Municipal Fixed Income Commentary

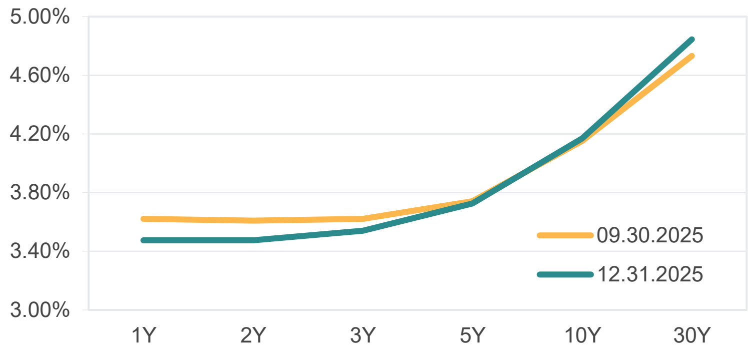
4th Quarter 2025

In the fourth quarter of 2025, the municipal bond market was shaped by persistent yield-curve flattening, solid but uneven new-issue supply, and strong investor demand that together supported positive returns. The ICE BofA 1-10Y Municipal Securities Index delivered a total return of 0.76%, bringing the full year to 4.95%, underperforming duration-matched U.S. Treasuries as municipal-to-treasury ratios oscillated in a tight range but generally cheapened across the curve amid heightened uncertainty stemming from the U.S. government shutdown. Ratios entered the quarter reflecting bifurcated relative values with the 5-year level at a rich 62% while the 10-year presented a more attractive level at 71%. The longer maturity value drove investor sentiment and flattened the municipal yield curve early in the quarter. Ratios ended the year at 69% for the 5-year and 67% for the 10-year, approximately in line with 3-year averages for each measure.

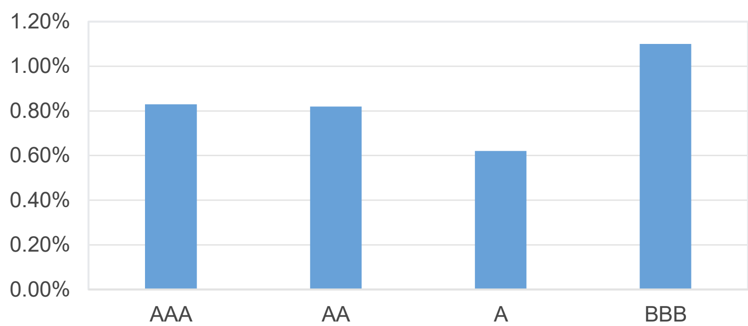
Primary market activity remained elevated during the quarter, with new issue supply totaling approximately $140B, representing an increase of over 15% from the same period in 2024 and bringing full-year issuance to roughly $570B, up 15% year-over-year. Issuance was front-loaded early in the period, particularly in October and early November, before decelerating into December in line with historical seasonal patterns. This supply was readily absorbed amid consistently strong reinvestment demand via steady municipal mutual fund inflows, with net inflows of $6.9B during the quarter and $28.8B for the year according to Lipper. Secondary market activity remained subdued compared to prior quarters as strong market performance curtailed tax-loss harvesting opportunities, with bid-wanted volumes averaging roughly $900M in par-value per day according to Bloomberg. Yield-curve dynamics were capricious, marked by pronounced inversion early in the quarter, as short-maturity yields rose and pushed the 1-to-5-year spread to its most inverted level of the year, before gradually re-steepening into year-end as diminished economic data flow during the government shutdown renewed expectations for Federal Reserve (Fed) easing. Refinitiv's AAA-municipal curve 2-year to 10-year spread differential declined by 27 basis points (bps) during the quarter to end at 35 bps with the 10-year municipal rate ultimately declining 16 bps and ending at 2.76%, while the 2-year yield moved higher by 9 bps reaching 2.39%.

Municipal credit performance during the fourth quarter was broadly positive, with returns modestly favoring lower-quality credit given limited dispersion across rating categories. Within the ICE 1-10 Year Index, BBB-rated bonds led quality performance with a total return of 1.10%, followed by AA- and AAA-rated bonds at 0.82% and 0.83% respectively, while A-rated bonds lagged with a 0.62% total return. The relative underperformance of A-rated securities was driven by weakness in prepaid gas and electric bonds, where A-rated prepaid bonds returned -0.03% for the quarter, as elevated new-issue supply pressured

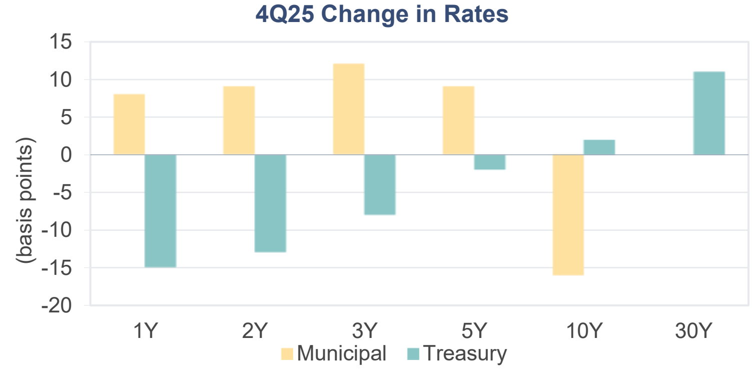
Refinitiv AAA Municipal Yields



4Q25 Total Return % by Rating Category



4Q25 Change in Rates



Data is as of 12.31.2025. 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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spreads wider and weighed on index-level results. Pre-paid issuance swelled to $9.8B during the quarter, greater or equal to total annual prepaid supply across 2018-2022, and the sector's weight within the index approached 15%, up materially from below 10% at the start of 2025. As a result, prepaid credit option-adjusted spreads (OAS) widened by over 20 bps to end the quarter at approximately 112 bps. Sector performance otherwise reflected a slight risk-on bias again with a tight dispersion, as hospital, airport, and toll road outperformed general obligation bonds. OAS movements were generally modest among higher-profile issuers, with names such as Metropolitan Transportation Authority and the State of Illinois remaining largely range-bound, while credits such as Los Angeles Department of Water and Power (LADWAP) saw incremental spread tightening following significant widening earlier in the year.

Municipal credit fundamentals remained largely stable during the fourth quarter, supported by solid state-level fiscal management and resilient economic activity, despite pockets of emerging pressure. Moody's reported that rating actions in the third quarter reflected a second consecutive modest tilt toward quarterly downgrades, driven primarily by challenges within the local government sector, most notably K-12 school districts. Districts continue to maintain high investment grade rating levels, but rising labor and benefit costs, combined with demographic-driven enrollment declines continued to strain operating budgets. In contrast, state-level credit conditions remained favorable in our view, underpinned by stronger-than-expected tax revenues and improving pension funded ratios. According to the National Association of State Budget Officers, aggregate rainy day fund levels declined slightly in fiscal 2025 from the prior year, though the majority reported increases and projected further increases in fiscal 2026, continuing to provide states with what we believe is meaningful flexibility despite a gradual normalization from peak surplus levels. Looking ahead, Moody's maintained stable outlooks across most sectors heading into 2026, citing broad economic stability and expectations for modest revenue growth. Indicators of consumer activity remained supportive, with Transportation Security Administration data showing average daily passenger throughput of approximately 2.48M, up 1.15% year-over-year, signaling continued strength in travel and discretionary spending.

Our View

Following a December interest rate cut from the Fed to a 3.75% top-end federal funds rate, we remain constructive on economic growth in 2026, though we continue to expect above-target inflation. Importantly, despite entrenched upward pressure on prices in the broad economy, we view monetary policy as being fairly responsive to further weakness in the labor market. Fed Chair Jerome Powell has continued to prioritize heading off downside risks to employment in recent months, and we believe that the appointment of the new Fed chair in May 2026 is likely to inject incremental dovishness into the Federal Open Market Committee (FOMC)'s reaction function.

With this context, we enter 2026 with a neutral duration position favoring a bulleted curve allocation to benefit from an expected re-steepening of the yield curve back towards the approximate long-term average municipal 2-year to 10-year spread differential of approximately 60 bps. We anticipate that municipal credit fundamentals will remain broadly sound, while closely monitoring tail risks stemming from policy uncertainty. We expect new issuance supply will remain ample, likely setting a record for total issuance, but will be well absorbed by steady investor demand. Given our positive outlook for the economy and stable municipal credit fundamentals, we look to capitalize on moments of market dislocation in credits with solid fundamentals. Finally, we continue to overweight prepaid energy bonds relative to the index, where we believe its solid credit fundamentals and attractive spread levels underpin relative value. In a market hungry for yield, prepaid taxable-equivalent yields reaching approximately 6% for the top marginal tax bracket are likely to attract more investor demand in our view, particularly if the technical headwinds experienced during the quarter continue.

Important Information & Disclosures

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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.

Option-Adjusted Spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is then adjusted to take into account an embedded option. Typically, an analyst uses Treasury yields for the risk-free rate. The spread is added to the fixed-income security price to make the risk-free bond price the same as the bond.

Federal Open Market Committee (FOMC), the key monetary policymaking body of the U.S. Federal Reserve System, responsible for setting interest rates (like the federal funds rate) and managing the nation's money supply to achieve maximum employment and stable prices.

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