

# Three pillars of municipal bonds

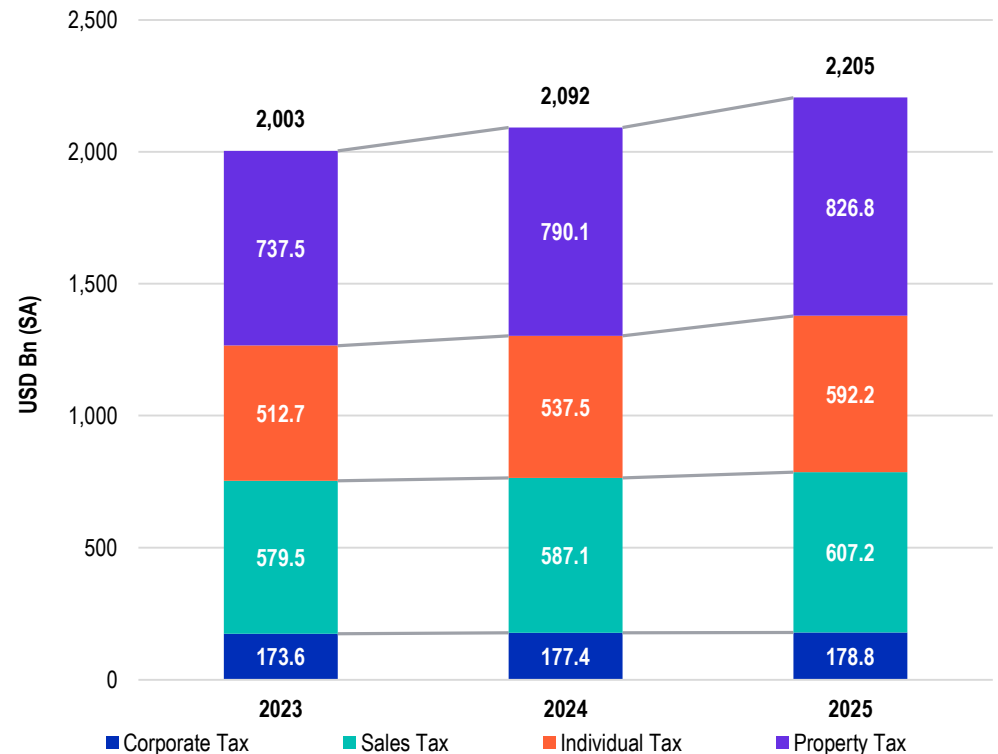
We believe there are reasons to be optimistic about the municipal bond market, which offers solid conditions from the perspectives of fundamentals and technicals, and also valuations, albeit to a lesser degree. This subsector of fixed income currently offers what we regard as very attractive risk-adjusted return potential (with income that is typically exempt from federal income taxes) while acting as a powerful diversifier of equities as well as some parts of the taxable fixed income market where correlations are relatively low.

## Fundamentals

- Overall fundamentals have remained stable/solid.
- The BBB/A credit-rating cohort has outperformed AA credits. Defaults have remained extremely low across the credit curve for municipal bonds.
- State and local tax estimates for the last quarter of 2026 show more than 5% growth from the quarter a year earlier, with all four major tax categories (individual, corporate, sales and property) showing robust growth for the full year.
- Although rainy day funds are still not at the extremely elevated levels seen just after the pandemic, they have remained healthy enough to cover in managing growing expenses.
- Finally, the upgrade/downgrade ratio although not as positive as it had been, is still about even.

Exhibit 1: US Tax Revenue by Category

2023–2025



Source: US Census Bureau. Analysis by Franklin Templeton Institute and Franklin Templeton Global Research Library.

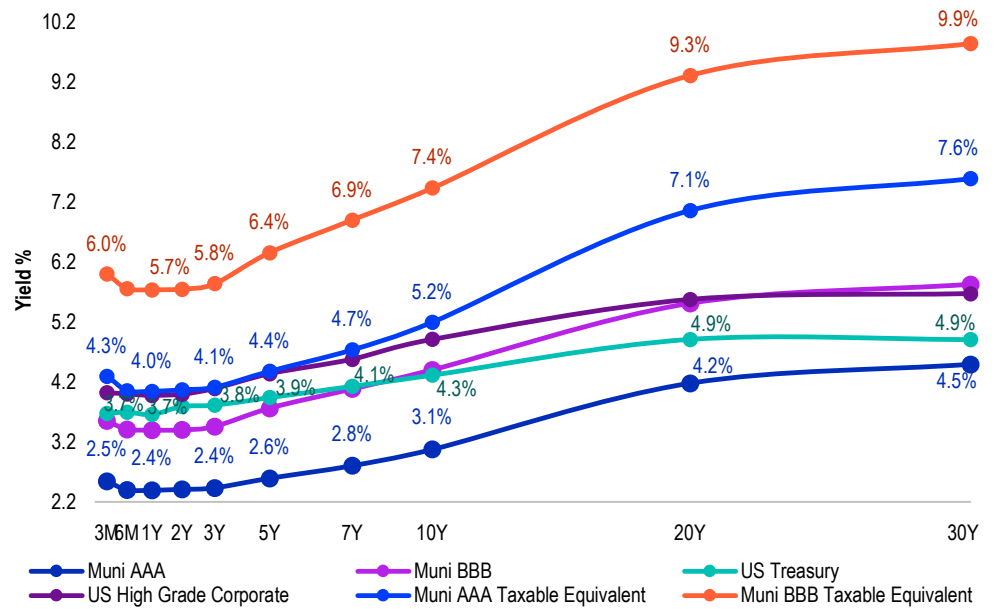
## Valuations

- Valuations are particularly attractive for investors willing to go further out on the yield curve; however, short and intermediate maturities are still investable.
- We believe valuations relative to other subsectors of fixed income overall are still attractive.
- Taxable-equivalent yields have come down but remain elevated relative to their historical averages.
- We believe active investment management is becoming even more critical, as valuations have tightened recently.

## Exhibit 2: Municipal Bond TEYs Attractive across the Curve

### Municipal Bond Yield Curve vs. US Corporate vs. US Treasury Yield Curve

As of 3/31/2026



Source: Bloomberg. Analysis by Franklin Templeton Institute. Muni AAA, Muni BBB, High Grade Corporate, and Treasury yields are based on Bloomberg Valuation Service (BVAL) AAA Muni Curve, BVAL General Obligation BBB+, BBB, BBB- Muni Yield Curve, BVAL US Corporate AA+, AA, AA- Curve and US Treasury Actives Curve, respectively. Taxable-equivalent muni curve considers the top marginal effective tax rate of 40.8%. The tax-equivalent yield (TEY) is the yield on a taxable bond that an investor would have to earn to match the return on a comparable tax-free municipal bond. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance does not guarantee future results, or any profit or gain.**

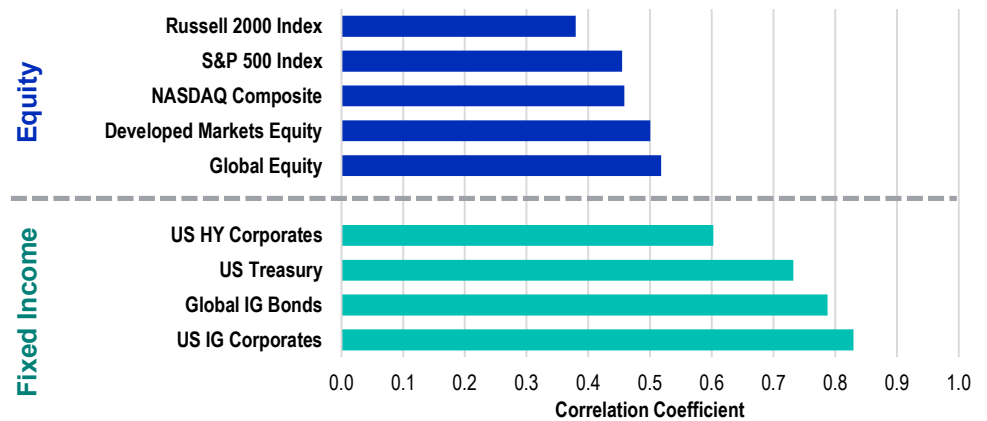
## Technicals

- Investor demand for municipal bonds has remained solid. Demand has been particularly robust on the short end of the yield curve. Supply levels in 2026 are on pace for another annual record, after setting records for the past couple of years.
- Flows into all vehicle types have been positive, however, mutual funds and ETFs have led the way. Since the modest outflows of 2022 and 2023, the past couple of years have provided net inflows, a trend we expect to continue.
- Finally, the correlations between municipal bond returns and major equity market indexes have been extremely low over the past couple of decades, allowing their diversification benefits to remain extremely powerful from a total portfolio perspective.

## Exhibit 3: Potential Diversification Benefits of Municipal Bonds

### Correlation of Municipal Bond Index to Equity and to Other Fixed Income Asset Classes

Last 10 Years Ending 3/31/2026



Source: Bloomberg. Analysis by Franklin Templeton Institute. Indices: Bloomberg Municipal Bond Index, DM Equity = MSCI World, Global Equity = MSCI ACWI, US HY Corporates = Bloomberg US Corporate High Yield, US Treasury = Bloomberg US Treasury, Global IG Bonds = Bloomberg Global Aggregate, US IG Corporates = Bloomberg US Corporate Index. Correlation describes a complementary or parallel relationship between two investments. The correlation coefficient is a measure that determines the degree to which two variables' movements are associated and will vary from -1.0 to 1.0. Note that -1.0 indicates perfect negative correlation, and 1.0 indicates perfect positive correlation. Based on monthly total returns. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance does not guarantee future results, or any profit or gain.**

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All investments are subject to certain risks, including possible loss of principal.

**Fixed income securities** involve interest rate, credit, inflation and reinvestment risks, and possible loss of principal. As interest rates rise, the value of fixed income securities falls. **Low-rated, high-yield bonds** are subject to greater price volatility, illiquidity and the possibility of default. An investor may be subject to the federal **Alternative Minimum Tax** and state and local taxes may apply.

Generally, investments offering the potential for higher returns are accompanied by a higher degree of risk. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in a portfolio adjust to a rise in interest rates, the portfolio's value may decline. Changes in the credit rating of a bond, or in the credit rating or financial strength of a bond's issuer, insurer or guarantor, may affect the bond's value. **High-yield, lower-rated (junk) bonds** generally have greater price swings and higher default risks. Municipal income may be subject to state and local taxes. Some income may be subject to the federal alternative minimum tax for certain investors. Capital gains, if any, are taxable.

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