

Looking Back to Look Ahead: Historical Municipal Market Patterns

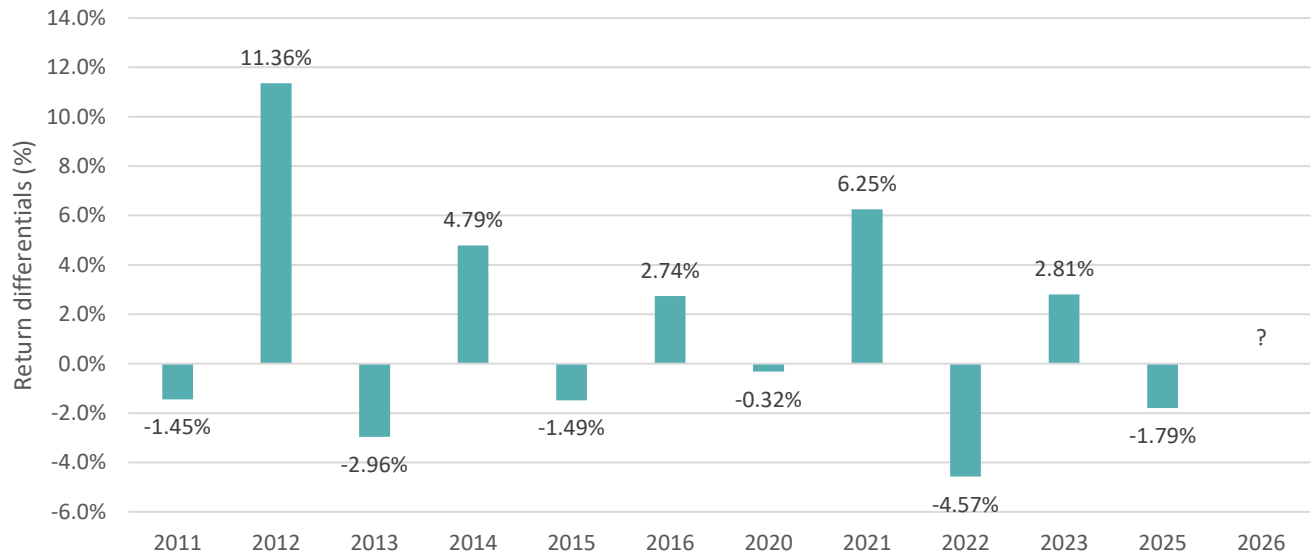
As we step into 2026, it is worth reflecting on historical performance patterns in the municipal bond market to help frame expectations for the year ahead. Over the past three decades, municipal bonds have demonstrated resilience and competitive returns compared to other fixed income sectors. Since 2008, the Bloomberg Municipal Bond Index has delivered average annualized returns that were 33% better than those of the Bloomberg U.S. Aggregate Bond Index, highlighting favorable return characteristics that go beyond the fact that income is exempt from federal and often state tax.

When focusing just on the tax-exempt market, high yield municipal bonds have demonstrated an even more compelling record. In addition to delivering an annualized return 79% higher than the Bloomberg Municipal Bond Index, the Bloomberg High Yield Municipal Bond Index has outperformed in seventeen of the past 30 years and in eleven of the last 17 years, highlighting its ability to deliver incremental returns over time. Notably, the Bloomberg High Yield Municipal Bond Index has not underperformed the Bloomberg Municipal Bond Index in consecutive years since 2007 and 2008, a pattern that speaks to their tendency to rebound following periods of relative weakness.

The year 2025 marked the sixth instance since 2008 where the Bloomberg Municipal Bond Index outperformed the Bloomberg High Yield Municipal Bond Index. Historically, these years of underperformance have coincided with a widening gap between the yield-to-worst (YTW) of the High Yield Index and the AAA sub-index of the Bloomberg Municipal Index. This spread behavior likely played a role in setting the stage for future performance shifts. In fact, in every year but one following high yield underperformance, the high yield municipal index has outperformed, and spreads tightened, reinforcing the cyclical nature of risk premiums in the municipal market. The chart below illustrates the difference in returns during years when high yield underperformed and in the subsequent year, from 2011 onward.

Annual Index Return Differentials

(Bloomberg High Yield Municipal Bond Index - Bloomberg Municipal Bond Index)



Of course, a spike in inflation that leads to higher rates and a flight from fixed income could derail historical tendencies. An economic downturn could also stress high yield spreads and therefore disrupt the mean reversion that high yield municipal bond performance has demonstrated since 2008.

For investors, these historical trends suggest that periods of relative weakness in the high yield municipal bond segment have often been followed by strong recoveries. As we enter 2026, understanding these dynamics can help position portfolios to capture potential opportunities while maintaining a disciplined approach to risk and diversification.

Special Credit Profile

Chicago Board of Education: Credit Concerns Mount

Summary: The Chicago Board of Education (CPS) remains a credit story of contrasts: a large, diverse tax base and strong state support on one hand, and persistent budget gaps, high debt, and declining enrollment on the other. The district’s below investment grade credit ratings (S&P BB+, Moody’s Ba1) are stable, but future downgrades are possible if reserves erode or if structural solutions are not found.

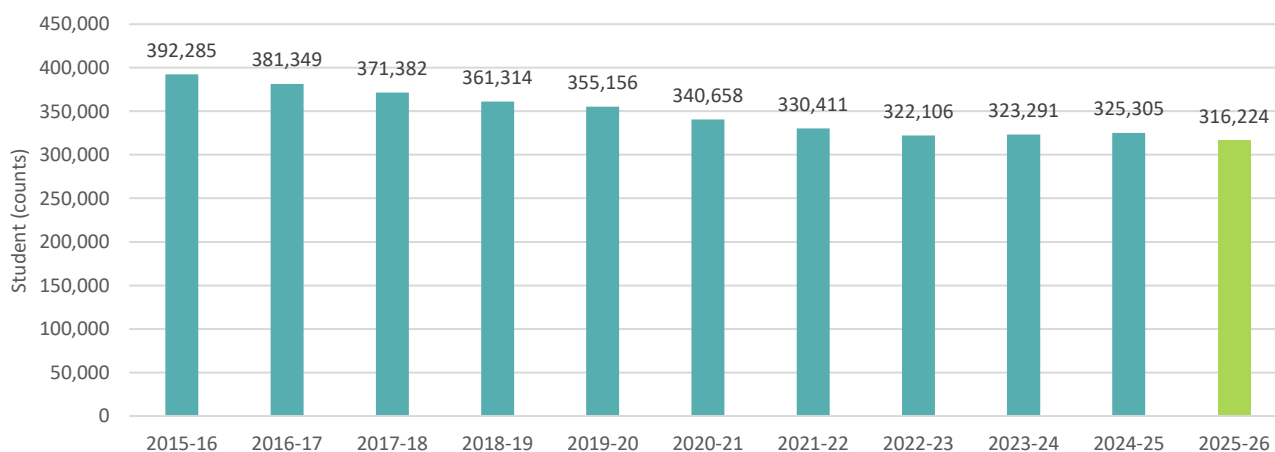
Key Facts:

- **Budget and Liquidity:** CPS’s FY2026 budget is balanced using one-time measures, but out-year gaps are projected to grow. Liquidity is tight, with \$1.2 billion in short-term notes outstanding at the end of FY2025.
- **Enrollment:** Enrollment has declined by more than 70,000 students over the past decade, leaving many schools underutilized. State law prohibits school closures until 2027, limiting the district’s ability to reduce costs.
- **Pension and Debt:** The teachers’ pension fund is only 48% funded, and annual contributions are rising. CPS’s debt burden is high, with debt service and pension costs consuming a large share of the budget.
- **Governance:** The transition to a fully elected board in 2027 and recent management turnover add uncertainty to the district’s fiscal outlook.

Bottom Line:

CPS bonds are supported by strong legal pledges, but the district’s structural budget challenges, high fixed costs, and declining enrollment warrant close monitoring. The stable outlook could change if reserves are drawn down or if structural budget reforms are not implemented.

Chicago Public School Enrollment



Source: Chicago Public Schools, Pre-K-12, SY 2015-16 through 2025-26.

Glossary

Bloomberg High Yield Municipal Bond Index flagship measure of the US municipal tax-exempt non-investment grade bond market.

Bloomberg Municipal Bond Index tracks the performance of investment-grade, fixed-rate municipal bonds with maturities greater than two years.

Bloomberg US Aggregate Total Return Index measures the performance of the U.S. dollar-denominated, investment-grade, taxable fixed-rate bond market.

Credit risk, also known as default risk, is the likelihood that a borrower won't repay a loan or meet their debt obligation.

Credit quality is a measure of a bond issuer's ability to repay interest and principal in a timely manner. Rating agencies assign letter designations such as AAA, AA and so forth. The lower the rating, the higher the probability of default. Credit quality does not remove market risk and is subject to change.

Duration is the measure of price sensitivity to changes in interest rates. In general, the higher the duration, the more a bond's price will drop as interest rates rise. This also indicates a higher level of interest rate risk.

An exchange-traded fund (ETF) is a security that tracks an index or asset like an index fund, but trades like a stock on an exchange.

Federal Funds rate is the interest rate banks charge each other for overnight loans.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

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Municipal Bonds: Interest on municipal bonds is generally exempt from federal income tax; however, some bonds may be subject to the alternative minimum tax (AMT). Typically, state tax exemption applies if securities are issued within one's state of residence and, if applicable, local tax exemption applies if securities are issued within one's city of residence. The tax-exempt status of municipal securities may be changed by legislative process, which could affect their value and marketability.

Municipal to Treasury Ratio compares the yield of municipal bonds to the yield of U.S. Treasury bonds. This ratio helps investors assess the relative value of municipal bonds, especially considering their tax-free nature. The ratio is calculated by dividing the yield of a municipal bond by the yield of a Treasury bond with the same maturity.

Separately Managed Account (SMA) type of investment portfolio owned by an individual investor but managed by a professional investment manager.

Yield is the income return on an investment referring to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value. Yields and distribute rates are historical and subject to change.

A **yield curve** shows the annualized yields of fixed-income securities across different contract periods as a curve. When it is inverted, bonds with longer maturities have lower yields than those with shorter maturities.

Yield to worst (YTW) refers to the lowest possible yield an investor can expect to receive on a bond, assuming the issuer does not default.

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