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Unlocking Value In Municipal Bonds

Unlocking Value: Trading Private Credit's High Fees, Impaired Liquidity, and Declining Floating Rates for the Tax-Free Certainty and Security of Municipal Bonds

The municipal bond market navigated a turbulent first quarter in 2026, characterized by a "tale of two halves." While the year began with robust demand and falling yields, a sharp reversal in March, driven by reignited inflation fears and the outbreak of the conflict in the Middle East, erased early gains. Despite this volatility, the fundamental case for municipal bonds has strengthened, particularly as a transparent and liquid alternative to the increasingly opaque private credit market.

Q1 2026 Market Performance and Yield Dynamics

The first two months of 2026 saw municipal bonds off to one of their strongest starts since 2020, with the Bloomberg Municipal Bond Index gaining over 2% through February. However, March brought a significant repricing due to geopolitical strife, with the 10-year tax-exempt benchmark yields, which had bottomed at 2.52% in late February, rising to end the quarter at 3.12% — a 59-basis point jump in a single month, according to the Municipal Market Data AAA muni curve.

Key drivers of the Q1 performance included¹:

- **Technical Conditions:** Record issuance in 2025 continued into Q1 2026, with total volume reaching \$129.6 billion, up 7% year-over-year.
- **Resilient Inflows:** Despite March's volatility, tax-exempt mutual funds and ETFs saw nearly \$26 billion in net inflows for the quarter, comfortably absorbing supply, illustrating strong retail appetite.
- **Yield Curve Shifts:** The long end of the curve (30-year) became particularly attractive as the Muni/Treasury ratio rose to **91%**, the highest level in nearly two years.

The Rising Tide of Local Taxes

In our recent [Clinton Investment Jan Commentary](#), we highlighted a critical and growing risk: the increasing frequency of state and local tax increases across the country. We note that, while state-level credit fundamentals remain generally stable, local municipalities are increasingly choosing to raise income taxes on the wealthy to balance budgets as pandemic-era federal aid is fully exhausted and to address growing unfunded mandates.

We see this trend accelerating, evidenced by tax increase proposals in CA, VA, RI, and ME, together with passage of a 9.9% income tax increase in the state of Washington on those making more than \$1 million, effective in 2028. Recently, the state of Illinois began considering a 3% "millionaire's tax" on high earners.

Munis vs. Private Credit: The Safety and Yield Advantage

As the Federal Reserve continues to cut short-term rates, the landscape for income-seeking investors appears to be shifting away from floating rates, preferred savings, money market funds, and private credit, toward municipal bonds.

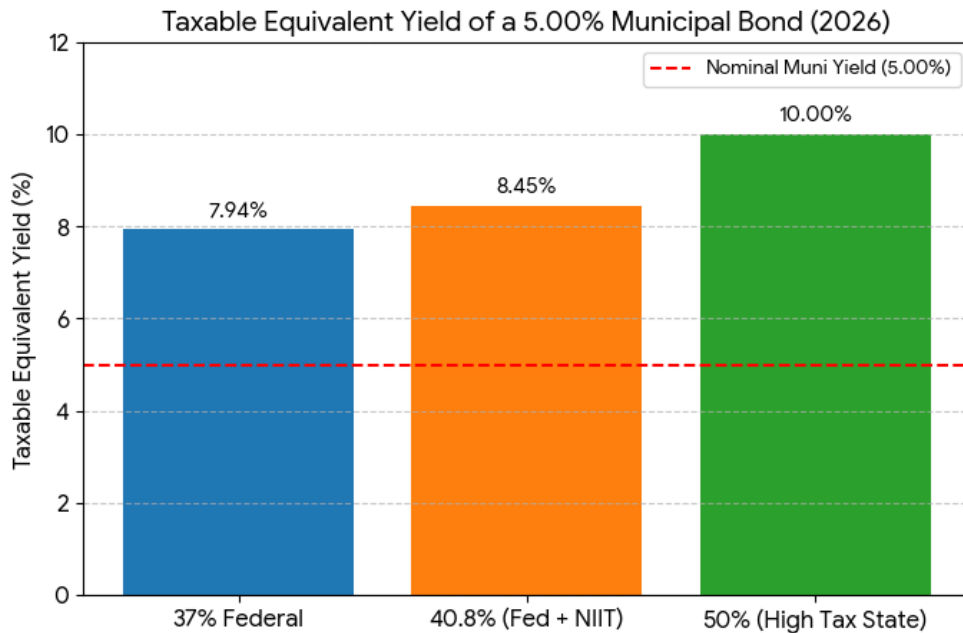
The Decline of Private Credit

Private credit, once the darling of the "yield at any cost" era, is facing significant headwinds in 2026.

- **Fee and Liquidity Burdens:** Private credit funds often charge high management and performance fees (e.g., 2% and 20%) and frequently utilize "lock-ups" and "gates" that prevent investors from freely accessing their capital during market stress, as is occurring with increasing frequency in the current environment, evidenced by the plethora of news articles referencing funds implementing these tactics.
- **Floating Rate Risk:** Most private credit loans are floating rate. As the Fed cuts rates, the yields on these loans will naturally decline, potentially eroding the income profile that attracted investors initially.
- **Default Concerns:** A recent quote from **Fitch Ratings** highlights the rising fragility in this sector, estimating a private credit default rate of roughly 6%.² By contrast, municipal bond default rates remain historically below 1%, according to Moody's.³

The Taxable Equivalent Yield (TEY) Calculation

Municipal bonds currently offer a compelling alternative to private credit and other taxable fixed income instruments. with TEY's of **8% to 9%** for those in the highest tax bracket, seeking protection from federal, state, and local taxes. For example, if a long-term muni bond offers a **5.00%** tax-free yield (as seen recently in the 20-30 year area of the curve for NY), the TEY is approximately **8.45%**.⁴



The visualization above illustrates how a base tax-free yield of 5.00% scales as the investor's tax burden increases. In high-tax states like New York or California, the TEY can easily surpass 9.5% when accounting for both federal and state exemptions.

Conclusion

The first quarter of 2026 reaffirmed that while municipal bonds are not immune to interest rate volatility, they have historically been, and we believe will remain, among the most resilient and sound investments for high-income investors. When one considers the rising pressure to raise state and local taxes, especially on high-income earners, together with the rising default concerns, high fees, and declining floating rate yields in private credit, municipal bonds remain a compelling alternative given their return profile, credit stability and higher level of liquidity they offer investors.

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¹Source: Municipal Securities Rule Making Board

²Fitch: U.S. Private Credit Default Rate Continues Upward March to 5.8% in January 2026

³Moody's: [US municipal bond default and recovery rates, 1970-2024 | Default Report | Moody's](#)

⁴The taxable equivalent yield is calculated by dividing the tax-exempt yield by 1- the maximum federal income tax rate of 40.8% (37% federal + 3.8% NII tax).