U.S. Municipal Bond Market

The Transition from Credit Momentum to Credit Selection, Public Finance Enters a More Demanding Phase

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Summary

- Our 2026 Sector Credit Outlook anticipated that the municipal bond credit backdrop was moving from broad credit momentum toward a more demanding period of issuer-by-issuer differentiation. Moody's second quarter public finance rating actions support that view.
- Despite generally supportive economic conditions, public finance rating downgrades exceeded upgrades 116 (55%) to 96 (45%), driven largely by continued pressure in the K-12 School District, Higher Education, and Healthcare sectors.
- Demographics, enrollment trends, competition, governance, and fiscal management are increasingly determining credit quality, reinforcing the importance of credit selection.

2026 as a "Discipline Year" is Taking Shape

We anticipated that 2026 would be a discipline year, one in which credit outcomes would increasingly depend on planning, strategy, and budget decisions rather than inherited momentum. Moody's second-quarter public finance rating actions suggest that the Post-Golden-Age Realignment continues to unfold. Economic growth remains supportive. Most state and local governments remain financially stable. Yet downgrades are not only increasing but outpacing upgrades overall and in certain sectors. This dynamic suggests that broad economic and fading fiscal support is no longer powerful enough to overwhelm structural weaknesses in certain sectors and among certain issuers.

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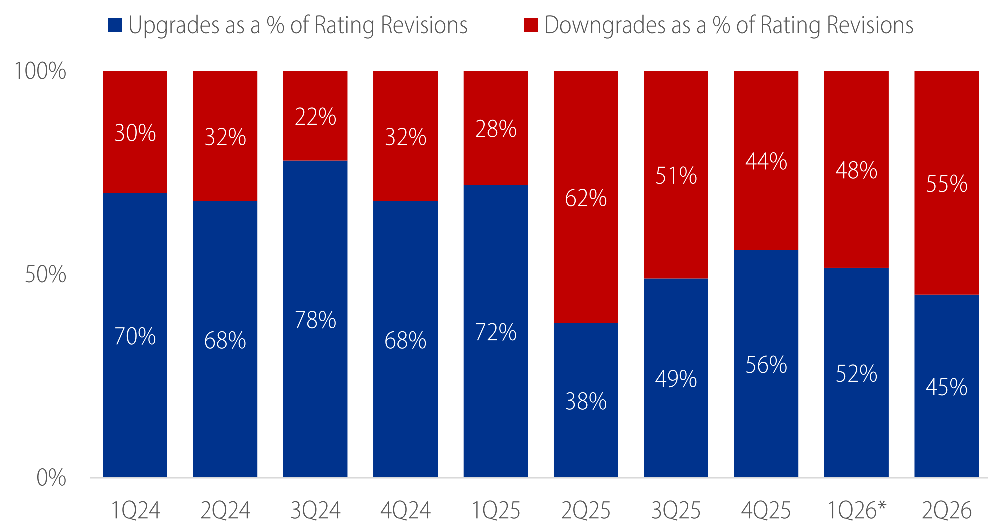
Public Finance Downgrades Have Outpaced Upgrades in Three of the Last Five Quarters After Broad Based Credit Peaked Around 2024



Source: Moody's and HilltopSecurities. *Numbers are adjusted.

The quarterly headline is that downgrades exceeded upgrades by 116 (55%) to 96 (45%). Similar periods occurred during and/or just after the Great Financial Crisis and the COVID-19 crisis. The more important message today is that relatively stable fundamentals are no longer producing uniform credit outcomes. K-12 school districts accounted for more than half of all downgrades. Higher Education continued to record more downgrades than upgrades. The Healthcare sector recorded more downgrades than upgrades for the first time since the end of 2025.

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These developments do not describe a municipal market where credit quality is moving uniformly lower. ***This is not a broad-based municipal credit deterioration story.*** Most state and local governments and public entities remain financially stable, and most credits continue to demonstrate resilience. Economic growth and fiscal support are simply no longer enough to overcome structural challenges in certain sectors.

The Broad Uplift is Gone, Issuers are Searching for Structural Balance

During the Golden Age of Public Finance, federal support, strong revenue growth, reserve fund accumulation, and economic activity lifted much of the municipal market all at the same time. The Post-Golden Age Realignment began as those extraordinary tailwinds faded. Entering 2026, we argued that credit quality had reached a plateau and that further progress would increasingly depend on issuer-level "discipline."

Moody's second quarter data reinforces that view. Economic conditions still matter, but they no longer determine credit outcomes on their own. Factors such as demographics, enrollment trends, competition, labor costs, governance, and fiscal management are becoming more decisive, especially in certain sectors.

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Evidence from the K-12 School District sector offers the clearest example so far. Moody's reported that the sector has recorded more downgrades than upgrades for five consecutive quarters. School districts accounted for 68 of the 91 local government downgrades in the second quarter of 2026. Declining school-age populations and greater competition are adding pressure. **K-12 credit quality is not deteriorating everywhere.** Pressures and solutions differ from one district to another. Two districts operating in the same state and under similar economic conditions can follow very different credit paths.

Activity in the Higher Education sector reflects challenges as well. Moody's recorded nine downgrades and one upgrade during the quarter, consistent with our "Negative" outlooks for both Public and Private higher education. Enrollment pressure, changing student preferences, rising costs, and competition continue to separate institutions with financial flexibility, and strong market positions from those with fewer options in the current environment.

And the Healthcare sector is showing signs of pressure supporting our "Cautious" sector outlook. Labor costs, reimbursement pressure, capital needs, and fiscal management are producing increasingly different results across healthcare systems.

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Credit Selection Means Identifying Issuers That Can Adapt

This environment continues to raise the importance of credit selection for investors. Credit selection is the process of identifying issuers with the financial capacity, discipline, operating flexibility, and willingness to adapt as conditions change. The practice of credit selection when investing in municipal bonds requires investors to look beyond sector labels and broad economic forecasts to determine which issuers can recognize pressure early, make difficult adjustments, and preserve and maintain structural balance before circumstances force the issue.

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Entities with strong credit profiles do not avoid challenges. They maintain reserves, preserve flexibility, understand their operating risks, and make adjustments while choices remain available. Entities with weaker credit profiles often wait until reserves decline and financial options narrow. This is the type of circumstance that can lead to rating downgrades.

Moody's second quarter data confirms what we expected entering 2026. The municipal market is moving from broad credit momentum toward greater credit differentiation, where issuer-specific fundamentals can matter more than broad economic tailwinds. The defining question in U.S. public finance is no longer whether conditions are generally improving or deteriorating. It is which issuers and sectors can adapt to changing demographic, economic, policy, and competitive realities, and which cannot, or will not. That distinction is becoming increasingly visible in credit performance and rating actions.

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- Many Public Pensions Look Better, but Credit Risk and Hard Choices Remain, August 11, 2026
- The Digital Front Line Runs Through Public Infrastructure, Recent Attacks on Water Infrastructure in at Least Seven U.S. States, August 7, 2026
- Inflation and Everything Else, Second Half 2026 Municipal Outlook, July 29, 2026
- The Future of Money, Again: The New Rails of Finance Are Already Being Built, July 22, 2026
- Take-aways from the Hilltop Webinar- In the Era of AI: What is Top of Mind for Two Higher Education Leaders, June 26, 2026

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