Municipal Market Quarterly Review

Municipal Market Review

The S&P Municipal Index (Municipal Index) returned 2.85% in the third quarter, bringing its year-to-date total to 2.67% (**Figure 1**). Longer-duration assets drove the strong return, particularly for maturities beyond seven years, as investors took advantage of attractive tax-equivalent yields relative to taxable alternatives. Increased expectations for interest rate cuts by the Federal Reserve (Fed) also served as a tailwind, with the market pricing in four rate cuts over the next-twelve-months following the Fed's cut of 25 basis points (bps) in September.

Municipal yields moved lower across the yield curve. Long-term yields decreased more than short-term yields, flattening the yield curve by 2 bps, as measured by the spread between 2- and 30-year rates (**Figure 2**). The shift in municipal term structure indicated a decreased risk premium for interest rates. Conversely, the U.S. Treasury (UST) curve steepened, albeit to a lesser extent, as the spread between 2- and 30-year yields increased 5 bps to 1.12% (**Figure 3, page 2**). Long-term bonds outperformed shorter-term maturities as yields declined most for long-term obligations, which are the most sensitive to changes in interest rates.

Relative to taxable fixed income sectors, the Municipal Index outperformed the Bloomberg UST Index by 82 bps in the third quarter as municipal yields decreased more than similar maturity USTs. Municipals also outperformed the Bloomberg U.S. Aggregate and Bloomberg U.S. Corporate indices by 133 bps and 25 bps, respectively, similarly driven by the relative change in interest rates. Among quality cohorts, A-rated and BBB-rated bonds outperformed higher-quality bonds, benefiting from stable spreads and higher relative yields.

Figure 1. Fixed Income Returns and Statistics

S&P Municipal Bond Indices	Q3 2025 Return	YTD Return	Yield to Worst	Duration
Main	2.85%	2.67%	3.71%	6.0
Intermediate	2.69%	3.92%	3.27%	4.7
Short-Intermed.	1.91%	3.98%	2.82%	3.0
Short	1.14%	3.14%	2.71%	1.7
General Obligation	2.83%	2.84%	3.41%	5.6
Revenue	2.89%	2.57%	3.93%	6.3
Taxable	2.57%	6.51%	4.83%	7.6
Bloomberg Indices				
U.S. Treasury	2.03%	6.13%	4.37%	6.0
U.S. Aggregate	1.51%	5.36%	3.94%	5.8
U.S. Corporate	2.60%	6.88%	4.81%	6.8

As of 9/30/2025.
Sources: S&P Dow Jones Indices LLC, Bloomberg L.P., PNC

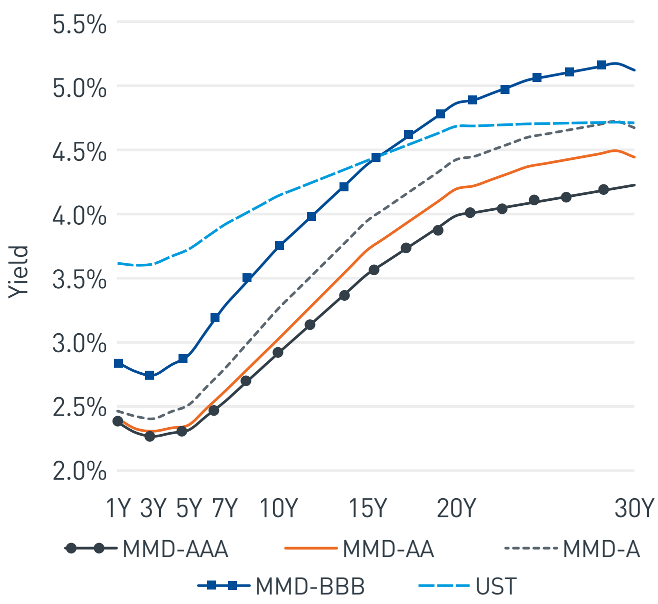
Figure 2. Quarterly Yield Curve Change (bps)

	Market Spot Rates				
Maturity	AAA	AA	A	BBB	UST
1 Year	-19	-19	-19	-19	-33
2 Year	-28	-28	-28	-28	-11
3 Year	-31	-31	-31	-31	-6
5 Year	-35	-35	-35	-35	-5
7 Year	-34	-34	-34	-34	-6
10 Year	-34	-34	-34	-34	-8
15 Year	-31	-31	-31	-31	-8
20 Year	-30	-30	-30	-30	-9
30 Year	-30	-30	-30	-30	-6

From 6/30/2025-9/30/2025.
Sources: Refinitive, S&P Dow Jones Indices, Bloomberg L.P., PNC

Indices are unmanaged, not available for direct investment, and not subject to management fees, transaction costs or other types of expenses that an account may incur.

Figure 3. Municipal Market and UST Yield Curves



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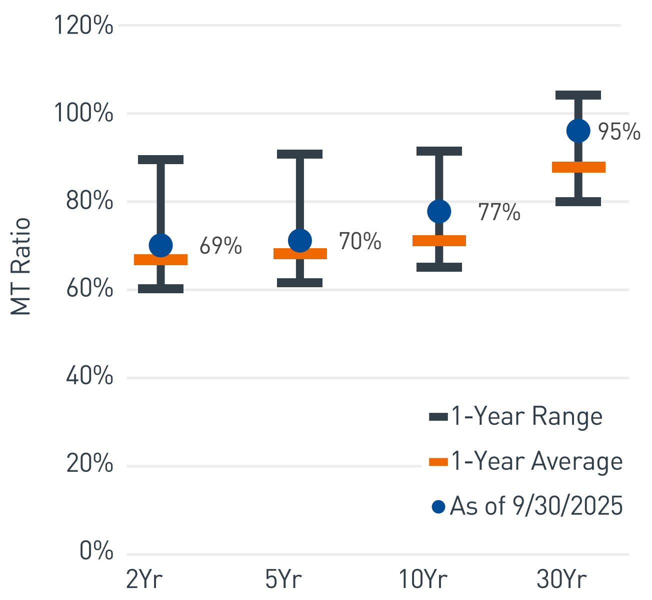
Sources: Refinitive, S&P Dow Jones Indices, Bloomberg L.P., PNC

Figure 4. MT Yield Ratios



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Sources: Refinitive, S&P Dow Jones Indices, Bloomberg L.P., PNC

From a technical perspective, investor demand for municipals improved, particularly among retail investors and mutual funds, the largest natural buyers of municipal bonds. Municipal mutual funds experienced net inflows of $9.1 billion during the quarter, improving compared to the $1.8 billion in outflows in the second quarter. On the supply side, municipal bond issuance of $157 billion increased by 12%, compared to the same quarter in 2024. Issuance is on pace for a record year, up 15% compared to 2024. Approximately 6% of all municipal bonds issued in 2025 have been taxable, similar to 2024.

Tax-exempt Municipal Valuations

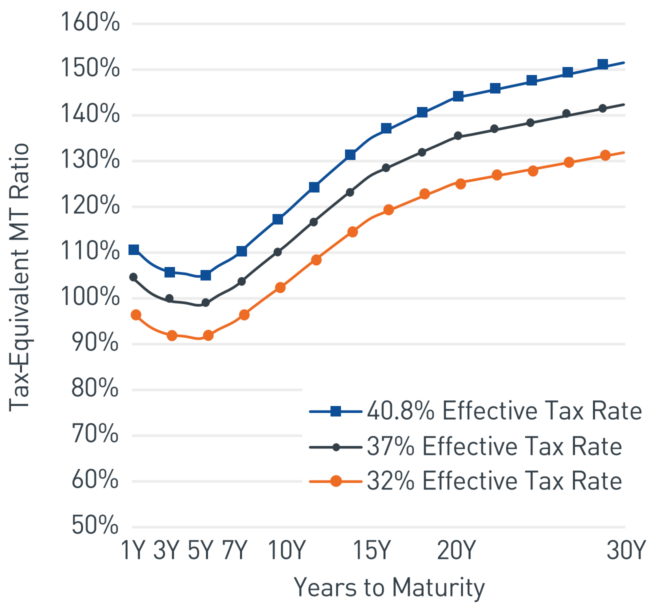
Municipal valuations relative to USTs were richer across the yield curve quarter over quarter (q/q) as the decline in municipal yields outpaced the decline in UST yields. The 5- and 10-year Municipal-to-Treasury (MT) ratios both declined most, falling by 8.4% and 6.7%, respectively, while the 2- and 30-year MT ratios declined between 5-6%. Despite the shift in relative valuations q/q, the 10- and 30-year ratios improved on a year-to-date basis. The 2-, 5- and 10-year MT ratios are now below their respective 1-year averages (**Figure 4**).

Tax-exempt municipal bonds remain attractive on a tax-equivalent basis versus taxable alternatives, particularly for longer maturities. Assuming an estimated federal tax rate of 40.8% (37% maximum federal income tax level and 3.8% Medicare tax that may apply to some taxpayers), the tax-equivalent yield of a 10-year AAA-rated municipal bond now offers 119% of the 4.16% yield offered by the 10-year UST, down from 130% since last quarter. For investors with a tax rate of 40.8%, tax-equivalent MT ratios are above 100% across the yield curve, with more advantage in long-term bonds. Investors with a lower tax rate of 32% can also find value in tax-exempt municipals, reflected by tax-equivalent MT rations above 100% for maturities 10 years and beyond (**Figure 5**, **page 3**).

Taxable Municipals Underperformed Tax-exempt

The S&P Taxable Municipal Bond Index (Taxable Municipals) returned 2.57% in the third quarter, underperforming tax-exempt municipals by 28 bps, dampening the year-to-date outperformance of 385 bps. Taxable municipals also underperformed the Bloomberg U.S. Corporate Index by a more modest 3 bps for the quarter as relative credit spreads were

Figure 5. Tax Equivalent MT Yield Ratios



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Sources: Refinitive, S&P Dow Jones Indices, Bloomberg L.P., PNC

little changed. A-rated taxable municipal bond yields are largely in line with A-rated corporates across the yield curve. We believe supply-side technicals remain supportive of valuations given the landscape of competitive yields and our expectation for stable taxable issuance through year end.

Municipal Credit Review

The credit pricing weakness that materialized in the second quarter remained present in the third quarter as relative credit spreads were essentially flat across investment grade credit. Year to date, credit performance remains negative following the widening that occurred in April as investors reacted to fiscal and trade policy uncertainty. Corporate credit risk pricing has since rebounded strongly, with credit spreads modestly tighter in the third quarter.

The municipal hospital sector will likely experience impacts from the passage of the One Big Beautiful Bill (OBBB) Act as it outlines $1.1 trillion in healthcare cuts set to take place in 2027, of which $665 billion will be in the form of changes to Medicaid eligibility and access. Congressional Budget Office (CBO) scoring suggests that 10 million people could lose coverage by 2034. The changes will likely pressure cash flows as lower Medicaid spending leads to

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higher levels of bad debt and charity care expenses. Over time, hospital systems may need to enact service reductions and layoffs to manage expenses. However, impacts will differ materially by obligor. Hospitals that serve a large Medicaid population and are most reliant on supplemental payments face the most challenges. These upcoming changes strengthen our preference for large hospitals that are well-funded and serve markets with favorable demographics.

The cuts also place additional pressure on state budgets as some states may seek ways to cover any funding gaps with their own resources. The states that expanded Medicaid coverage as a part of the Affordable Care Act will experience the most impacts as they relied on the provider tax to pay for their coverage of additional Medicaid recipients. States that will face the most challenges, in our opinion, include New Mexico, Louisiana, California and New York. Ultimately, however, we believe states have the financial flexibility to adapt to the changes as strong fundamentals and historically high reserves suggest that municipal issuers will remain resilient despite recent reforms.

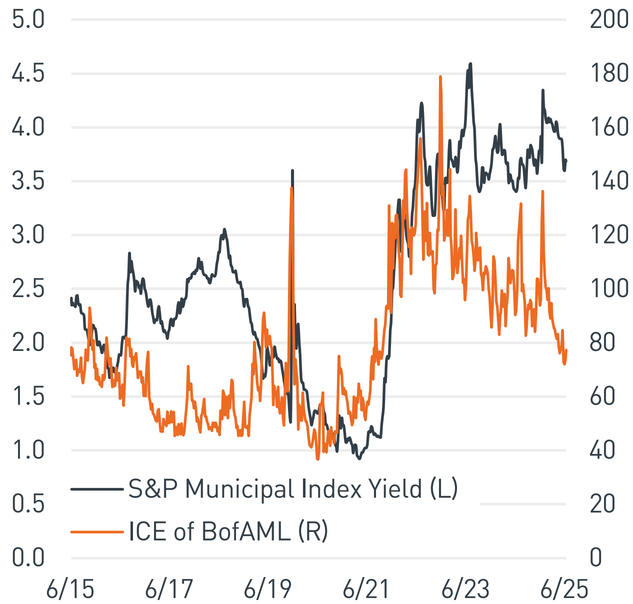
Looking Ahead

The recovery seen since April's peak in municipal yields has normalized valuations relative to taxable alternatives. Additionally, while the OBBB Act will have some negative implications for specific municipal sectors, markets are reflecting the general reduction in broader uncertainty. However, a federal government shutdown resulting from the budget impasse adds incremental uncertainty back into the equation heading into the fourth quarter. If prolonged, it could delay grant disbursements, disrupt the provision of services and unsettle programs tied to federal funding. Nevertheless, municipalities' strong credit profiles and record-level rainy day funds should help them remain resilient to near-term funding disruptions.

The PNC Economics team forecasts sub-2% real GDP growth through 2027 amid a backdrop of slowing inflation, but higher unemployment. This dynamic frames the primary factors the Fed will have to consider when setting policy rates given their dual mandate of price stability and full employment. The slower pace of rate cuts in 2025 reflects the Fed's cautious approach as they weigh recent signs of labor market deterioration against progress made on reducing inflation toward their 2% target. From a credit perspective, we believe a more conservative approach to risk is prudent and expect credit spreads to be flat to wider through year end. As such, we expect income to be the primary driver of total return for municipal bonds in calendar year 2025.

The decline in municipal bond yields since mid-April has brought yields down to the 84th percentile of their 10-year range, down from 94% last quarter, reflecting the broad shift lower in fixed income rates and rate volatility (**Figure 6**). However, for tax-sensitive investors, tax-exempt municipals continue to offer excess yield on a tax equivalent basis, particularly for maturities beyond 7 years, with duration risk being well compensated compared to the last 15 years.

Figure 6. S&P Municipal Bond Index Yield & Rate Volatility



As of 9/30/2025.
Sources: Bloomberg L.P., PNC

Key Theme Recap

- The Municipal Index returned 2.85% in the third quarter and outperformed comparable taxable indices.
- The municipal yield curve flattened as long-term yields fell and short-term yields rose, indicating a decreased risk premium for interest rates.
- Municipal valuations are richer versus USTs on a maturity-matched basis; intermediate- and long-term MT ratios remain improved year to date.
- A-rated and BBB-rated municipals outperformed as credit spreads were little changed. We expect spreads to be flat to wider for the remainder of 2025.
- We believe municipal yields offer a compelling option for tax-sensitive investors relative to taxable alternatives, particularly for longer-dated bonds.

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