

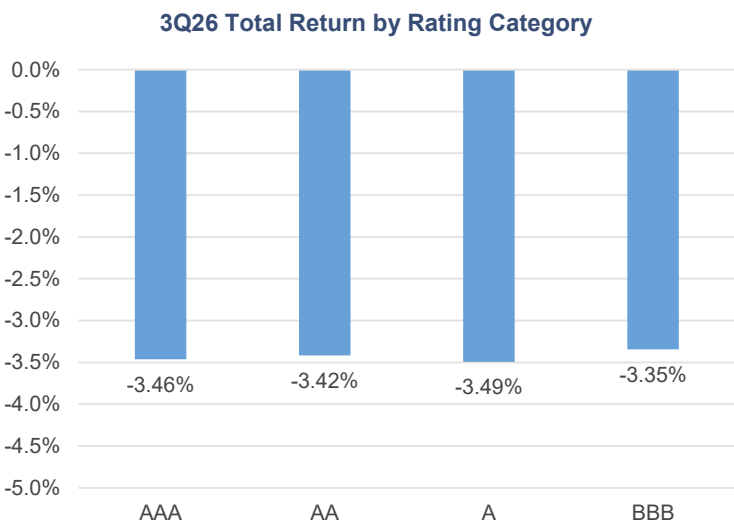
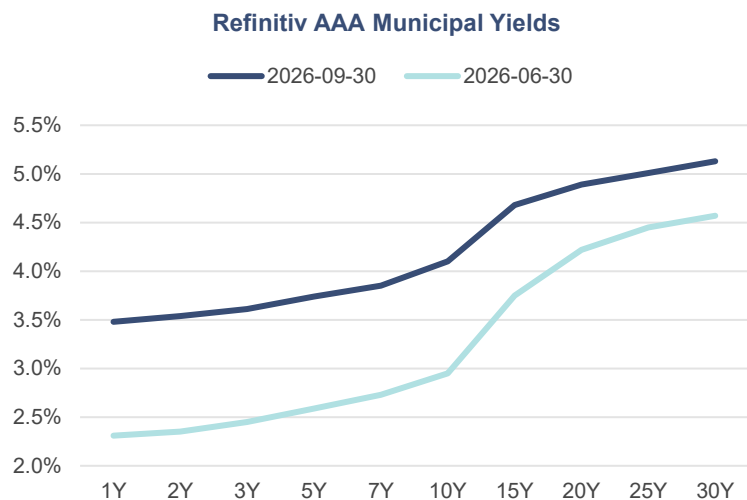
# Municipal Fixed Income Commentary

3Q 2026

The municipal market repriced sharply during the quarter as elevated new issue supply, rich starting valuations, and more restrictive monetary policy weighed on performance. The ICE BofA 1-10 Year U.S. Municipal Securities Index returned -3.45%, underperforming duration-matched U.S. Treasuries by 2.22%. It was the weakest third quarter on record, dating back to 1988. While the quarter opened on firm technical footing, supported by strong July reinvestment and positive mutual fund flows, escalating tensions in the Middle East renewed inflation concerns and drove fixed income yields higher. A weaker-than-expected July employment report triggered a brief reversal in early August, though it faded as U.S. Treasury yields resumed their climb and the Federal Open Market Committee (FOMC) raised rates by 25 bps (basis points) in September.

Adding to headwinds during the quarter, net municipal issuance totaled \$164.3 billion, up 7.6% year-over-year. Tax-exempt issuance made up \$157.1 billion of that, up 7.8% from a year earlier, while taxable issuance fell 38.4% from the second quarter to \$7.2 billion. Year-to-date supply of \$459.9 billion is running 6.6% ahead of last year. New issues were well received through August, with deals often repricing to lower yields, but a full September calendar and rising yields required measured price concessions. LSEG Lipper reported municipal mutual fund inflows of \$12.36 billion for the quarter, but a 21-week inflow streak ended with a \$1.8 billion outflow following the FOMC’s mid-September rate hike. Maturing and called bonds returned \$144.4 billion of proceeds to investors, a tailwind for reinvestment demand early in the quarter. Roughly three quarters of this came in July (\$54.6 billion) and August (\$55.2 billion), leaving \$34.6 billion for September. Secondary market supply also rose sharply, with bid-wanted activity on Bloomberg averaging approximately 1.55 billion in daily par value, up 42% from the third quarter of 2025. Bid-wanted volume peaked in September, averaging 2.35 billion per day, more than double a year earlier, as investors sold to harvest tax losses. As selling pressure persisted, municipal yields rose across the curve, increasing 119 bps at the 2-year point, 115 bps at the 5- and 10-year points, and 94 bps at the 30-year. Municipal-to-Treasury ratios cheapened as municipals underperformed, ending the quarter at 72% for the 2-year and 77% for the 10-year, up from 57% and 67% at the start. Both are now above their respective five-year averages of 63% and 71%.

Municipal credit held up well amid the rate-driven selloff, with spreads stable to modestly tighter. Dispersion among rating categories was narrow, with BBB-rated bonds again edging ahead at -3.36%, compared with -3.43% for AA, -3.48% for AAA, and -3.50% for A. Spreads tightened 12 bps for BBB-rated bonds and 5 bps for A-rated bonds, versus 2 bps for the broader index. Sector dispersion was far wider. Tobacco bonds led at -1.17%, while single-family housing (-5.57%) and education (-4.19%) lagged. Defensive sectors, including refunded bonds (-2.14%) and local general obligation bonds (-3.11%), held up better than the index. Prepaid gas bonds were in line with the index at -3.48%, while prepaid electric bonds lagged at -3.82%. Spreads in both sectors tightened, by 11 bps for gas and 13 bps for electric, suggesting the underperformance reflected rate sensitivity rather than credit concerns.



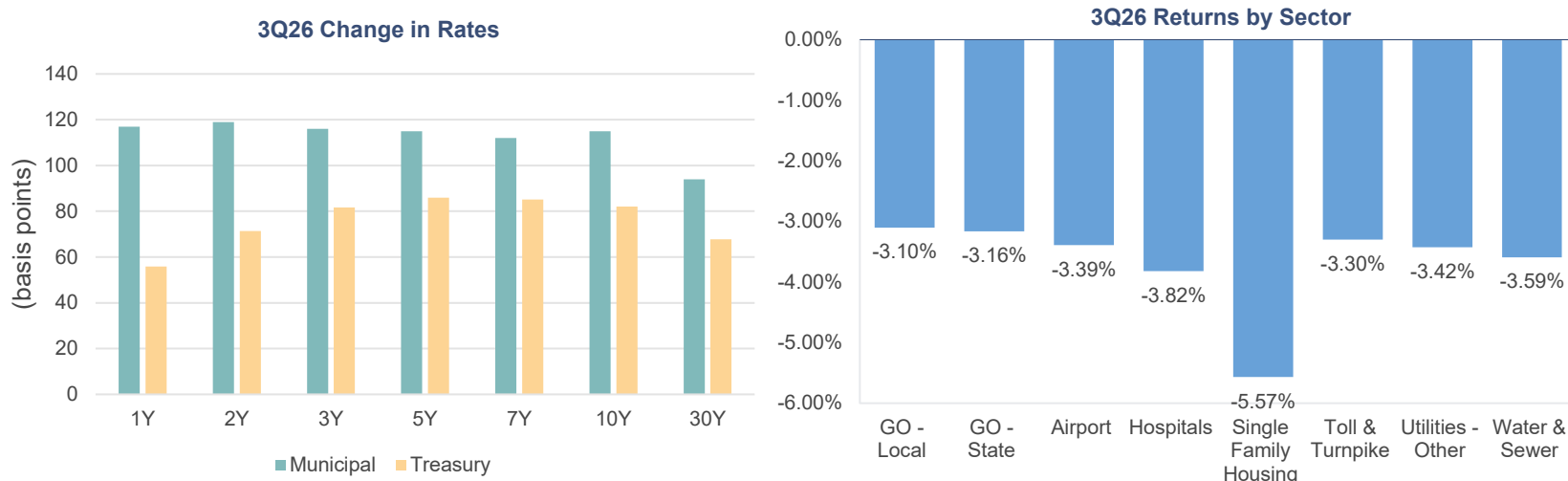
Data is as of 09.30.2026. Textual data source: Bloomberg L.P. Chart data sources: Bloomberg L.P.; U.S. Treasury; Refinitiv. Charts are for illustrative purposes only. Yields are subject to market conditions and are therefore expected to fluctuate. The views expressed represent opinions of Sterling Capital Management. Any type of investing involves risk and there are no guarantees that these methods will be successful. This information must be read in conjunction with the important disclosures and definitions on page 3.



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Municipal credit fundamentals remained broadly firm during the quarter, though rating trends pointed to an increasingly differentiated credit environment. Moody's reported that downgrades outpaced upgrades in 2Q26, ending five consecutive quarters of positive rating migration. The shift was largely driven by K-12 public school districts, which face increased charter school competition and declining school-age populations. Moody's also revised its outlook for U.S. cities and counties to negative in July, citing expectations that inflation may outpace local revenue growth. Even so, state and local finances remained sound. The U.S. Census Bureau's most recent release showed state and local government tax revenue totaling \$1.14 trillion in the first half of 2026, up 5.8% from the prior year, led by gains of 8.6% in individual and 9.5% in corporate income tax collections. Sales tax revenue grew 4.0%, while property taxes, the primary source of local government revenue, climbed a more modest 3.7%. Public pension funding also continued to improve, with S&P Global Ratings estimating average funded ratios of 89% in fiscal 2026. Positive rating actions during the quarter went to issuers with improving pension positions and demonstrated financial flexibility, including the states of Illinois and New Jersey and the cities of Austin, Houston, and Savannah. Illinois earned upgrades from both Moody's and S&P, lifting its Moody's rating to its highest level in 15 years. At the same time, issuer-specific stress persisted. The Los Angeles Unified School District, the city of Buffalo, and the Fayette County (KY) School District were downgraded amid operating deficits, declining reserves, and enrollment pressures.

## Our View

We entered the quarter with a long relative duration and bulleted curve positioning, anticipating a strong summer technical backdrop. As rate volatility picked up and yields rose, we let portfolio duration drift to neutral or slightly short versus benchmarks, reflecting continued caution on rates even as valuations cheapened. We used the late-quarter repricing to execute swaps that helped enhance portfolio yields while maintaining current duration. As we enter the fourth quarter, yields now offer attractive tax-adjusted income across the curve. Near-term trading is likely to stay uneven while tax-loss harvesting and rate volatility persist, and we expect issuance to remain above average as issuers address long-term capital needs. With yields at these levels, we expect a wave of demand once rate volatility subsides, aided by a return to positive fund flows. We remain constructive on municipal credit overall, seeing broad fundamental strength rather than systemic deterioration. We are selective in adding lower-rated, more cyclical sectors for additional yield. We continue to favor prepaid gas and electric bonds, but with spreads near cycle tights we plan to maintain current weightings rather than add.

Data is as of 09.30.2026. Textual data source: United States Census Bureau. Chart data sources: Bloomberg L.P. Sector returns are based on the ICE BofA 1-10 Year Municipal Securities Index. Charts are for illustrative purposes only. Yields are subject to market conditions and are therefore expected to fluctuate. General Obligation (GO) bond is a type of municipal security backed by the full faith, credit, and taxing power of the issuing government entity rather than a single-revenue generating project (like a toll road or utility). The views expressed represent the opinions of Sterling Capital Management. Any type of investing involves risk and there are no guarantees that these methods will be successful. This information must be read in conjunction with the important disclosures and definitions on page 3.



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**The ICE BofA 1-10Y Municipal Securities Index** is a subset of the ICE BofA U.S. Municipal Securities Index including all securities with a remaining term to final maturity less than 10 years.

**Refinitiv Municipal Market Monitor (MMD) AAA benchmark:** The Municipal Market Monitor has been delivering the municipal market’s MMD AAA benchmark for over 30 years and is integrated into the most comprehensive source of critical municipal market information.

## Technical Terms:

**BPS** = basis points.

**LSEG Lipper** is a global financial data and fund research platform owned by the London Stock Exchange Group (LSEG), tracking independent fund performance and analytics

**General Obligation (GO) bond** is a type of municipal security backed by the full faith, credit, and taxing power of the issuing government entity rather than a single-revenue generating project (like a toll road or utility)