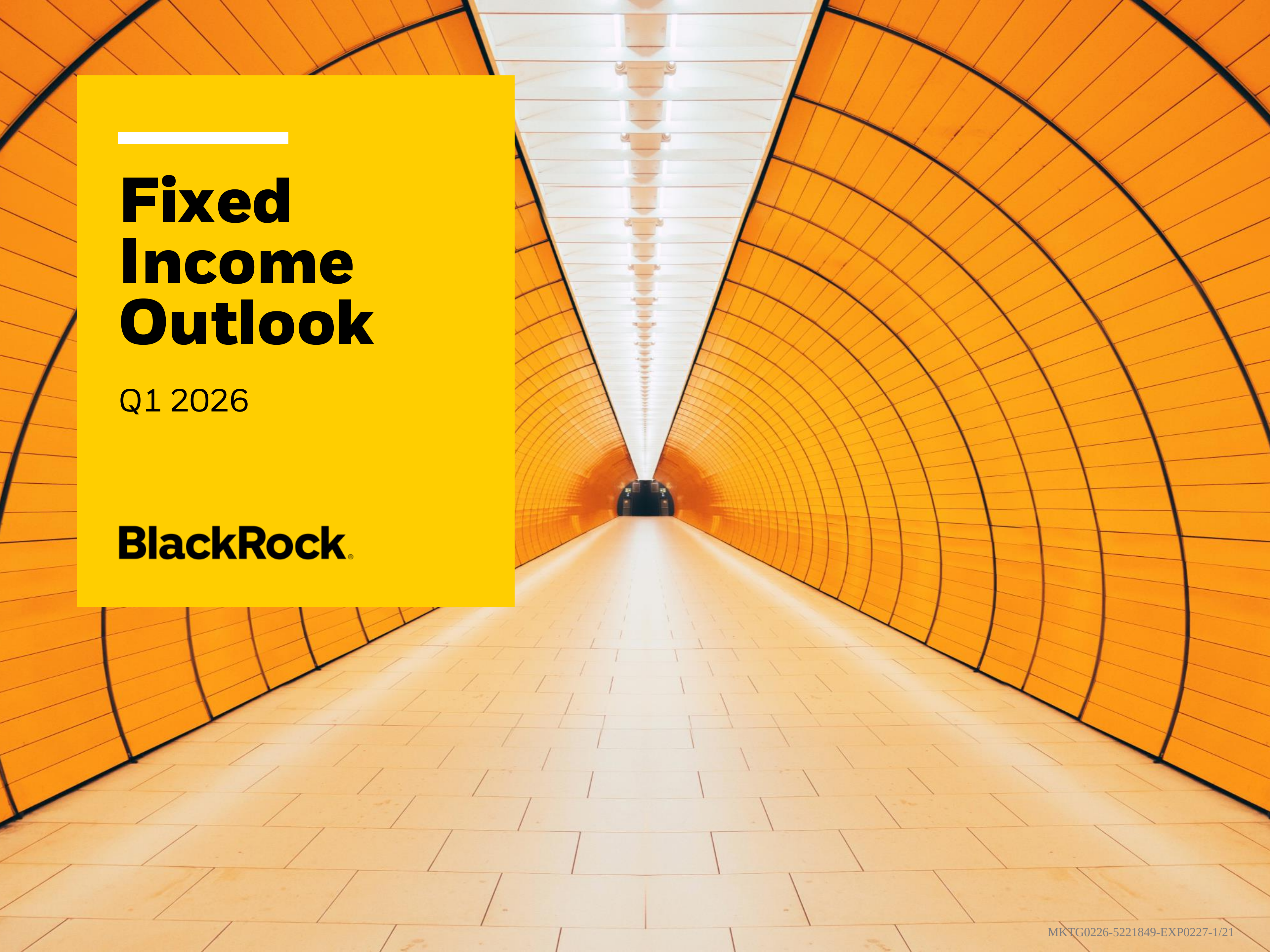

Fixed Income Outlook

Q1 2026

BlackRock

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Foreword

Rick Rieder
Chief Investment Officer
of Global Fixed Income

Tom Parker
Chief Investment Officer of
Systematic Fixed Income

Pat Haskell
Head of the Municipal
Bond Group

We are in a golden age of fixed income — and the opportunity is income

The most defining feature of today's environment is the strength, breadth and durability of income. For the first time in more than a decade, we believe investors across regions can build higher-quality portfolios with less volatility and materially higher yields. This is not just a U.S. story: Euro area, U.K. and Japanese markets all offer compelling foreign exchange-hedged real yields, while securitized sectors, global corporate credit and emerging markets (EM) provide powerful income diversification. While this window won't last forever — policy easing expected later in 2026 will eventually push yields lower — the opportunity today is unusually attractive, supported by starting yields that remain in the top third of their long-term ranges across both U.S. and European investment grade markets, especially in securitized products.[1] Income did its job in 2025; the conditions for a repeat are still in place.

Interest rates are now genuinely two-sided and where you hold duration matters

The 2026 fixed income landscape is shaped by a new reality: Rates can hedge, but they can also hurt. Rising term premium, widening fiscal pressures in the U.S. and Europe and divergent global policy paths have made rate volatility more persistent than in past cycles. In this world, the belly of global yield curves stands out, offering particularly compelling characteristics. Importantly, central banks are no longer moving in lockstep. Global monetary cycles are now differentiated, presenting opportunities far beyond the U.S. — from Europe's normalization to Japan's regime shift to Asia's varied easing paths. These realignments can reprice curves quickly, creating both return potential and the need for thoughtful, globally diversified duration placement.

Benchmarks haven't kept up with how the bond market has evolved

Traditional aggregate benchmarks — across the U.S., euro area and global markets — remain heavily concentrated in government bonds. While these exposures still anchor portfolios, they may reduce risk-adjusted returns in certain environments and often underrepresent the segments driving today's most compelling opportunities. Many of the markets offering the best income, diversification and structural advantage — securitized assets, global corporates, EM hard and local currency debt, private-credit-adjacent sectors — remain only partially captured in benchmark-heavy allocations. And while benchmarks are evolving, access to these "plus" sectors still requires intentional and skilled portfolio construction, not reliance on traditional indices.

1 Source: Bloomberg, as of January 9, 2026.

Foreword

The path forward is less about broad beta exposure and more about discerning where fundamentals, valuations and liquidity align opportunistically.

Divergence, dispersion and the case for selectivity

As global central banks move through differentiated cycles, dispersion is rising — across countries, curves, currencies, sectors and issuers. Some regions are easing, others are holding, and a few are tightening. Labor markets, inflation dynamics and fiscal trajectories vary widely. This environment rewards precision. With spreads tight in higher quality credit and fundamentals diverging beneath the surface, the most attractive opportunities come from selectivity, and the ability to identify where fundamentals, valuations and liquidity align. This requires deep research, robust risk management and the flexibility to reposition as policy and macro conditions evolve. Today's market rewards investors who can combine index efficiency, systematic insights and fundamental security selection across public and private markets, global rates, securitized assets, corporate credit and emerging markets. The opportunity in fixed income is extraordinary and distinctly global. In this quarter's Fixed Income Outlook, our leading active investors across our entire global platform share their insights on how to navigate this dynamic market.

The real gravity: Labor, not inflation or growth

Rick Rieder
Chief Investment Officer
of Global Fixed Income

Income very much did its job in 2025, and we don’t see any reason why today’s broad environmental conditions don’t suggest that it will be fruitful again in 2026.

As we begin 2026, we can look back at last year as one that started with the profound shock of the highest tariffs seen in decades and ended with the longest federal government shutdown on record. Along the way, we witnessed the unfolding of a once-in-a-generation technological acceleration in artificial intelligence (AI) that is profoundly reshaping the economic and market landscape, and of course, all these things hold implications for future inflation, growth, the jobs landscape, and markets. To set the stage, while inflation is running at a somewhat sticky level above the Federal Reserve’s (Fed) 2% target, we think that previously excessive gains to the price level are contained, and it’s clear to us that inflation is likely yesterday’s problem, while labor market weakening is shaping up to be today’s and tomorrow’s concern.

Overall, the trajectory of core services inflation has moderated nicely to its longer-term run rate. At the same time, the core consumer price index (CPI) has come down meaningfully and inflation break-evens for the period five years ahead do not display anything worrisome. All told, virtually the only CPI categories that are running higher than their 2015 to 2019 run rate are, perhaps unsurprisingly, tariff-impacted sectors, but even here tariff pricing pressures haven’t been as profound as many expected. Thus, from a monetary policy perspective, inflation isn’t anywhere near the problem it was post-COVID, and we don’t think it’s likely to be a concern in 2026.

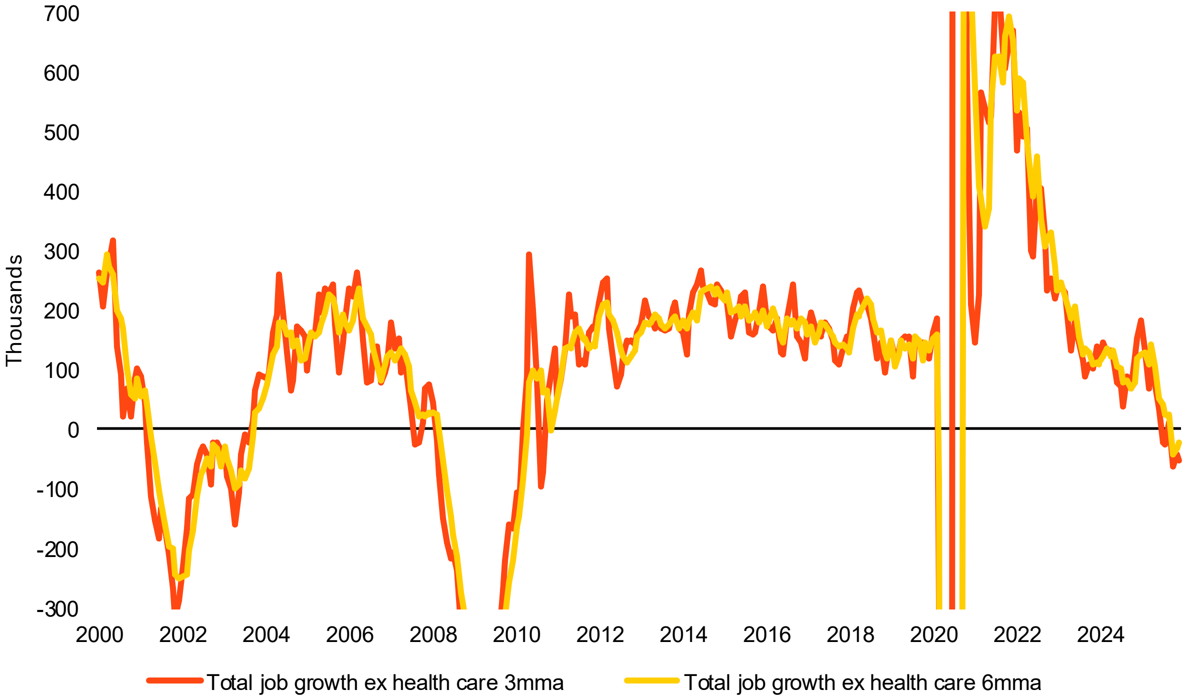
Unfortunately, the same can’t be said about the labor market, where we would have a hard time characterizing hiring as anything but anemic. The unemployment rate of 4.4% isn’t that concerning on first glance, but it is quite different than the 3.4% rate trough in April 2023. When you dig deeper into the unemployment rate of the younger age cohort of 20 to 24, this group has a considerably higher unemployment rate of 8.2%, so it becomes clear we are witnessing a labor market that needs careful consideration by policymakers.[2]

Further, by the end of 2025, the jobs data showed a monthly gain of 50,000 in December, but as we have been pointing to for a while, when you strip out the less cyclical, and interest-rate sensitive healthcare sector, the number shrinks to only 29,000 jobs gained. That is in very sharp contrast to the total average monthly job growth seen over the prior several years of 603,000, 380,000, 216,000, 168,000 and 55,000, respectively, from 2021 to 2025 (see chart on the next page). In fact, when looking at the monthly average of job growth over the last eight months (excluding the healthcare sector), we actually see a very disappointing -213,000 figure, suggesting that the healthcare sector has essentially been holding up the labor market. Still, if people question whether productivity is occurring in today’s economy, we would point to our productivity tracking measure, which displays a considerable pickup in the productivity growth rate versus the more stagnant pre-COVID period. So, this means that while U.S. growth is solid, broad-based labor is not really participating in the economic vitality.

2 Source: Bureau of Labor Statistics.

The real gravity: Labor, not inflation or growth

Average monthly job growth



Source: Bureau of Labor Statistics, data as of January 9, 2026.

From the standpoint of Fed policy, we continue to hold that the equilibrium Fed funds rate for this labor dynamic is below the current level, and consequently we believe the market pricing of two more policy rate cuts in 2026, at least, is appropriate. Hence, from an investment perspective, we continue to take comfort in owning income-producing assets, particularly at the front-to-belly of the yield curve. Income very much did its job in 2025, and we don't see any reason why today's broad environmental conditions don't suggest that it will be fruitful again in 2026.

“Steepening” out of cash

Tom Parker
Chief Investment Officer, Systematic Fixed Income

Jeffrey Rosenberg
Senior Portfolio Manager, Systematic Fixed Income

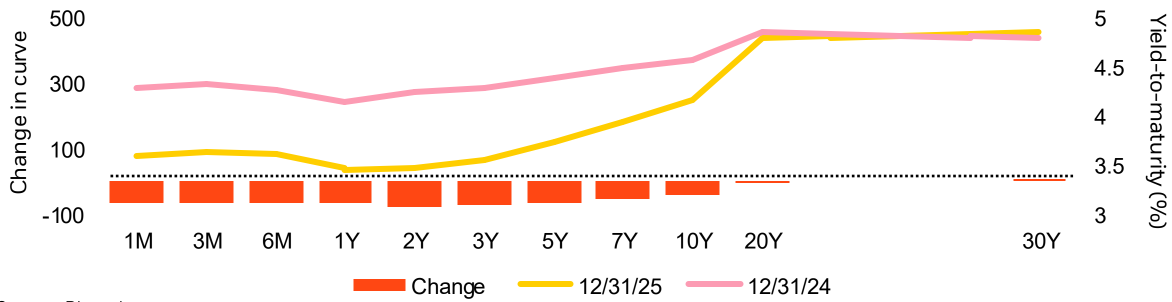
Beneath the surface of a ‘winner-take-all’ market and economy, widening dispersion across company and country outcomes is driving alpha opportunities.

In 2025, the 7.30% fixed income return (of the main benchmark index) beat the 4.3% return to cash, marking the first time since 2020 that fixed income significantly outperformed cash.[3] That followed a combination of higher starting income for bonds vs. cash and the tailwind of lower interest rates that both fueled price appreciation for bonds and lowered the cash hurdle rate.

In the bond market, it was the shortest maturity bonds that most closely tracked the Fed’s policy easing. Longer maturity bonds, in contrast, saw the Fed’s impact offset by the influence of higher global interest rates, increased investment demands and greater expected government debt issuance in the context of residual stickiness in inflation. But for fixed income investors, stepping out of cash finally yields a benefit from a steepening in the yield curve now making the income from bonds greater than the income from cash. For 2026, that income advantage is likely to mean another year of bonds beating cash, reversing the post-COVID trend of underperformance.

The chart below highlights the change in the yield curve over the past year: The largest interest rate declines occurred in the shortest maturities, while the longest maturity yields increased. The impact for bond investors is notable, as the income advantage of fixed income is finally positive after being at or below cash yields since the Fed embarked on quashing the COVID inflation in 2022. And with another two interest rate cuts expected in 2026 due to weaker labor markets, even as economic growth expectations push higher, cash yields look to fall further to 3%. That should lead to front-end rates continuing to support fixed income returns from both higher income and some price appreciation on the back of lower policy rates.

Interest rate declines led by the shortest maturities following Fed cuts

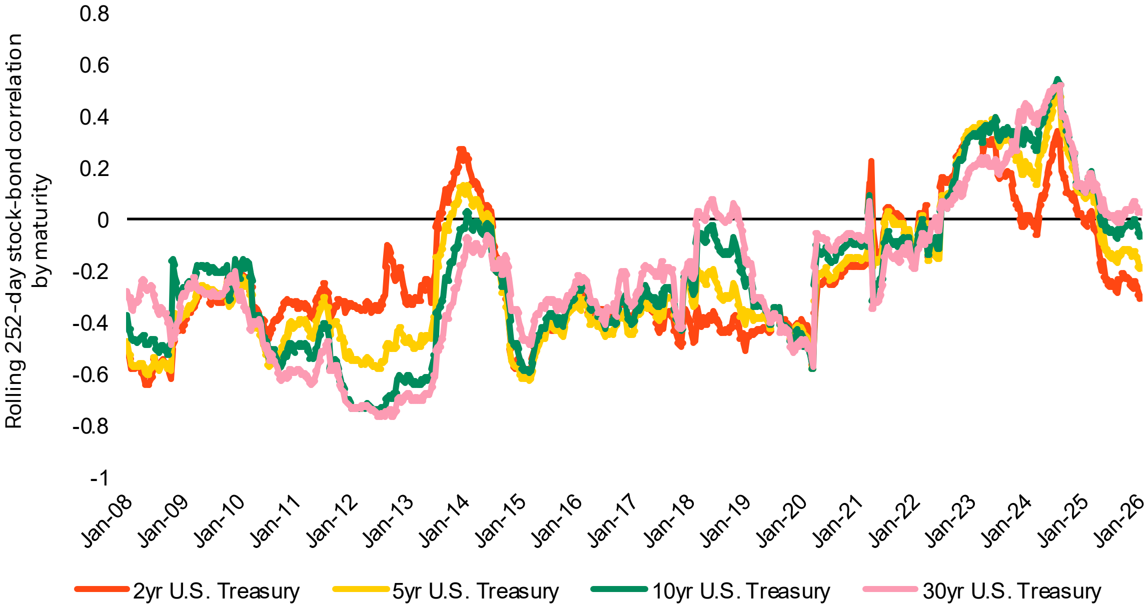


Source: Bloomberg

3 Source: Bloomberg, as of December 31, 2025, referencing returns to the Bloomberg U.S. Aggregate index less the Bloomberg U.S. Treasury Bill: 1-3 Month index.

“Steepening” out of cash

Stock bond correlation by maturity highlights the best portfolio diversification in shorter maturity bonds



Source: BlackRock Aladdin, as of January 2026.

And more importantly through a portfolio construction lens, the correspondence of shorter maturity rates to Fed policy registered in the relationship of bonds to stocks. Following the COVID inflation surge, stock bond correlation (SBC), which had benefited from the long period of *below* target inflation contributing to strongly *negative* correlated returns, reversed to a period of strongly *positive* correlated returns as both stock and bond returns turned negative due to the impact of unexpected inflation. As inflation ebbs with the recovery in the supply side and tempering of demand side stimulus, SBC has seen some normalization, but not back to pre-COVID levels — consistent with the observation that still-elevated levels of inflation relative to target have not returned the underlying dynamics of SBC to pre-COVID levels. Importantly for bond investors as highlighted in the chart to the left, this return to lower levels of SBC has been led by the shortest maturities, reflective of the steepening trend described above and the stronger anchoring of shorter maturities to Fed policy.

“Steepening” out of cash

Credit spread risk premia across investment grade, high yield and securitized assets remain at, or near, historical tights, reflecting consensus expectations for above trend growth in 2026 and a continued benign default outlook.

Although corporate and consumer-linked securitized assets show widening performance gaps between large and small issuers and between wealthy and lower income consumers, overall credit markets still reflect very muted aggregate default and credit risk expectations and low compensation for credit risk. The consensus outlook for continued strong economic growth supported by fiscal and monetary support keep the outlook stable at low defaults and tight spreads, leaving credit-expected returns both capped at income and carry and asymmetric to any negative surprise.

Equity concentration remains challenging following years of “winner-take-all” technology-driven dominance. Market capitalization stands more concentrated with the top 10 names accounting for more than 40% of total market capitalization.[4] Directional exposure at the index level hence has been as much about a reflection of the macro as it is about the micro — specifically the earnings dominance and sustainability of the AI-fueled tech concentration.

Idiosyncratic risk, however, also remains high as the flip side of “winner-take-all” microeconomics reflects those left behind. The result has been an extremely fruitful environment for long/short investing. Higher risk issuers have been rewarded and lower risk, more stable and quality names typically found on the losing end of the AI-fueled creative destruction have underperformed. As a result, quality-oriented insights have been more challenged. Credit dispersion hence remains another source of returns, albeit more through idiosyncratic exposures than overall beta exposure in an environment of benign economic conditions.

As inflation normalizes globally from its COVID-era surge, macroeconomic dispersion increases as monetary policy can exit an era of general coincidence to one more reactive to domestic considerations. The result is a widening in policy outcomes and dispersion in global rates, curves and currencies. This adds macroeconomic sources of dispersion to alpha generation in 2026.

So, while the outlook for market direction appears supported by stable growth expectations and monetary and fiscal easing, alpha opportunities appear to have also improved on the widening impact of dispersion in individual company and country outcomes.

4 Source: BlackRock, FactSet, S&P 500, index weights as of November 2025.

Europe's yield reset creates opportunity

James Turner
Head of Global Fixed Income in EMEA

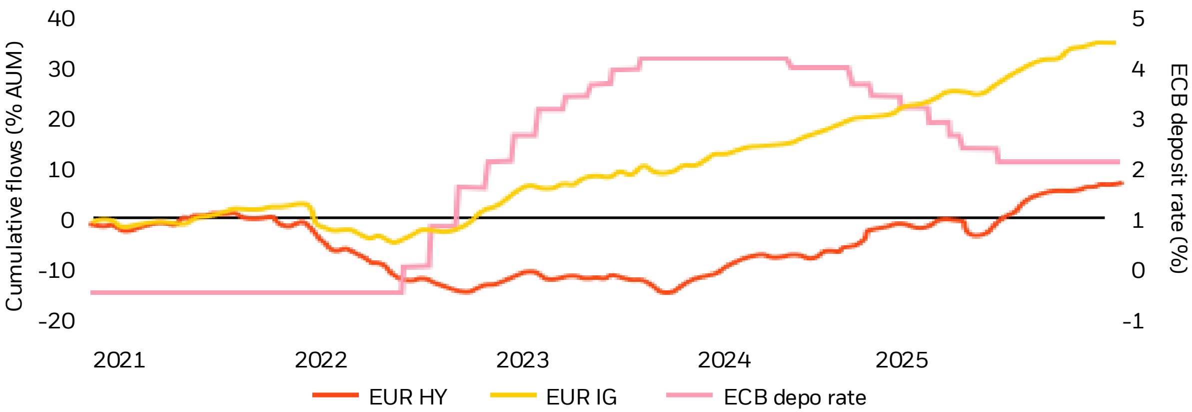
Europe continues to present an attractive opportunity set for fixed income investors, underpinned by elevated yields, improving credit quality and supportive technicals.

While global growth remains uneven, the European economy has demonstrated a degree of resilience and stability, supported by easing inflationary pressures and a gradual normalization of monetary policy. Against this backdrop, we believe Europe continues to present an attractive opportunity set for fixed income investors, underpinned by elevated yields, improving credit quality and supportive technicals.

After a significant cycle of rate increases by the European Central Bank (ECB), nominal yields across Europe have risen to approximately 3%. Meanwhile, inflation expectations are stabilizing below the ECB's 2% target. As a result, real yields have climbed to just under 2%, marking the highest levels in over a decade.[5] For many years, real rates hovered near zero or were negative, but this reset has reignited interest in European fixed income markets, with real yields now providing meaningful purchasing power and income emerging as a reliable driver of steady returns.

These dynamics are evident in investor flow data, with European credit, for example, reaching record inflows in 2025 (see chart below). Consistent demand from both institutional and retail investors continues to underpin the market. In parallel, elevated cash balances remain on the sidelines and declining interest rates have prompted greater consideration of broader fixed income allocations.[6]

European credit reached record investor inflows in 2025



Source: ECB and Emerging Portfolio Fund Research (EPFR), as of January 21, 2026.

5 Source: Bloomberg as of January 20, 2026.
6 Source: EPFR as of January 2026. Based on Total Net Assets invested in European Money Market Funds.

Europe's yield reset creates opportunity

With a clear focus on locking in attractive yields and putting cash to work, this appetite has contributed to greater interest in the asset class, a trend we expect to persist well into 2026. That said, while the outlook remains constructive, investors should remain mindful of potential challenges across the region.

Germany's creditworthiness remains firmly intact, but expectations have become more tempered amid political fragmentation and fiscal uncertainty. The country is set to increase its federal debt issuance in 2026 to fund infrastructure modernization, defense and economic stimulus. France continues to face headwinds from high public debt, persistent deficits and ongoing political uncertainty. The U.K. faces an uncertain growth outlook, with inflation proving slower to moderate. This raises the risk that interest rates remain in restrictive territory for longer, keeping funding costs elevated.

Positioning for what's ahead: Spreads over rates

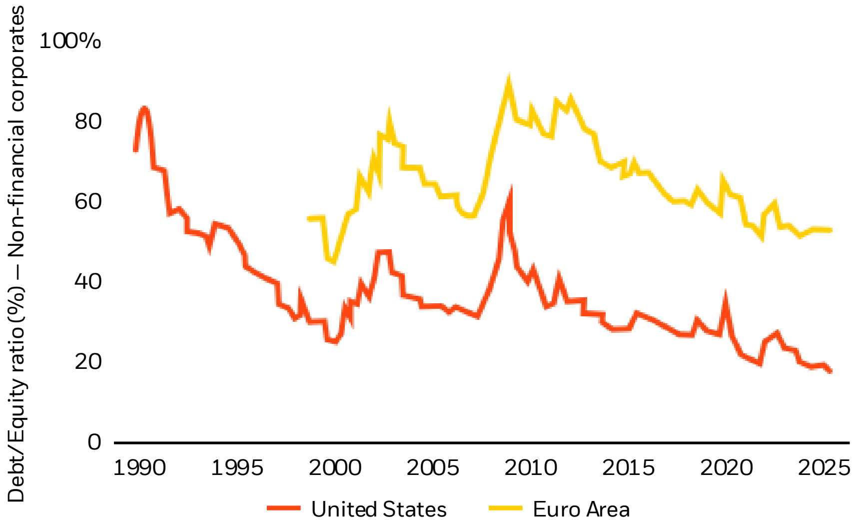
Shifts in market dynamics increasingly point to credit spreads — rather than duration — as the more compelling source of opportunity. While credit spreads remain tight, we expect them to remain broadly range-bound at current levels, with periods of volatility creating selective opportunities rather than a sustained phase of further compression.

Looking forward, we maintain a constructive stance on front-end credit carry strategies, supported by the diminishing impact of tariffs, targeted fiscal measures and supportive technical factors, with the asset class attracting growing interest from yield-focused investors. Credit valuations are undeniably tight, but the opportunity set needs to be viewed through a more nuanced lens:

First, as discussed previously, real yields are at decade-high levels, allowing investors to capture attractive carry from spread sectors despite tight valuations.

Second, corporate fundamentals have been improving. As shown in the chart below, companies in the euro area have been actively deleveraging, strengthening equity buffers, improving efficiency and profitability ratios. This trend is evident not only in investment grade, but increasingly in high yield markets as well, where the universe has shifted toward higher-rated, higher-quality issuers than seen in prior cycles.

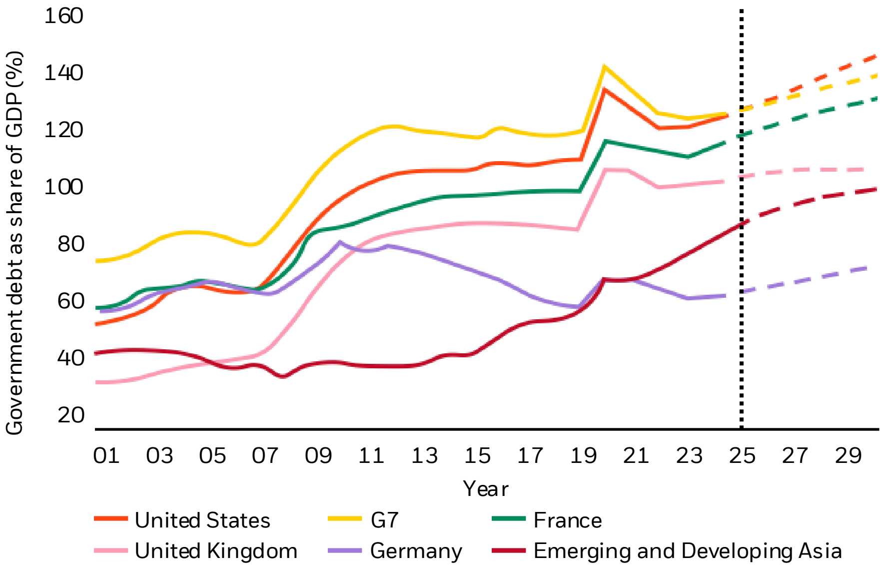
Corporates have been disciplined, decreasing leverage and improving balance sheets



Source: BlackRock, Bloomberg, IMF, BEA as of September 2025.

Europe’s yield reset creates opportunity

Government debt (balance sheets) started deteriorating post-GFC globally



Source: BlackRock, Bloomberg, IMF, BEA as of September 2025.

That said, aggregate balance sheet strength masks meaningful dispersion beneath the surface, with some industries and issuers struggling to adapt to the current environment. Technological change — particularly the adoption of AI — is likely to accelerate this differentiation, creating clearer winners and losers both within and across sectors. In this context, staying invested continues to make sense, particularly for active managers able to distinguish between improving and deteriorating credit profiles.

By contrast, government debt faces a less supportive backdrop. As illustrated in the chart to the left, sovereign balance sheets across the G7 have deteriorated materially since the Global Financial Crisis, with debt-to-GDP ratios rising steadily and remaining elevated. Ongoing fiscal pressures, alongside increased spending commitments in areas such as defense and infrastructure, point to continued issuance and leave government bond markets more exposed to policy uncertainty and rate-driven volatility — especially at longer maturities.

Taken together, this divergence between sovereign and corporate fundamentals underpins our preference for sourcing income from credit spreads. In an environment where most volatility is likely to emanate from government bonds, we believe actively capturing credit spreads, staying invested and allocating selectively across issuers and sectors offers a more effective path to generating income and managing risk within fixed income portfolios.

A stronger foundation meets a supportive cycle

Michel Aubenas
Head of Emerging Market Debt

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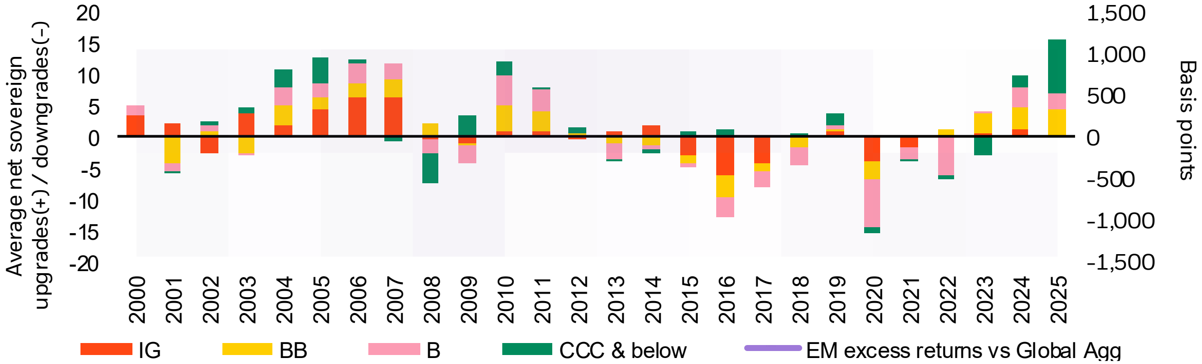
Dispersion – across countries, sectors and ratings – creates a fertile setting for active alpha via country selection, relative value and idiosyncratic repricing.

A stronger foundation meets a supportive cycle

Emerging markets debt (EMD) enters 2026 with renewed attention from global investors. After several years in which many remained cautious, the combination of improving fundamentals, stronger repayment capacity and a moderating global macro backdrop has reestablished EMD as a compelling source of diversification, income and total return potential. This large, diverse and liquid asset class now sits at the center of a supportive environment marked by smoother inflation dynamics, cyclical divergence and a softer U.S. dollar. EMD now represents a sizeable share of global fixed income, with broad issuer and currency breadth across sovereigns and corporates. Importantly, the opportunity set is anchored by an investment-grade core offering of over $1.2 trillion for sovereigns, $1.5 trillion corporates and $3 trillion of local-currency debt — helping to change the quality and size perception of prior cycles.[7]

Following a prolonged downgrade cycle, emerging markets sovereigns have now recorded several consecutive years of net rating upgrades. Stronger growth, moderating inflation, healthier policy frameworks and firmer fiscal/external balances are driving this turnaround. The improvement has been especially visible in high yield and frontier issuers, where reforms and post-restructuring normalization can translate into spread compression and capital appreciation. We expect these trends to continue through 2026.

Net rating change in EM sovereigns and EMD excess returns over global bonds



Source: Moody’s, S&P, Fitch and Bloomberg, as of December 31, 2025.

7 Source: Market cap of Index from J.P. Morgan EMBI monitor, data as of December 2025.

A stronger foundation meets a supportive cycle

A defining feature of this cycle has been the rebuilding of external buffers. Improved current accounts, higher foreign direct investment, greater International Monetary Fund engagement and domestic policy reforms have boosted reserve adequacy and reduced repayment risk. The result is a stronger foundation and credibility for both hard currency and local markets.

Where income meets differentiation

Over long investment horizons, emerging markets (EM) hard-currency sovereigns have outperformed global aggregate bonds, delivering both higher income and competitive risk-adjusted outcomes (Sharpe ratios).

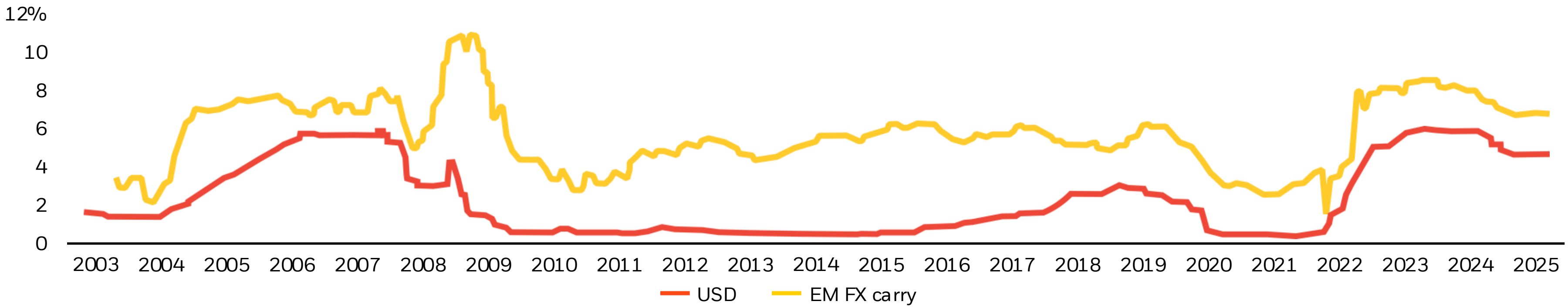
The asset class distinguishes itself even more through its inherent differentiation. EM cycles are less synchronized with developed market cycles, reflecting different inflation dynamics, policy regimes and growth drivers. This can provide valuable diversification in multi-asset portfolios. Equally important, dispersion — across countries, sectors and ratings — creates a fertile setting for active alpha via country selection, relative value and idiosyncratic re-pricing.

Macro tailwinds: Not too hot, not too cold

The macro environment entering 2026 — a mix of near trend growth, gradual disinflation and less restrictive policy — adds further support to EMD. In such an environment, EM can benefit from a combination of supportive carry, potential for spreads to grind tighter and select duration opportunities where domestic easing cycles have room to continue. Meanwhile, a softer U.S. dollar tends to help EM through easier external financing conditions, improved debt sustainability metrics and supportive foreign exchange dynamics that can lower volatility and potentially enhance returns.

A broad opportunity set allows investors to express EMD exposure in ways that align with their objectives — whether through the liquidity and improving credit quality of hard-currency sovereigns, the dual alpha potential of local currency markets, the income with limited rate sensitivity available in short duration strategies or the long-term carry profile of EM corporates. Taken together, the resilience of 2025 has created a strong springboard, positioning the asset class to benefit from ongoing structural improvements, timely tactical catalysts and meaningful cyclical divergences in policy and growth paths.

EM currencies provide excess carry vs. USD



Source: BlackRock, data as of August 2025.

Dispersion turns into opportunity

Navin Saigal
Head of Global Fixed Income, Asia Pacific

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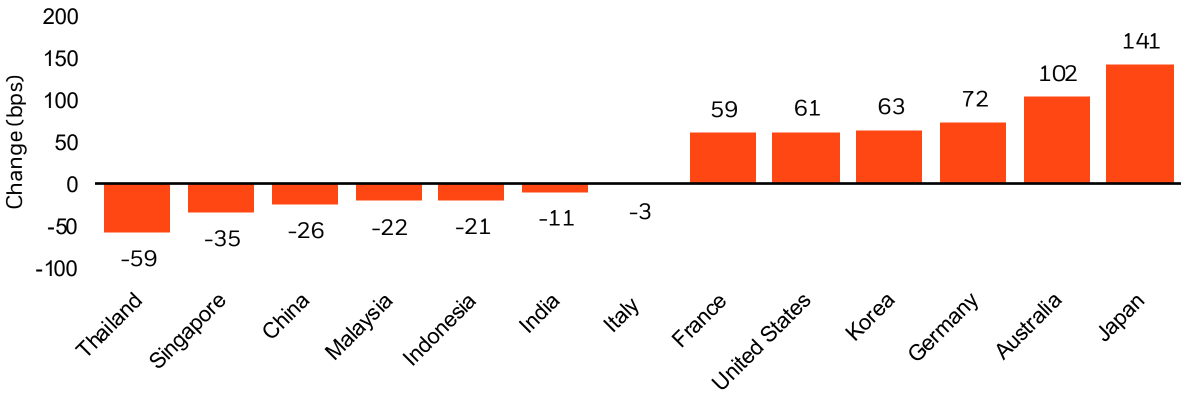
Asian fixed income is transitioning from a diversifying complement to a potential return leader.

Through most of 2025, Asian central banks generally set policy on domestic terms — easing where inflation cooled and tightening where wages or sticky prices kept pressure on. That independence matters more in 2026 as the Fed signals a disinflationary path. Removing the currency depreciation constraint, the region has more room to make genuinely local policy choices — rather than reacting to the U.S. cycle.

Asia is not monolithic and this divergence has deepened into an investable structural characteristic. Forward curves across the Philippines, India, Indonesia and Thailand price meaningful room for easing, supported by benign inflation and slowing but resilient domestic demand. Australia tells a different story. Wage growth and resilient consumption have kept core inflation elevated and have pushed markets to price a credible tightening bias from the Reserve Bank of Australia, creating valuation and income differentials unique to the rest of the region. Japan is undergoing a different kind of transition. With growth running above potential and wages rising, Japanese Government Bond yields remain under upward pressure — especially at the front end. Markets expect at least two further Bank of Japan hikes in 2026, as investors adapt to a world where Japan exports term premium rather than anchoring it.

Huge divergence *within* Asia Pacific (APAC), and *between* APAC and developed markets
Change in 10-year rate since Fed 50 bps cut in September 2024



Sources: J.P. Morgan, Bloomberg and BlackRock, as of September 9, 2025.

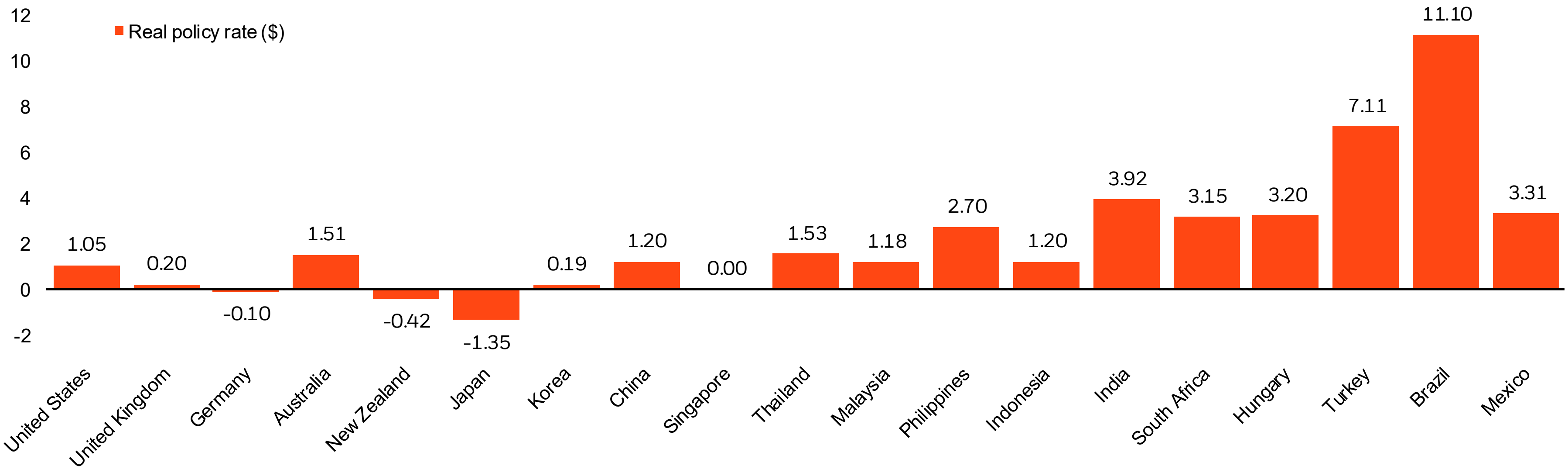
Dispersion turns into opportunity

This divergence in policy regimes has enhanced the diversification properties of Asian duration. Correlations between major Asian sovereign markets and the U.S. Aggregate Index are now deeply negative, reflecting not just differing inflation trends but differentiated economic structures (lowflation in China, disinflation in India and Indonesia, wage-driven cyclicality in Australia, tech sector strength in Korea and fiscal-monetary recalibration in Japan).

For global portfolios, that means a rare mix: Higher real yields, lower correlation and a positively skewed distribution of outcomes, since most Asian markets have priced only shallow easing cycles while possessing more policy space than currently reflected in rates curves.

Credit in 2026 looks more like a carry-dominated year than one of spread-compression. We believe all-in yields remain attractive even as headline valuations look tight, and fundamentals continue to hold up. Asia ex-China corporates saw EBITDA growth above 7% year-over-year in the first half of 2025, while leverage and debt-to-capital ratios declined across most sectors. Default expectations for Asian high yield (HY) continue to improve and are well below both EM and European HY defaults. And net supply — negative for several years — has turned modestly positive as refinancing resumes across India, Japan and Australia. But this shift remains moderate and does not threaten market balance.

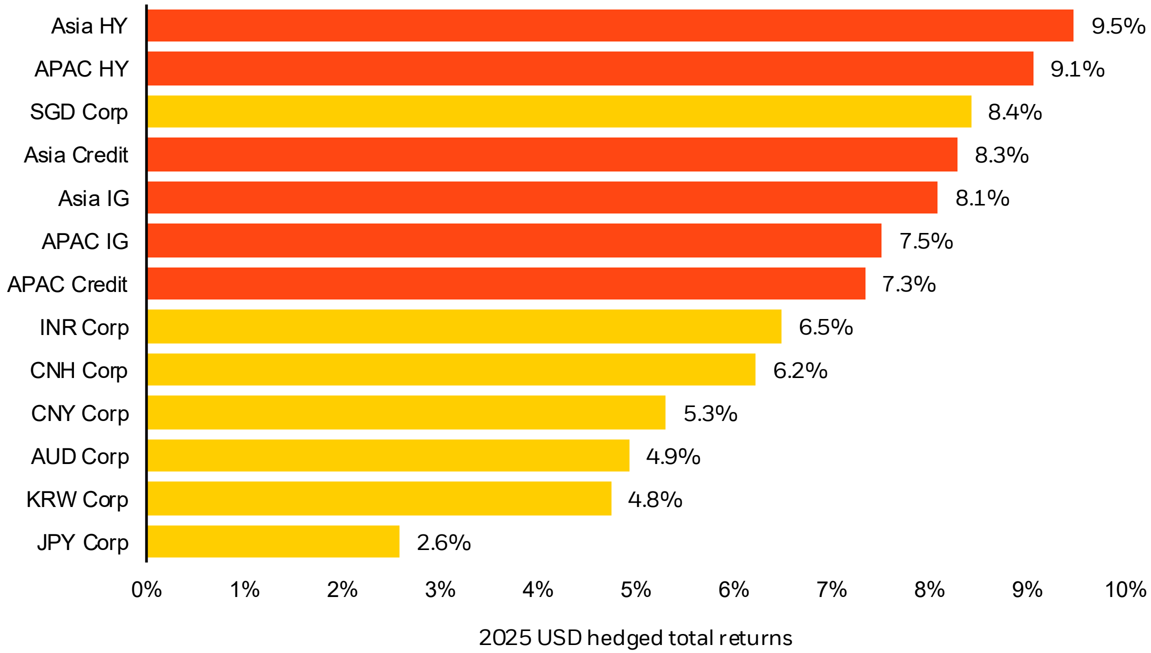
Real policy rates suggest more room to ease across parts of Asia



Source: Bloomberg, as of January 29, 2026.

Dispersion turns into opportunity

Diversification into local corporate credits has boosted returns and built resilience



Source: Bloomberg, iBoxx, Morgan Stanley Research.

Where valuations screen tight, carry provides the safety net. Asian HY would need materially wider spreads than U.S. or European HY to offset this year's carry, supporting the sector's resilience. BB-rated issuers remain compelling given improving fundamentals in India and Indonesia, declining default risks and limited new issuance. In investment-grade, we believe generic beta is less attractive after multi-year re-rating, but selective opportunities remain in AUD and JPY local-currency, which continue to offer meaningful swapped-yield pickup. Offshore Chinese local government financing vehicles also stand out for their spread premia versus onshore markets, where yields have fallen to historic lows.

The unifying theme is that Asian fixed income is transitioning from a diversifying complement to a potential return leader. Markets are idiosyncratic, fundamentals are resilient and carry is abundant. The dispersion that creates opportunity also demands skilled active management: Capturing relative-value dislocations, rotating exposures across cycles and selecting credits where fundamentals, liquidity and valuation align.

Selective strength in a shifting market

Pat Haskell
Head of the Municipal Bond Group

While volatility may persist, municipals remain well positioned to deliver attractive, tax-efficient income with selective opportunities for outperformance.

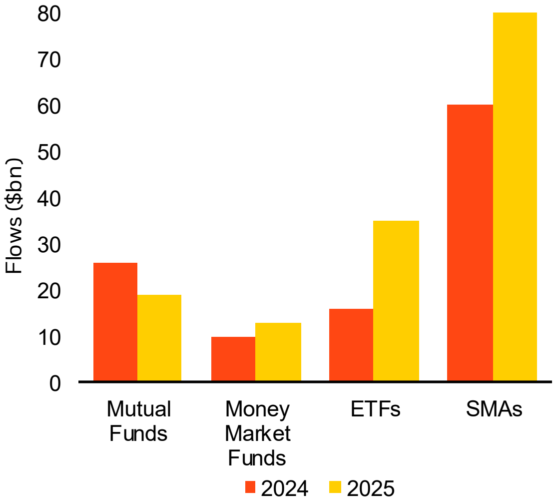
After a year of policy uncertainty and uneven performance, the municipal market enters 2026 with clearer technical and fundamental signals. And while broader economic risks remain, supply, demand and income generation are increasingly driving market dynamics, rather than macro headlines.

Stable supply meets durable demand

Issuance is expected to remain elevated as pandemic-era federal support fades and higher construction and labor costs persist. We forecast approximately $575 billion in total issuance with $97 billion in net new supply — elevated versus last year, but modestly below broader expectations.[8]

With policy uncertainties better defined, supply should follow traditional rhythms — lighter early-year and summer. New issuance will likely remain concentrated in the intermediate portion of the curve, particularly between 7 and 20 years, aligning with both issuer preferences and investor demand. Demand conditions remain structurally supportive. Separately managed accounts (SMAs) and exchange traded funds (ETFs) continue to represent the primary sources of inflows, generating over $100 billion in 2025 and expected to remain key in 2026.[9] Demand should remain focused on the intermediate portion of the curve, though modest duration extension may occur if frontend yields decline.

Demand increasingly concentrated in ETFs & SMAs



Source: Lipper, Cerulli, BlackRock, as of December 31, 2025.

Poised to recapture relative performance

After lagging comparable Treasuries in 2025, we believe municipals now face a more favorable relative setup. Consecutive years of underperformance are rare and typically tied to weaker fundamentals. Credit quality remains sound, supported by strong state and local balance sheets and resilient essential service revenue streams. Combined with supportive technicals, this backdrop positions municipals to recapture relative performance.

8 Source: Median estimate from: Barclays, Hilltop, J.P. Morgan, Municipal Market Analytics (MMA), Ramirez, Jefferies, Morgan Stanley, Bank of America, Janney Montgomery Scott,as of December 31, 2025.
9 Source: Lipper, Cerulli, BlackRock, as of December 31, 2025.

Selective strength in a shifting market

We expect mid- to upper-single-digit total returns for investment-grade municipals, driven by coupon income and stable supply-demand dynamics, rather than spread compression. With valuations offering less margin for error, income generation is likely to be the primary return driver.

In high yield, issuer-specific outcomes are likely to drive performance, rather than broad market stress. Isolated credit events may influence index level results, but outside of these pockets, fundamentals remain constructive. Strong demand and relatively modest supply should continue to support performance, and we expect high-yield municipals to outperform investment grade municipals.

Overall, the municipal market enters the year with solid fundamentals, manageable supply, and durable demand. And while volatility may persist, we believe municipals remain well positioned to deliver attractive, tax-efficient income with selective opportunities for outperformance.

Municipal bonds in 2026: Solid footing, narrower paths to return

Credit quality remains largely intact, though the return environment is evolving. After several years in which broad exposure was rewarded, current valuations now reflect much of the good news, and the next phase is likely to be defined by differentiation rather than momentum. Yields remain attractive, but tighter credit spreads — particularly among higher-quality municipals — offer less cushion. Incremental return is likely to come from issuer-specific analysis and bond structure than from taking broad credit risk.

Tax-backed issuers: A strong core with growing divergence

State governments continue to represent the most stable segment, and many maintain sizable reserve balances, providing flexibility if economic growth slows. Fiscal discipline will matter more in 2026 — states that align spending with sustainable revenues and avoid converting temporary windfalls into permanent tax cuts will be better positioned.

Below the state level, dispersion is increasing. Local governments in high-growth regions, particularly the Sun Belt and Mountain West, have benefited from expanding tax bases and investment. Yet outcomes are becoming more uneven. Governance challenges, long-term budget pressures and rising climate-related insurance and resiliency costs are playing a larger role in credit outcomes.

School districts remain the most challenged tax-backed sector. Declining enrollment, fading pandemic aid, and rising operating costs continue to pressure finances. Districts with strong property tax bases tend to be more resilient, while those heavily reliant on state aid warrant closer review.

Selective strength in a shifting market

Revenue bonds: Emphasizing stability and structure

We believe revenue backed credits continue to offer attractive carry, supported by essential services and the flexibility to adjust rates and fees. However, many sectors are entering capital-intensive phases, elevating the importance of affordability, management quality and bond structure.

Utilities face ongoing infrastructure and resiliency needs, with waning political tolerance for rate increases. Transportation credits remain broadly sound but increasingly asset-specific, favoring larger diversified systems. Hospitals appear stable but remain sensitive to policy and reimbursement changes. Housing credits remain fundamentally steady, though increased supply and evolving prepayment behavior heighten the importance of structure.

High yield municipals: Precision matters

High yield municipals can add value, but selectivity is critical. Spread dispersion creates opportunities for active positioning, while defaults are likely to remain isolated. Risk remains concentrated in familiar areas, including senior living, smaller charter schools, select private colleges, speculative project financings and structure-driven tobacco bonds.

Bottom line and portfolio positioning

We recommend anchoring portfolios in high-quality state and essential-service revenue bonds and adding yield selectively where credit fundamentals, structure and liquidity are well supported and clearly understood.

With credit spreads tight and prices near fair value, the market leaves little room for error. Even so, a supportive Fed remains constructive. We maintain a modestly long duration posture and favor a barbell approach — pairing more attractive value at the front end of the curve with steepness in the 15- to 20-year range. We also see opportunities in Alternative Minimum Tax bonds, where limited applicability has created potential to pick up incremental spread. Higher-coupon bonds and high-quality income sectors such as transportation, housing, prepaid gas, and healthcare remain core holdings. Staying invested, selective and disciplined remains key in 2026.

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