budgets and maintain stable credit profiles as the sector's weaker issuers come under greater strain.

Approaching the Public School District Sector

In our view, credit selection largely drives results in the public school district sector, and careful work can still be rewarded with attractive yield. Rather than owning school districts broadly, we favor evaluating each district on its own merits, starting with a close read of audited financials, budgets and multiyear forecasts. We examine how reserve levels and payroll costs have trended and whether enrollment projections, and the state funding tied to them, are realistic. We also watch for early warning signs, including structural deficits masked by one-time funds, thinning reserves and enrollment losses without a matching plan to cut costs. Once invested, we believe it is important to monitor each holding for shifts in enrollment, reserves and management behavior. Investors should be prepared to sell early should trends weaken. In a sector where pressure is spreading, we believe selectivity is the best insulation for investor capital.

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