

U.S. Municipal Bond Market

The Fed Waits as Municipal Bonds Regain Their Defensive Role

Summary

- The Federal Reserve left its target rate unchanged, but continued economic strength and persistent inflation could keep a December increase in play.
- Municipal bonds provided protection during last week's technology selloff, while strong demand, attractive tax-exempt yields, and generally stable credit continue to support the market.

Tom Kozlik
Head of Public Policy and
Municipal Strategy
214.859.9439
tom.kozlik@hilltopsecurities.com

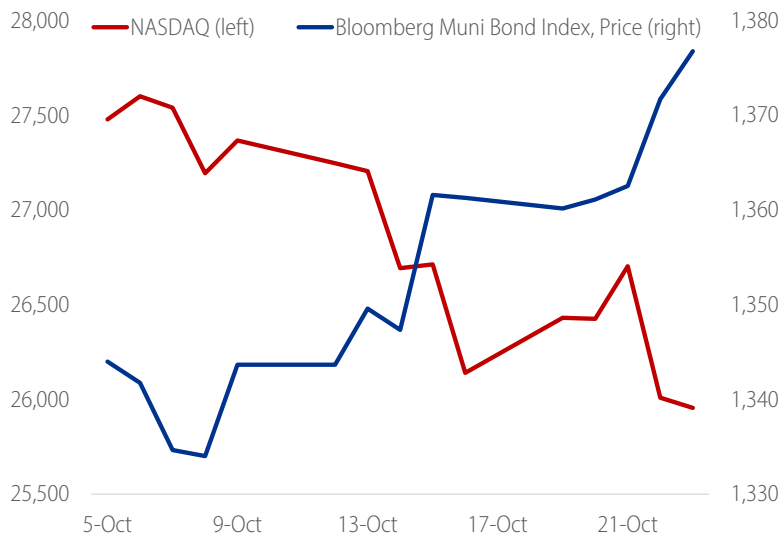
A Flight to Safety Returned Before This Week's Fed Decision

The Federal Open Market Committee left its target interest rate unchanged today, as expected. Attention now turns to the statement, any dissenting votes, and what Chair Kevin Warsh says, or does not say, about December. Chair Warsh has limited the forward guidance markets once relied upon, leaving investors to draw more of their own conclusions from the economic data and the Fed's actions. A quarter-point increase at the Dec. 9 meeting remains possible if growth stays firm and inflation fails to ease. As of early Wednesday afternoon, federal funds futures placed the probability of a December increase near 86%.

Last week provided an important reminder that bonds can still protect portfolios when risk assets weaken. Treasury and municipal yields fell as investors moved toward safety during a technology-led equity selloff. The traditional flight-to-safety relationship has been less reliable in recent months because economic strength, inflation pressure, heavy Treasury issuance, and changing expectations for Federal Reserve policy have sometimes pushed stocks and bonds lower at the same time. Last week, the more familiar relationship returned. Equity investors became more cautious, and bond prices rose in response.

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Municipal Bonds Provided Protection as Technology Shares Fell, Last Week



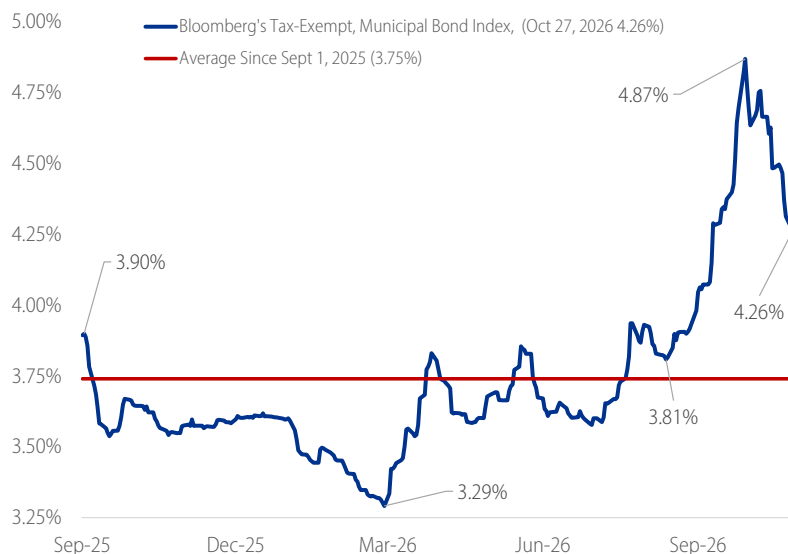
Source: Bloomberg and Hilltop Securities.

Please see disclosure starting on page 4.

Municipal demand has remained strong. Municipal bond mutual funds recorded a third consecutive week of inflows exceeding \$1.1 billion, including \$1.6 billion last week. The yield on the Bloomberg Municipal Bond Index declined by over 60 basis points since reaching 4.87% in late September but still remains attractive at 4.26%. The 10-year AAA Municipal Market Data yield closed Tuesday at 3.46%, while the 30-year yield finished at 4.85%. Investors may have missed the market's recent highest yields, but tax-exempt income remains attractive as demand strengthens and municipals regain some of their defensive value.

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Municipal Yields Retreat but Remain Historically Attractive



Source: Bloomberg and HilltopSecurities.

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Credit Remains Stable, but Selection Still Matters

Municipal credit conditions remain uneven but relatively stable given the economic, political, and geopolitical uncertainty. We have made no broad changes to the HilltopSecurities [sector outlooks published in February](#), although [credit selection remains a priority](#). Investors should continue to examine the revenue structure, cost pressures, financial flexibility, and management decisions supporting individual issues.

The broader economy continues to provide support. The Federal Reserve Bank of Atlanta's [GDPNow model estimated](#) annualized real GDP growth of 3.4% for the third quarter as of Oct. 27. The government's initial reading is expected Thursday but, the estimate suggests that economic activity remained firm heading into the final quarter of the year.

Technology Infrastructure Buildout May Be Creating a Floor for Growth

Last week's pressure on technology shares exposed a concern we have tracked throughout 2026. Investors recognize the potential of artificial intelligence, but they are paying closer attention to the cost of building it and the time required to earn an acceptable return. That concern became [more visible around Meta](#), where questions about AI spending competed with confidence in the company's underlying business.

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The meaningful potential economic forces as it relates to accelerating technology remain considerable. Demis Hassabis, CEO of Google DeepMind, reportedly shortened his estimate for the arrival of artificial general intelligence (AGI) from a 50% chance within five years to two to three years, according to a [Wall Street Journal article published last week](#). Separately, [BofA Global Research estimated](#) that global data-center spending could reach \$1 trillion in 2026 and \$2.1 trillion by 2028. These forecasts are not assurances, but together they point toward faster technological development and sustained demand for hardware, construction, electricity, cooling systems, and supporting infrastructure.

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Mark Zandi, chief economist at Moody's Analytics, [estimates that AI-related activity](#) already accounts for roughly one-third of U.S. economic growth. That represents approximately 0.6 to 0.7 percentage points of an economy growing near 2%. Without that support, Zandi estimates that the rest of the economy would be expanding by only 1% to 1.5%. The AI investment cycle may therefore be placing a meaningful floor beneath economic activity even as other parts of the economy soften.

This creates a more complicated interest-rate outlook than last week's bond rally might suggest. A flight to safety can push yields lower when equity markets come under pressure. At the same time, sustained AI and data-center investment will compete for capital, labor, electricity, equipment, and construction capacity. If that spending keeps economic growth near or above 2%, inflation and interest rates may remain higher than investors became accustomed to during the low-rate period.

Municipal bonds can benefit from defensive demand without entering an uninterrupted period of falling interest rates.

Geopolitical uncertainty and the approaching midterm elections provide additional sources of volatility. Affordability, federal deficits, and tax policy will remain important issues for municipal investors. None of these forces means that yields must move in one direction. Municipal bonds can benefit from defensive demand without entering an uninterrupted period of falling interest rates.

Recent HilltopSecurities Municipal Commentary

- [The Municipal Bond Tax-Exemption Finances America's Public Infrastructure](#), October 9, 2026
- [Modernization Meets the Limits of Public-Sector Capacity, Results of 2026 HTS Public Finance Leaders Survey](#), October 7, 2026
- [A Stronger-Than-Expected Economy Is Offering Less Support to the Public Sector, While Municipal Yields and Relative Value Remain Very Attractive](#), October 5
- [The Municipal Opportunity Strengthens as Yields and Relative Value Rise](#), September 28, 2026
- [The Return of Higher Yields Rewards Investors and Tests Borrowers](#), September 21, 2026

Readers may view all of the HilltopSecurities Municipal Commentary [here](#).

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