



CIO MARKET NOTE

After the Worst Quarter Since 1981: Where the Value Sits in Municipal Bonds

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The Bloomberg Municipal Bond Index lost 4.36% in September and 6.35% for the third quarter — the worst quarterly return since 1981. September alone was the weakest month since the Lehman collapse in September 2008. For an asset class owned primarily for stability, that is a jarring print.

Our reading, and the reading of most of the large municipal desks we follow — PIMCO, BlackRock, Nuveen, Invesco — is that the damage was driven by rates and market plumbing, not by credit. That distinction matters, because plumbing problems tend to resolve on a calendar, while credit problems do not.

WHAT ACTUALLY HAPPENED

Three forces converged in a single quarter.

A rate shock. On 16 September the FOMC raised the policy rate by 25 bp — the first hike since 2023 — and 16 of 18 members projected at least one more before year-end ([Invesco, 24 Sep 2026](#)). Inflation concerns tied to the US-Iran conflict had already been pushing Treasury yields higher. PIMCO's October outlook places the 10-year Treasury around 5.25% after a selloff since mid-August ([Briefs/PIMCO, Oct 2026](#)).

A supply wave. Issuance reached \$294.9 billion in the first half, a record, up 5.8% year over year ([Bond Buyer/LSEG](#)). September supply was the highest on record ([Nuveen, citing J.P. Morgan](#)), and August was the strongest August on record ([Goldman Sachs AM](#)).

A reinvestment air pocket. Principal and interest paid to holders — the cash that normally recycles into new deals — fell from \$62.2 billion in August to \$38.4 billion in September ([Bond Buyer, citing CreditSights](#)). Record supply met a sudden drop in organic demand at exactly the moment the Fed turned hawkish.

Credit, by contrast, held up. State and local tax collections rose 5.75% through the first half of 2026 ([Nuveen](#)). Invesco notes that year-to-date daily volatility on the Treasury index (4.38% annualized) ran roughly 1.3× that of the muni index (3.36%) — munis were the passenger, not the driver ([Invesco](#)).

WHY THE SELLOFF LOOKS OVERDONE

1. The supply shock was seasonal and is fading

Gross supply is not net supply. Once maturities, calls and coupons are netted out, the summer months are historically the most favorable technical window; September is when supply begins to outrun organic demand ([LPL Research, Aug 2026](#)). The quarter landed squarely on the worst part of that calendar.

The forward calendar looks different. Invesco expects issuance to stay heavy through October, then moderate as redemption activity picks back up into November and December ([Invesco](#)). Nuveen observed issuers pulling deals in late September amid the volatility, and early-October supply was lighter ([Nuveen](#)).

Of course, deals that were pulled have not disappeared. Nuveen flags a backlog waiting for stable rates, which could cap the pace of recovery if it all prices at once. The trend is toward slower supply; the path will not be smooth.

2. Much of the selling was mechanical, not a vote against the asset class

- **Ownership transfer, not exit.** In the week to 1 October, open-end funds lost \$2.7 billion while ETFs gained \$2.1 billion — a pattern consistent with tax-loss harvesting rotation ([Nuveen, citing LSEG Lipper/J.P. Morgan](#)).
- **Model-portfolio rebalancing.** The Schwab Municipal Bond ETF suffered a record single-day \$360 million withdrawal, with market participants attributing it to model reshuffling rather than end-investor capitulation ([Bloomberg via Yahoo Finance](#)).
- **Dip-buying already visible.** The two largest muni ETFs recorded their largest weekly inflows ever in mid-September ([Bloomberg](#)).

Forced and tax-motivated selling exhausts itself. Investors who harvest losses in September and October typically need to redeploy before year-end.

3. Valuations have reset to levels rarely seen in two decades

Municipal valuations after the Q3 selloff		
Metric	Level	Source
Index taxable-equivalent yield	8.07% (near 20-year high)	Nuveen
30-yr AA taxable-equivalent yield, top bracket (10 Sep)	8.67% (best since Nov 2000)	Invesco / J.P. Morgan
5-yr AAA yield / muni-Treasury ratio	3.62% / 72%	Nuveen / MMD
10-yr AAA yield / ratio	4.04% / 77%	Nuveen / MMD
30-yr AAA yield / ratio	5.13% / 91%	Nuveen / MMD

Taxable-equivalent yields assume a 40.8% marginal rate (37% federal + 3.8% NIIT). Long muni yields are at their highest since 2011 ([Nuveen](#)). Ratios widened across the curve: the sub-3-year ratio moved from roughly 60% to 75% ([Morningstar, Q3 2026](#)).

4. A structural buyer gap the market keeps mispricing

PIMCO's April analysis remains the clearest articulation of why the long end is persistently cheap: banks, historically natural buyers of long tax-exempts, have retreated, while retail demand concentrates in shorter bonds held directly. The result is a curve where short and intermediate tax-exempts look rich and longer maturities offer value; PIMCO measured the 10s/30s slope at about 135 bp, the steepest since the taper tantrum, and favored a barbell to capture spread, carry and roll-down ([PIMCO, 9 Apr 2026](#)). The quarter's selloff steepened the curve further.

What would make us wrong

- **More Fed hikes than priced.** The dot plot already implies another; a more aggressive path would pressure duration across all fixed income.
- **The deferred-deal backlog** returning faster than reinvestment demand.
- **Credit dispersion.** PIMCO warns that the roll-off of pandemic aid and Medicaid changes will widen gaps between issuers, with smaller, government-payer-heavy hospitals most exposed ([PIMCO](#)). BlackRock flags negative rating-agency outlooks for higher education ([BlackRock, May 2026](#)). The technical argument applies to essential-service, high-grade paper — not indiscriminately.

IS 10-15 YEARS THE RIGHT PART OF THE CURVE?

Largely yes — with the qualification that the case is about *where the damage concentrated* as much as where the yield is.

The 15-year segment (Bloomberg 12-17 yr index) is down 5.49% year to date, the worst-performing maturity bucket — worse even than the 22+ year long bond at -4.51% ([Nuveen](#)). That is not accidental. BlackRock noted at the start of the year that supply would concentrate in the 7- to 20-year range, matching issuer preference ([Bond Buyer, quoting Pat Haskell](#)). The bucket that absorbed the most supply cheapened the most; it should also benefit most as supply recedes.

The major desks are not uniform here, which is worth being clear about:

- **PIMCO** — long-end value via a barbell (short + long).
- **AllianceBernstein** — yield plus roll maximized in the 15- to 20-year area ([AB, Jan 2026](#)).
- **Capital Group** — relative value around 20 years ([Capital Group](#)).
- **LPL** — the intermediate range as the sweet spot, capturing most of the yield and roll-down without long-end volatility ([LPL, midyear 2026](#)).
- **Nuveen** — taxable-equivalent yields more attractive in longer maturities.
- **BlackRock** — sees opportunities in the 10-15 year maturities (John Ryan, BlackRock municipal analyst, conversation with Thalassa Capital, October 2026).

A 12- to 17-year position sits at the intersection: it captures the bulk of the curve's steepness beyond 10 years, earns roll-down as bonds age toward the richer intermediate segment, and carries materially less duration than 25- to 30-year paper. Roll-down, illustratively: a 5% coupon 15-year bond at 4.40% that rolls to 14 years on a curve sloping 6 bp per year (yield 4.34%) gains about 0.31% in price from the passage of time alone, before any change in rates.

IS LOW COUPON THE BETTER BET? CONDITIONALLY

Low-coupon bonds — typically 2–3% coupons issued in 2020–2021 — now trade at deep discounts, and many trade below their *de minimis* threshold. That threshold determines how the discount is taxed:

- **Threshold price** = $100 - (0.25 \times \text{full years to maturity})$. For a 12-year bond: $100 - 3.00 = \mathbf{97.00}$.
- **Above the threshold**, the discount is taxed as a capital gain (20% + 3.8% NIIT = 23.8%).
- **Below the threshold**, the *entire* discount is taxed as ordinary income (37% + 3.8% = 40.8%) ([Schwab](#); [Dividend.com](#), 28 Sep 2026).

Because high-bracket buyers avoid this, below-threshold bonds trade cheaper. The question is whether the extra yield more than pays for the tax.

Illustrative comparison: 12-year AA, top-bracket investor

Assumptions: semiannual pay, held to maturity, 40.8% ordinary / 23.8% capital-gains rates. The 2.5% coupon is assumed to trade 40 bp cheaper than current-coupon paper. Hypothetical figures, not quotes.

Coupon structure vs. after-tax outcome — 12-year AA, top bracket							
Structure	Stated yield	Price	Discount tax at maturity	After-tax yield	TEY @ 40.8%	Mod. dur.	Convexity
5.0% coupon (premium)	4.25%	106.99	none	4.25%	7.18%	9.08	101
4.0% coupon (near par)	4.25%	97.67	$2.33 \times 23.8\% = 0.55$	4.21%	7.12%	9.41	106
2.5% coupon (deep discount)	4.65%	80.40	$19.60 \times 40.8\% = 8.00$	4.06%	6.85%	9.98	115

Derivation for the 2.5% bond: the investor pays 80.40 and receives 100 at maturity, but owes 8.00 of ordinary-income tax on the 19.60 discount, so the effective terminal cash flow is 92.00. Solving for the semiannual yield that equates 80.40 to 24 coupons of 1.25 plus 92.00 at maturity gives **4.06%** — 19 bp *below* the premium bond despite a stated yield 40 bp higher.

Break-even. Re-solving at successively higher stated yields, the 2.5% coupon only matches the premium bond's 4.25% after-tax yield at a stated yield of about **4.91%** — a concession of roughly **66 bp**. Unless the bond is offered at least that cheap, the top-bracket buyer is worse off holding to maturity.

Where low coupon does earn its place

The case for low coupons is a *rates view*, expressed through higher duration and convexity. Holding period of 12 months, parallel shift, bond rolls to 11 years:

12-month pre-tax total return by scenario		
Scenario	5.0% premium	2.5% discount
Yields -50 bp	+8.59%	+9.51%
Yields +50 bp	+0.12%	+0.07%

(Pre-tax total return = price change + coupon, divided by starting price.)

If the selloff reverses meaningfully, the discount bond outperforms by roughly 90 bp on a 50 bp rally, with similar downside in a 50 bp backup. That asymmetry is real — but it is mark-to-market, and the de minimis tax still crystallizes at sale or maturity.

Two further points cut against a large allocation:

- **Liquidity.** Below-threshold bonds have a narrower buyer base, so bid-side pricing is weaker precisely when you want to sell.
- **The cliff is close.** The 4% bond above sits just 0.67 points above its 97.00 threshold; a backup of under 10 bp would push it across, re-pricing it into the discount buyer base. Near-threshold paper carries a hidden liquidity option you are short.

Premium callable bonds have their own trade-off — negative convexity if rates fall sharply and the bond is called — but for a holder who wants the tax-exempt income itself, that is generally the more tolerable risk.

Who should consider low coupons

- Investors in lower brackets, for whom the ordinary-income haircut is smaller.
- Investors holding through structures where the character of the gain matters less.
- Accounts expressing a deliberate view that rates will fall meaningfully over the next 12-24 months, sized as a tactical sleeve.
- Any buyer, when the offered concession clearly exceeds the computed break-even — run the after-tax yield explicitly, every time.

HOW WE WOULD POSITION

- **Core:** high-grade, essential-service GOs and revenue bonds in the 12- to 17-year range, in 4-5% coupons priced near par or at a modest premium. This captures the cheapest part of the curve without importing de minimis risk.
- **Tactical sleeve:** low-coupon discounts only where the concession beats break-even, sized as an explicit rates position.
- **Entry:** stagger purchases through October, while supply remains heavy, rather than committing in a single trade; the November-December redemption window is when the technical tailwind should be strongest.

- **Credit discipline:** avoid sectors where the yield reflects fundamentals rather than technicals — notably smaller healthcare systems with high Medicaid exposure and tuition-dependent higher education.
- **Tax-loss harvesting:** for existing holders, swapping into similar-but-not-identical paper locks in losses while keeping exposure — and can be used to upgrade out of near-threshold bonds.

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The third quarter was historically bad. It was also, by most measures that matter to a long-term tax-exempt investor, a repricing to some of the most attractive entry points in two decades.

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