

AUTHORS



David Hammer
Managing Director
Portfolio Manager



Paul Reisz
Executive Vice President
Fixed Income Strategist



Kenneth Meyer
Senior Vice President
Fixed Income Strategist



Jakob Bowling
Vice President
Fixed Income Strategist

Municipal Bond Reset: Volatility, Selectivity and the Active Advantage

Higher rates have strengthened return potential for tax-exempt municipals, while widening differences in credit quality are strengthening the case for active management.

Key Takeaways:

- Recent volatility has reset municipal yields higher, strengthening return potential and relative value while fundamentals remain intact.
- Growing supply and wider credit dispersion are creating clear winners and losers, reinforcing the value of active, research-driven security selection.
- We see potentially compelling opportunities by emphasizing yield curve positioning, bank retrenchment, and selective investments in healthcare and Continuing Care Retirement Communities (CCRCs).

The municipal market has undergone a meaningful reset, which may improve after-tax return potential for investors. Higher U.S. Treasury yields tied to geopolitical uncertainty – combined with increased interest rate volatility, seasonal tax related selling, and shifting supply dynamics – have driven a broad repricing. In March, benchmark AAA municipal yields rose 28–60 basis points across the curve,¹ with most of the move concentrated in the latest bout of volatility.

The reset has tangible implications. The yield to worst on the Bloomberg Municipal Bond Index now stands at 3.77%² – or 6.38%³ on a taxable equivalent basis – placing it in the 93rd percentile relative to the past 15 years. Higher starting yields can provide a stronger foundation for forward returns, and after tax outcomes.

Relative value has improved as well. On a taxable equivalent basis, investment grade municipals are currently offering almost 270 basis points over cash⁴ and about 120–220 basis points over comparable taxable fixed income alternatives.² This environment reinforces PIMCO's long standing view that municipals may represent one of the most compelling public

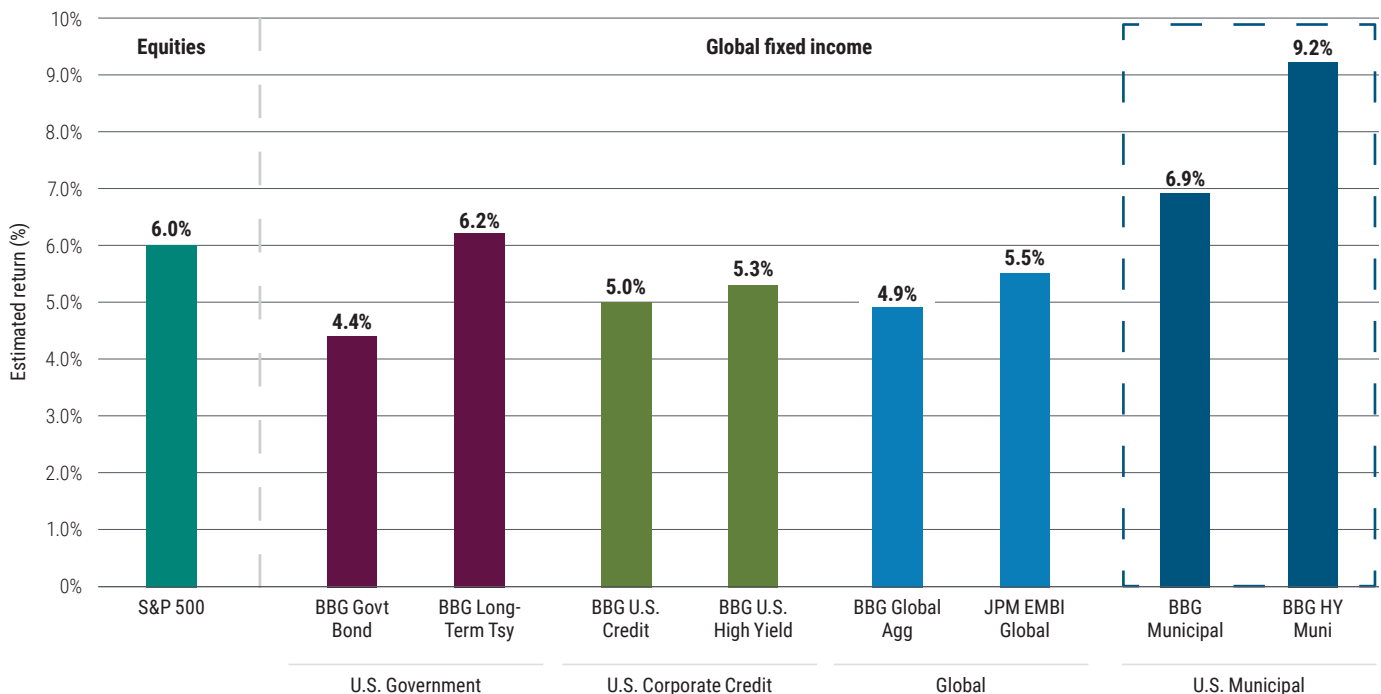
market opportunities for U.S. taxpayers on a tax and default adjusted basis. The recent reset higher in yields has only strengthened that case over the longer term (Figure 1).

PIMCO views periods of elevated volatility as opportunities, and the recent repricing may offer an attractive entry point for investors. This view is supported by our constructive outlook on U.S. duration, as the energy shock introduces downside risks to growth, with the U.S. economy appearing particularly vulnerable given an already softening labor market. In addition, with tax-exempt markets now negative year-to-date, investors evaluating their tax situation may find timely opportunities for tax-loss harvesting.

Looking ahead, a shifting supply backdrop, widening credit dispersion, and emerging stress in the lower-quality segments of the market underscore why disciplined security selection continues to be important. In this environment, disciplined portfolio management, robust and integrated investment resources, and a strategic, selective approach can help investors navigate challenges while seeking to position portfolios for resilience and opportunity.

Figure 1: PIMCO Capital Market Assumptions

5-year estimated return



As of December 2025. SOURCE: PIMCO. **For illustrative purposes only.** Figure is not indicative of the past or future results of any PIMCO product or strategy. There is no assurance that the stated results will be achieved.

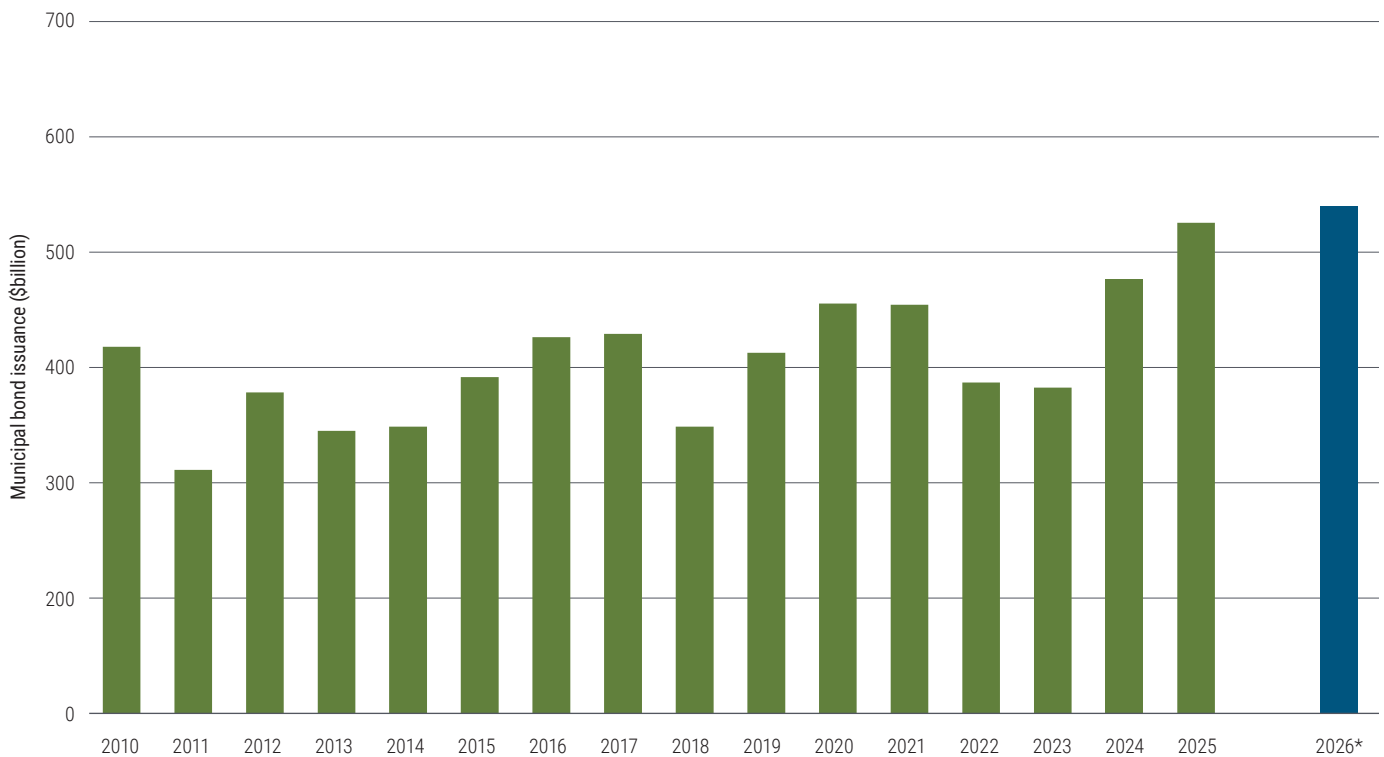
For indices and asset class models, return estimates (arithmetic) are based on the product of risk factor exposures and projected risk factor premia which rely on fair value models and qualitative inputs from senior PIMCO investment professionals. Returns for the BBG Muni and the BBG HY Muni are reported on a tax-equivalent basis assuming a 40.8% to marginal tax rate (37% federal and 3.8% Affordable Care Act tax rate).

Shifting issuance trends

Supply reached record levels in 2025⁵ and is expected to remain elevated, driven by infrastructure investment and deferred maintenance, both influenced by inflation and supported by prior legislation. Also, as pandemic-era stimulus rolls off in 2026 and municipalities seek to maintain healthy reserve levels, issuers will continue to turn to debt markets.

Current projections for 2026 estimate gross municipal issuance is between \$525 billion and \$600 billion, well above the post global financial crisis average of about \$417 billion (Figure 2). However, net issuance should be modestly more supportive than in 2025, while current valuations indicate one of the most attractive forward-looking return environments in the last decade.

Figure 2: Annual municipal supply



Source: Bond Buyer, J.P. Morgan Research, Barclays as of 31 December 2025

*Estimate

AI infrastructure and supply

The AI investment cycle has boosted capital spending on data center development and increased issuance in both public and private taxable markets, but it has not yet translated into higher municipal issuance.

Data centers have more than doubled their share of U.S. electricity consumption over the past five years, and current projections anticipate continued long-term growth. Before the data-center boom, the public power sector was already expected to enter its next investment cycle to develop firm capacity. However, issuers have been cautious about aligning capacity additions with current forecasts given the significant uncertainty over the pace and magnitude of data center load growth, likely to result in continued reliance on private-sector financing.

Sound credit fundamentals

State and local credit fundamentals today remain sound, revenue collections are stable and materially higher than five years ago⁶, while total balances – including rainy day reserves – are still near historically elevated levels.⁷ The exhaustion of pandemic-era federal relief funds is a notable development and likely to increase dispersion across issuers as deficits emerge. Some have already experienced downgrades while others are being assigned negative outlooks.

Default risk has historically been low in higher quality segments, as fiscal flexibility remains, but active credit selection is becoming increasingly important.

One Big Beautiful Bill in effect

State governments: Changes to Medicaid are anticipated to be a headwind for further state credit upgrades, as the program accounts for roughly 30% of state budgets. However, states benefit from discretion in managing their plans and will likely implement a combination of their own cuts and replacing a portion of lost federal revenue. We expect many states will run budget deficits as they intentionally spend down reserve levels that remain far above historic norms, with many using those funds for one-time projects.

Healthcare: Projected Medicaid spending cuts, along with the accelerated phase-in of work requirements by the end of 2026, are expected to pressure some healthcare systems. Potential revenue declines are estimated to be 1%–3% but could be bigger depending on exposure to government payers. Larger, multi-site systems should benefit from integrated operations and strong liquidity, while smaller, single-site providers with high government-payer exposure are more likely to face challenges.

Higher education: The bill enacts a tiered excise tax on private university endowments but raises the exemption threshold from 500 to 3,000 students, significantly reducing the number of affected institutions and mitigating the impact on smaller universities. While modestly negative for universities with large endowments, these institutions benefit from strong demand, good tuition pricing power, and healthy resources.

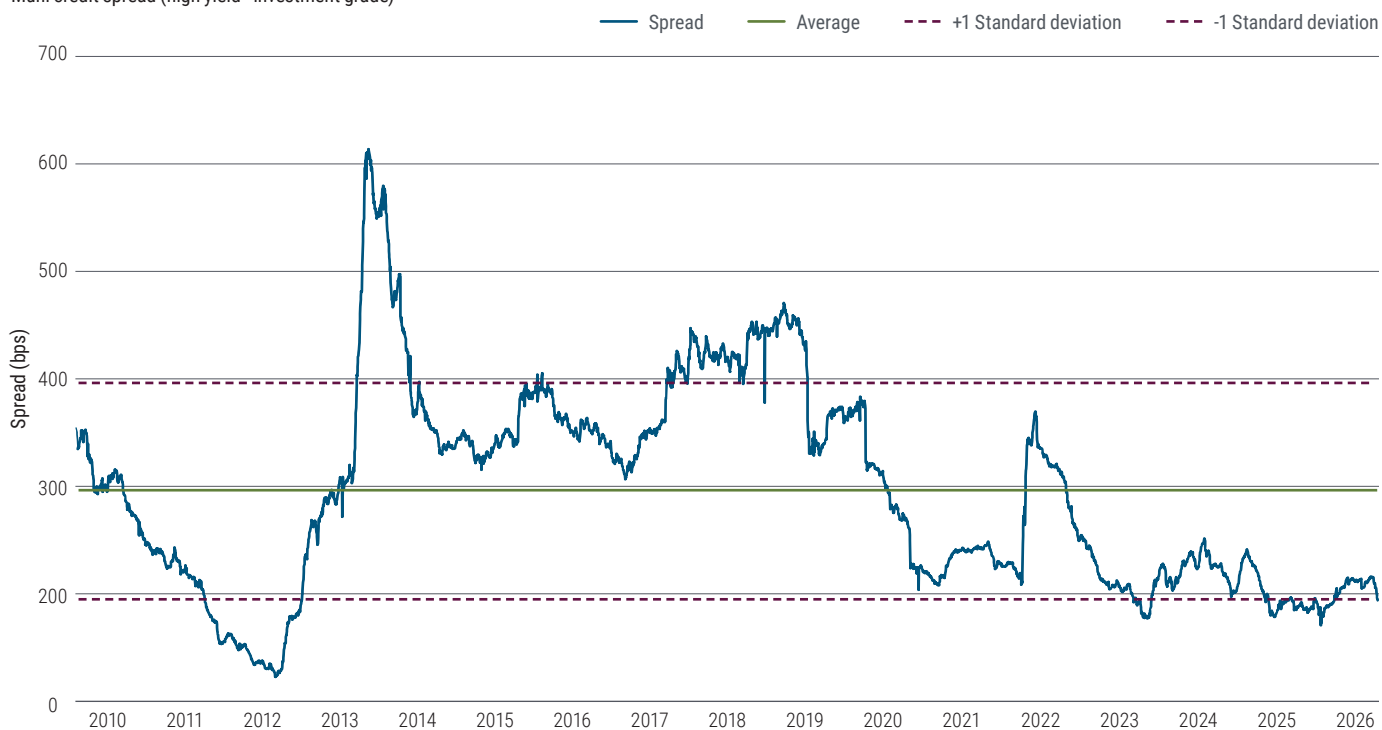
High yield appears particularly attractive

We remain positive on high-yield municipals for their potential to offer higher yields and excess return opportunities versus investment-grade debt. But tight spreads (Figure 3) and elevated default risk in the lowest-quality segments of the market reinforce the importance of careful security selection and disciplined risk management. Recent headlines and price declines tied to a large speculative-grade project-finance issuer exemplify these risks, which have emerged alongside the growth of non traditional issuers, and newer financing structures.

In our view, historical default data understates today's risk because it is based mostly on rated bonds, which now make up a smaller share of the market. Also, it doesn't reflect how much the market has grown both in size and complexity over the past decade. As investors reached for yield between 2016 and 2021, many deals were structured with weaker protections, and those issuers are beginning to experience credit stress. We believe the risk of elevated defaults and lower recoveries may be likely to increase in this segment of the market. As a result, we see value in select, private placements that offer yields in line with – or exceeding – traditional high-yield opportunities, while benefiting from more resilient credit profiles.

Figure 3: Municipal credit spreads remain near all-time tights

Muni credit spread (high yield - investment grade)



Source: Bloomberg as of 31 March 2026

Investment opportunities: actively identifying value

Municipal bonds continue to stand out as a potentially attractive opportunity, with the potential to offer attractive performance across a range of economic outcomes. Our active approach seeks to deliver above index returns without materially increasing risk by capitalizing on bank retrenchment opportunities and identifying value in healthcare and select CCRCs.

Capitalizing on bank retrenchment

As institutional investors have stepped back from municipals over the past 15 years, liquidity has become more uneven – creating both challenges and opportunities in public municipals while private investments have emerged. Through active management and thoughtful, disciplined implementation, we seek to capitalize on this increasingly target-rich environment.

Liquidity: With broker-dealers holding less inventory and more money sitting in daily liquid vehicles⁸, markets can come under pressure when retail investors rush for the exits. At PIMCO, we structure portfolios with liquidity as a core consideration, dynamically adjusting positioning based on current market conditions and forward expectations to play both defense and offense, aiming to help drive total and risk-adjusted returns.

Steep curve: Banks have historically been natural buyers of long-end, tax-exempt bonds, and their retreat – combined with strong retail demand through direct ownership of shorter maturity bonds – has contributed to valuation distortions. Today, yield-curve positioning is critical, as short and intermediate tax-exempts appear relatively rich, while longer-dated municipals may offer compelling value. The 10-year to 30-year slope stands at about 135 bps,¹ its steepest level since the taper tantrum. Taking a barbell approach may help add meaningful excess yield without taking on excessive interest-rate risk, while capturing attractive spread, carry, and roll-down potential.

Non-traditional, private placements: Banks' historical role as providers of private tax-exempt financing has created niche entry points for investors able to access proprietary deal flow. Multi-family housing represents a meaningful opportunity. These non-rated, typically privately placed investments are backed by high-quality assets and may offer tax-free yields of roughly 5.5%–6.5%, providing high-yield-like return potential while avoiding lower-quality credits and may enhance portfolio resilience.

Select opportunities in healthcare and continued care

Leveraging an experienced investment team and integrated platform, we see select opportunities to add spread risk in systems with below-average Medicaid exposure, supported by resilient volumes and pricing despite modest margin pressure. An aging population may continue to support volume, while consolidation pressures may enhance pricing power and greater use of non hospital settings could help limit incremental borrowing needs.

CCRCs are concentrated in the lower-quality segment of the municipal market, representing approximately 11% of the Bloomberg High Yield Municipal Bond Index.² Pandemic-related pressures and sharply higher labor costs made this one of the most challenged sectors from 2020–2024, with default rates averaging roughly 9% annually.⁹ We have taken a cautious approach to the sector over time, adjusting exposure as conditions evolved. More recently, a repricing of risk alongside strengthening fundamentals has begun to create meaningful opportunities.

Active advantage

Periods of volatility may create opportunities and today the municipal market presents differentiated potential opportunities for active investors. Elevated yields, widening dispersion, and evolving market dynamics are creating a more opportunity-rich environment – one where careful security selection, liquidity management, and yield-curve positioning can matter more than ever. In our view, an active, disciplined approach supported by resources spanning public and private markets is well-suited to help investors navigate complexity while seeking durable, tax-efficient income and capital appreciation across market cycles.

¹ TM3 MMD Interactive Data as of 31 March 2026

² Bloomberg as of 31 March 2026

³ Taxable-equivalent yield calculation assumes a 37% federal income tax and a 3.8% Medicare investment tax. The yield to worst is the yield resulting from the most adverse set of circumstances from the investor's point of view – the lowest of all possible yields.

⁴ FTSE 3-Month Treasury Bill Index as of 31 March 2026

⁵ Bond Buyer as of 31 December 2025

⁶ United States Census Bureau, quarterly summary of state and local taxes, not seasonally adjusted as of 30 September 2025

⁷ Pew as of 31 December 2025

⁸ The Federal Reserve as of 30 September 2025

⁹ Ziegler as of 10 July 2025

Past performance is not a guarantee or a reliable indicator of future results. There can be no guarantee that the trends mentioned above will continue. Statements concerning financial market trends are based on current market conditions, which will fluctuate.

A word about risk: All investments contain risk and may lose value. Income from **municipal bonds** is exempt from federal income tax and may be subject to state and local taxes and at times the alternative minimum tax; a strategy concentrating in a single or limited number of states is subject to greater risk of adverse economic conditions and regulatory changes. Investing in the **bond market** is subject to risks, including market, interest rate, issuer, credit, inflation risk, and liquidity risk. The value of most bonds and bond strategies are impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, and low interest rate environments increases this risk. Reductions in bond counterparty capacity may contribute to decreased market liquidity and increased price volatility. Bond investments may be worth more or less than the original cost when redeemed.

The credit quality of a particular security or group of securities does not ensure the stability or safety of an overall portfolio. The quality ratings of individual issues/issuers are provided to indicate the credit-worthiness of such issues/issuer and generally range from AAA, Aaa, or AAA (highest) to D, C, or D (lowest) for S&P, Moody's, and Fitch respectively.

Statements concerning financial market trends or portfolio strategies are based on current market conditions, which will fluctuate. There is no guarantee that these investment strategies will work under all market conditions or are appropriate for all investors and each investor should evaluate their ability to invest for the long term, especially during periods of downturn in the market. Outlook and strategies are subject to change without notice.

PIMCO does not provide legal or tax advice. Please consult your tax and/or legal counsel for specific tax or legal questions and concerns. The discussion herein is general in nature and is provided for informational purposes only. There is no guarantee as to its accuracy or completeness. Any tax statements contained herein are not intended or written to be used and cannot be relied upon or used for the purpose of avoiding penalties imposed by the Internal Revenue Service or state and local tax authorities. Individuals should consult their own legal and tax counsel as to matters discussed herein and before entering into any estate planning, trust, investment, retirement, or insurance arrangement. Charts are provided for illustrative purposes and are not indicative of the past or future performance of any PIMCO product.

Bloomberg Municipal Bond Index consists of a broad selection of investment-grade general obligation and revenue bonds of maturities ranging from one year to 30 years. It is an unmanaged index representative of the tax-exempt bond market. The index is made up of all investment grade municipal bonds issued after 12/31/90 having a remaining maturity of at least one year. The **Bloomberg High Yield Municipal Bond Index** measures the non-investment grade and non-rated U.S. tax-exempt bond market. It is an unmanaged index made up of dollar-denominated, fixed-rate municipal securities that are rated Ba1/BB+/BB+ or below or non-rated and that meet specified maturity, liquidity, and quality requirements. **Bloomberg US Aggregate Index** represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis. The **Bloomberg US Treasury Index** is a measure of the public obligations of the U.S. Treasury. The **Bloomberg U.S. Credit Index** is an unmanaged index comprised of publicly issued U.S. corporate and specified non-U.S. debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered. This index was formerly known as the Bloomberg Credit Investment Grade Index.

PIMCO as a general matter provides services to qualified institutions, financial intermediaries and institutional investors. Individual investors should contact their own financial professional to determine the most appropriate investment options for their financial situation. This material contains the opinions of the manager, and such opinions are subject to change without notice. This material has been distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable but not guaranteed. No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission. PIMCO is a trademark of Allianz Asset Management of America LLC in the United States and throughout the world. **Pacific Investment Management Company LLC**, 650 Newport Center Drive, Newport Beach, CA 92660 | 800.387.4626 ©2026, PIMCO.