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# Higher Interest Rates: What Municipal Bond Investors Should Know

**While rising interest rates have weighed on returns in 2026, strong market fundamentals and elevated yields offer an attractive entry point for long-term investors.**



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## KEY TAKEAWAYS

- Municipal bonds have historically been a resilient asset class. The recent rise in interest rates has triggered an unusual period of volatility, sending the broad municipal market index down 4.3% in September, its worst monthly return since 2008. Yet monthly losses exceeding 4% have occurred in less than 1% of observations since 1987, and periods of underperformance have historically been followed by strong recoveries.
- The fundamentals of the municipal bond market remain strong. State rainy-day funds are elevated and the share of the investment-grade municipal market based upon the Bloomberg Municipal Bond Index rated AAA or AA has risen to 79.2%, providing a strong foundation for the market despite recent price volatility.
- Municipal bond yields have reached near their highest levels in two decades, with the Bloomberg Municipal Bond Index yielding 4.87% as of September 30, 2026, equivalent to a taxable yield of approximately 8.23%.[1] These elevated yields offer an attractive starting point for investors seeking tax-exempt income.
- Starting yields have historically been a powerful indicator of longer-term returns. While further rate volatility is possible, higher income can help cushion price declines, and falling rates could provide additional appreciation.
- Active management, supported by rigorous credit research and careful bond selection, can help investors capitalize on today's attractive yields while managing risk.

## History of Municipal Bond Resilience Through Market Cycles

Municipal bonds have experienced significant volatility in 2026 as a sharp rise in interest rates has pushed prices lower. September was particularly challenging, with the Bloomberg Municipal Bond Index falling 4.3%, the worst monthly return since 2008. The third quarter's decline of 6.8% marked the weakest quarterly return since 1981. Through September 30, 2026, the index was down 4.2% year to date.

While these declines have been difficult for investors, negative returns are relatively uncommon in the municipal bond market. In fact, the Bloomberg Municipal Bond Index recorded positive returns in 36 of the 42 calendar years from 1985 through September 2026. Over the completed calendar years in that period, the index generated an average annual return of approximately 5.7%, while the year following a negative calendar year averaged 11.5% (see Figure 1).

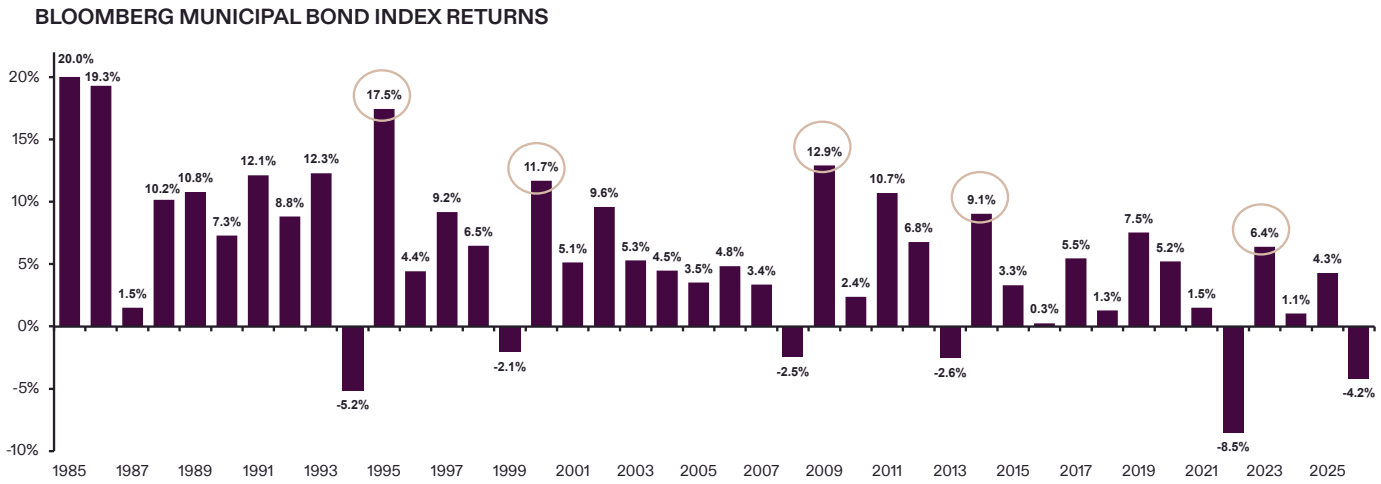
In addition, the Bloomberg Municipal Bond Index has experienced monthly declines of more than 4% just four times, representing less than 1% of the 477 months since 1987 through September 2026. Over the 39 completed calendar years from 1987 through 2025, only two years, or approximately 5%, recorded annual declines of more than 4%. These historically rare occurrences provide additional perspective on the recent volatility and the municipal bond market's long-term resilience. The data source is the Bloomberg Municipal Bond Index as of September 30, 2026.

Past performance does not guarantee that a similar recovery will occur this time. But the historical record provides useful perspective: periods of significant rate volatility have not necessarily translated into prolonged weakness in municipal bond returns

### Figure 1. Negative Returns Are Uncommon and Historically Followed by Strong Recoveries

Bloomberg Municipal Bond Index annual returns and year-to-date 2026, January 1, 1985-September 30, 2026

| 36 | 6 | 5.7% | 11.5% |
|---|---|---|---|
| Positive Years | Negative Years | Average Return | Average Return After a Down Year |




Source: Bloomberg. Data as of September 30, 2026. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. **Past performance is not a reliable indicator or guarantee of future results.** Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

## Strong Credit Fundamentals Support the Municipal Market

In the current environment, municipal bond price declines have reflected higher interest rates rather than widespread deterioration in credit quality. Underlying municipal credit fundamentals remain strong.

State general obligation bonds are a good starting point to analyze municipal bond market credit quality. States have built substantial financial reserves over the past several years, providing flexibility to manage unexpected revenue shortfalls or economic weakness. According to the National Association of State Budget Officers, aggregate state rainy-day fund balances are projected at approximately $154 billion for fiscal 2026, compared with roughly $77 billion in fiscal 2020. Total state balances, which include rainy-day funds and other available balances, are projected at approximately $287 billion.

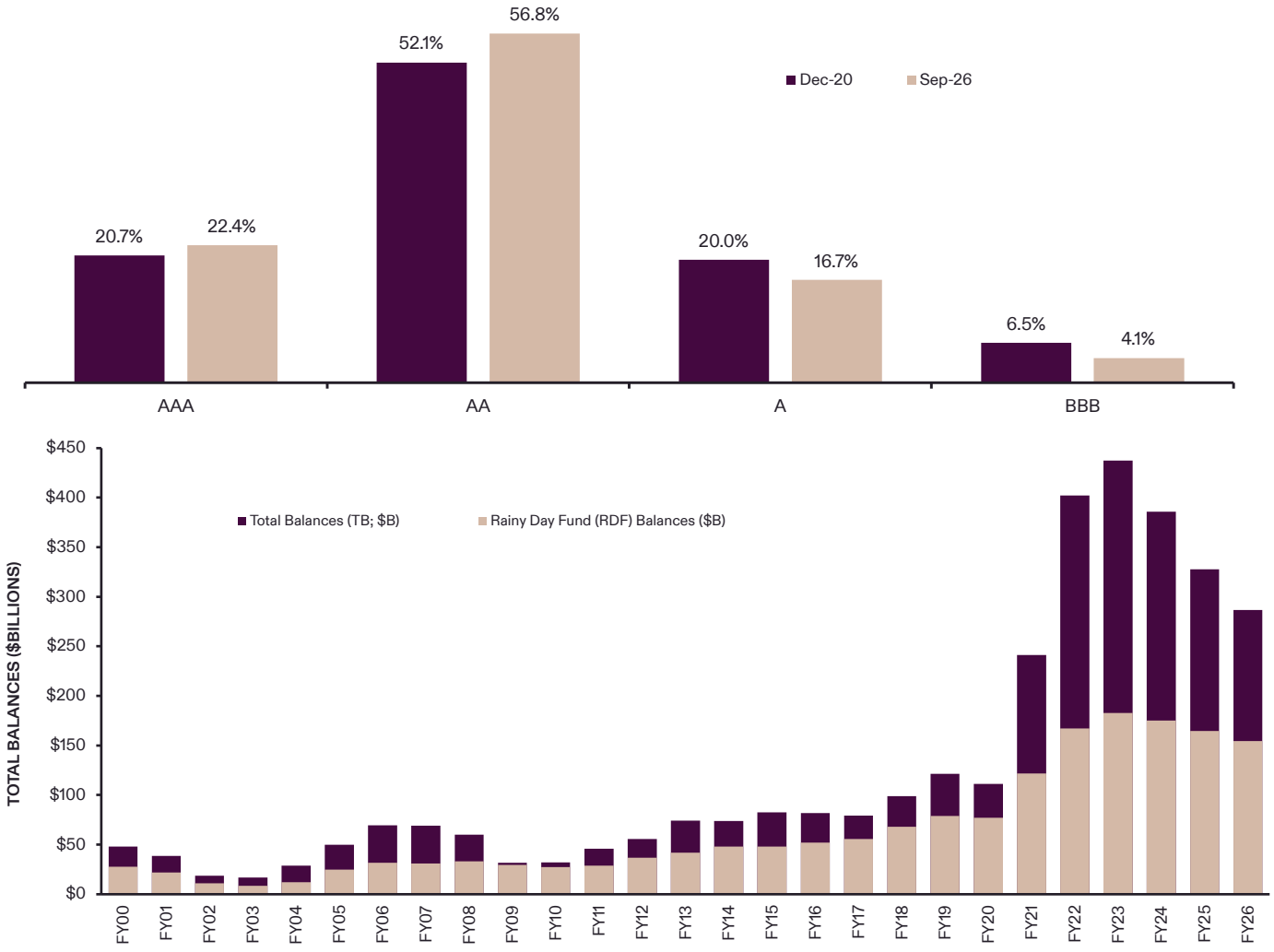
Credit quality has also remained strong. The share of the investment-grade municipal market rated AAA or AA increased from approximately 72.8% in December 2020 to 79.2% in September 2026, based on the Bloomberg Municipal Bond Index. To put this into perspective, the United States government is rated AA.

Individual states provide further support for resilience. California, supported by a large and diverse economy, reported a 5.7% increase in fiscal-year-to-date revenues and approximately $43 billion in budgetary reserves. This follows a period in which California already doubling its revenues and reduced its outstanding debt over the past few years. Florida has benefited from strong post-pandemic economic growth and migration, with fiscal 2026 revenues up 4.6% and approximately $12 billion in reserves. Both states face risks, including revenue volatility in California and slowing population growth in Florida, but their financial positions demonstrate the underlying strength of many municipal issuers.1 States have to maintain balanced budgets, unlike the Federal government, so they have a very different starting point for setting their finances.

These fundamentals do not eliminate credit risk, particularly given differences across issuers and revenue sources. They do, however, provide a stronger foundation for the municipal market than recent price performance alone might suggest.

## Figure 2. Municipal Credit Quality and State Reserves Remain Strong

Index credit quality breakdown (top panel) and state reserve balances (bottom panel)




Source: Bloomberg (top panel) and National Association of State Budget Officers (NASBO) and U.S. Census Bureau (bottom panel). Data as of September 30, 2026, and fiscal year 2026 (June 30). FY=fiscal year. Fiscal year 2025 is estimated. Fiscal year 2026 is projected. Index=Bloomberg Municipal Bond Index. Ratings reflect index ratings assigned by Moody's and S&P Global Ratings. Rainy-day fund and total balances are shown as a percentage of general fund expenditures, fiscal 2000–fiscal 2026; FY2025 estimated and FY2026 projected. Rainy-day funds, also known as budget stabilization funds, allow states to set aside surplus revenue for use during unexpected deficits. The historical data are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett or any particular investment.

## Higher Yields Offer More Income Potential

The sharp rise in municipal bond yields has created both a challenge and an opportunity. Investors holding municipal bonds have experienced short-term price declines, but those higher yields now offer an opportunity to lock in attractive levels of tax-exempt income.

As of September 30, 2026, the Bloomberg Municipal Bond Index had a yield to worst of 4.87%, equivalent to a taxable yield of approximately 8.23%.[2] These are among the highest municipal yields in more than two decades (see Figure 3).

For investors, higher yields have improved the opportunity for tax-exempt income. That additional income can help cushion potential price declines if rates rise further, while a decline in rates could also provide opportunities for price appreciation.

### Figure 3. Municipal Bond Yields Have Reached Historic Highs

Bloomberg Municipal Bond Index yield to worst, January 1, 2007-September 30, 2026




Source: Bloomberg. Data as of September 30, 2026. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Past performance is not a reliable indicator or guarantee of future results. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment

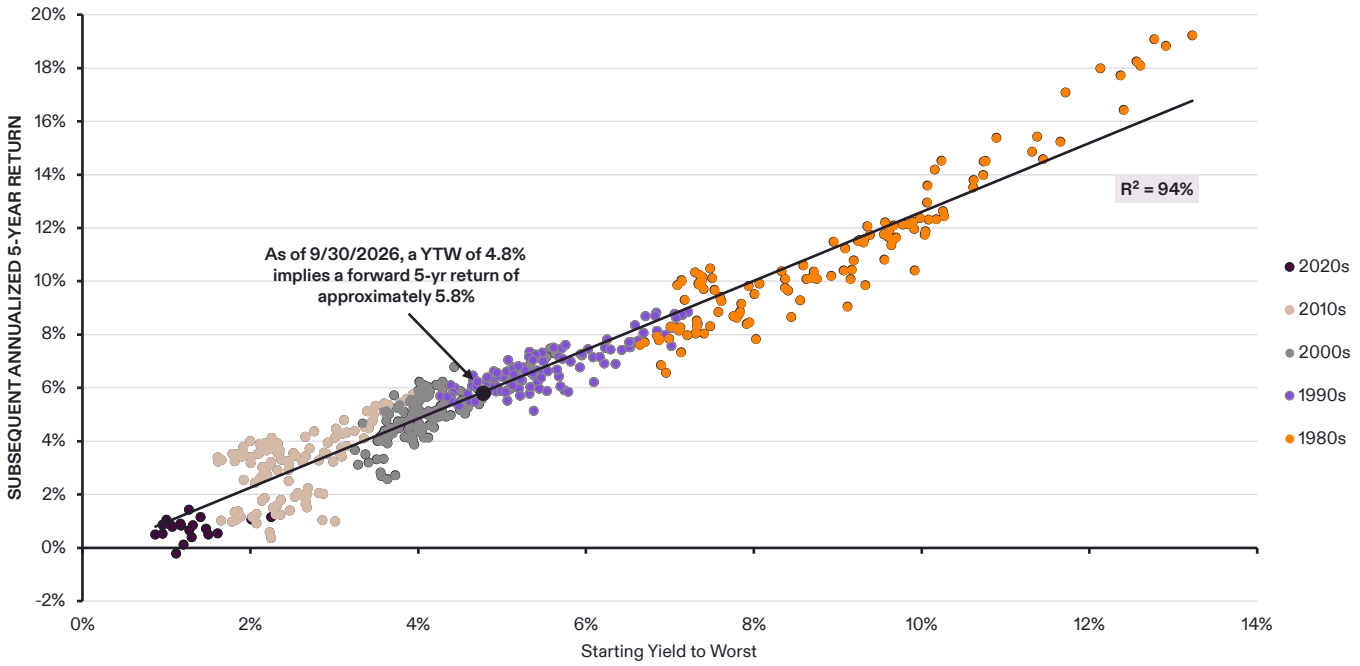
## Why Starting Yields Are Important

Historically, the yield available when a municipal bond investment is made has been a leading indicator of subsequent longer-term returns. Higher starting yields on the Bloomberg Municipal Bond Index have generally been associated with stronger annualized returns over the following five years (see Figure 4). That statistical relationship is supported by the fact that starting yields have also been historically closely linked to subsequent five-year bond returns, explaining 94% of the variation in returns over the period analyzed.

This relationship reflects a basic characteristic of fixed-income investing. A larger portion of total return comes from income when starting yields are elevated. Investors therefore may have less need to rely on falling interest rates (and rising bond prices) to help generate attractive returns. It is also important to note that long bond yields were around 2% in 2021, which was a very different starting point compared to today

### Figure 4. Higher Yields Have Historically Supported Stronger Forward Returns

Bloomberg Municipal Bond Index monthly yield to worst and subsequent five-year annualized returns since 1980




Source: Bloomberg. Data as of September 30, 2026. Based on monthly observations. R-squared ($R^2$) is a statistical measure that indicates how much of the variation in one variable is explained by its relationship with another variable in a regression model. An R-squared of 94% indicates that the model explains 94% of the variation in the observed data, reflecting a very strong statistical relationship. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Past performance is not a reliable indicator or guarantee of future results. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

History also shows that municipal bond yields have often reversed course following periods of sharp increases (see Figure 5). These reversals, reflected in declining yields and strong subsequent returns, may help investors benefit from both income and price appreciation.

### Figure 5. Municipal Bond Yields Historically Have Declined After Sharp Increases

Bloomberg Municipal Bond Index yield to worst, January 1, 2007-September 30, 2026




| Subsequent Forward Returns | 1 10/16/2008 | | 2 10/18/2011 | | 3 09/04/2013 | | 4 12/1/2016 | | 5 11/5/2018 | | 6 3/23/2020 | | 7 10/28/2022 | | 8 10/30/2023 | | 9 04/09/2025 | | Average | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 6 Mo. | 1 Yr. | 6 Mo. | 1 Yr. | 6 Mo. | 1 Yr. | 6 Mo. | 1 Yr. | 6 Mo. | 1 Yr. | 6 Mo. | 1 Yr. | 6 Mo. | 1 Yr. | 6 Mo. | 1 Yr. | 6 Mo. | 1 Yr. | 6 Mo. | 1 Yr. |
| Bloomberg Municipal Bond Index | 13.2 | 19.9 | 5.7 | 9.4 | 6.3 | 10.2 | 3.4 | 6.0 | 5.3 | 9.5 | 11.9 | 13.18 | 7.8 | 2.7 | 7.1 | 9.7 | 5.1 | 7.4 | **7.3%** | **9.8%** |

Source: Bloomberg. Data as of September 30, 2026. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Past performance is not a reliable indicator or guarantee of future results. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

We are not suggesting rates will come down from here. There are many factors that can cause rates to go higher, remain where they are, or come back down. But what we do know is that income at its current levels offers better protection against rates going higher, and if rates come down, it may offer an excellent opportunity for income and capital appreciation

As always, the timing and direction of future interest-rate movements remain uncertain. The current opportunity is therefore not dependent on accurately predicting when rates will decline but rather it begins with the income on offer today.

## Summing Up

The sharp rise in rates has challenged municipal bond investors in 2026, but strong credit fundamentals and substantial state reserves continue to support the market. At the same time, yields near their highest levels in two decades offer an attractive opportunity to generate tax-exempt income. Historically, higher starting yields have been associated with stronger longer-term returns, while periods of sharp rate increases have historically been followed by strong recoveries. Although further volatility is possible, today's elevated yields offer a stronger foundation for returns without requiring a significant decline in rates. For long-term investors, active management, supported by rigorous research and careful bond selection, can help capitalize on today's attractive yields while managing risk.

[1]Sources and data reflect FYTD revenue/tax trends and budgetary reserve/fund-balance figures from the latest available state budget, cash, and tax-collection releases: California State Controller's Office, August 2026 Statement of General Fund Cash Receipts and Disbursements and Florida Annual General Revenue Receipts by Source, June 30, 2026, and The Florida Legislature Fiscal Analysis in Brief for Fiscal Year 2025-2026.

[2]Tax-equivalent yield assumptions based on top U.S. tax rate of 40.8% (37% plus 3.8% Medicare tax).

**Glossary & Index Definitions**

**Annualized return** is the average yearly rate of return on an investment over a specified period, accounting for the effects of compounding.

**Basis point** (bp) is one one-hundredth of a percentage point (0.01%). Basis points are commonly used to describe changes in interest rates, bond yields, and credit spreads.

**Credit quality** refers to an assessment of a bond issuer's financial strength and ability to meet its debt obligations, generally reflected in credit ratings assigned by rating agencies.

**Credit ratings** are assessments of an issuer's creditworthiness, typically assigned by rating agencies such as Moody's and S&P Global Ratings. Ratings range from AAA, indicating the highest credit quality, to lower ratings associated with greater credit risk.

**Credit risk** is the risk that a bond issuer may fail to make required interest or principal payments.

**Duration** measures the sensitivity of a bond's or fixed-income portfolio's price to changes in interest rates. Generally, bonds with longer durations experience greater price fluctuations when interest rates change.

**Price appreciation** refers to an increase in the market value of an investment. Bond prices generally rise when market interest rates decline, assuming other factors remain unchanged.

**Rainy-day funds** are financial reserves maintained by state governments to help cover unexpected budget shortfalls, revenue declines, or economic disruptions. They are also known as budget stabilization funds.

**Regression model** is a statistical method used to analyze and quantify the relationship between two or more variables. It can help identify historical trends and estimate how changes in one variable are associated with changes in another.

**R-squared** ($R^2$) is a statistical measure indicating the proportion of variation in a dependent variable explained by a regression model. An R-squared of 94% means the model explains 94% of the variation in the observed data, indicating a strong historical statistical relationship, but not guaranteeing future outcomes.

**Starting yield** is the yield available on a bond or fixed-income investment at the beginning of an investment period. Historically, starting yields have been associated with subsequent longer-term fixed-income returns.

**Tax-equivalent yield** is the yield a taxable bond would need to offer to provide the same after-tax income as a tax-exempt municipal bond. It is calculated by dividing the tax-exempt yield by one minus the investor's marginal income tax rate. The calculation assumes the municipal bond's income is exempt from the taxes included in that rate and the comparable taxable bond's income is fully taxable. Actual results depend on an investor's tax circumstances.

**Tax-exempt income** is investment income that is excluded from certain income taxes. Interest on qualifying municipal bonds is generally exempt from federal income taxes, although some municipal bond income may be subject to state, local, or other applicable taxes.

**Total return** measures an investment's overall performance over a specified period, including income received and changes in market value.

**Yield to worst** (YTW) is the lowest potential yield a bond can generate under its contractual terms, assuming the issuer does not default. It considers possible early redemption or call dates and is commonly used to evaluate bonds with embedded call provisions.

**Bloomberg Municipal Bond Index** measures the performance of the U.S. investment-grade, tax-exempt municipal bond market. The index includes fixed-rate municipal bonds issued by state and local governments and other qualifying municipal entities.

Bloomberg Index Information

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