2Q 2024

Municipal Basis Points

MUNICIPAL FIXED INCOME TEAM

Tailwinds for Municipal Investors

- Now could be a good time to capitalize on higher yields and secure them for longer.
- Although the timing is uncertain, the Fed's next move on rates will likely be downward.
- Springtime municipal supply/demand dynamics may offer opportunities before technicals improve in summer.
- Lower-rated segments provide opportunity for yield pickup via security selection.

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PRIVATE WEALTH

Macro and Markets

Generous tax-free yields, sturdy fundamentals and the eventual easing of interest rates favor municipal bonds.

After a furious rally in the last two months of 2023, interest rates and municipal bonds took a bit of a breather in the first quarter of 2024. The primary driver for the year-end rally was the Federal Reserve's communication to the market that three rate cuts should be coming in 2024, and the market starting to expect even more. As the first quarter played out, economic data in the U.S. generally surprised to the upside, and inflation readings proved a little stickier than expected. This caused the market to dial back rate-cut expectations and move more in line with the Fed's projection of three 25-basis-point rate cuts in 2024. As a result, Treasury rates rose along with municipal yields.

The first three months of the year saw total tax-exempt new issuance of $94 billion, or almost 50% higher than a year earlier and the highest first-quarter total since 2007—although you wouldn't know it given how easily the additional supply was absorbed by the market. Despite the market's reducing its expectations for Fed rate cuts, investors still believe the central bank is done raising rates, and that its next move will be to lower them. That has inspired confidence to move out of cash and to start deploying funds into longer-dated fixed-rate bonds. In addition, technicals were quite favorable in the first quarter, as fund flows were generally positive and the size of the tax-exempt market actually decreased.

Despite fuller valuations, we entered this year with a constructive long-term view of the municipal market. Muni yields are much higher than they were two years ago, and we believe that even when the Fed starts lowering rates, it won't be going back to zero-rate policy any time soon. In our view, now is a good time to start taking advantage of higher yields and securing them for a longer period. With AAA municipal yields higher by about 30 basis points year-to-date through March, we like the market even more. We think the first two months of the second quarter may create additional pockets of weakness, as supply is generally expected to exceed the amount of maturities and bond calls in April and May. As a result, we anticipate a favorable backdrop to put money to work prior to technicals likely improving during summer.

Strategy and Outlook

Eventual rate reductions and supply/demand dynamics could help municipal investors heading into summer, with security selection providing an advantage in A-rated bonds.

Rate cuts will be the next Fed move. At its March meeting, the Federal Reserve reiterated its intention of carefully starting rate reductions later this year, although the number of cuts is uncertain. The Fed noted that the employment sector continues to perform well, but that inflation is still affecting many American households significantly. Despite these concerns, financial markets are anticipating two reductions across the six remaining meetings scheduled for 2024.

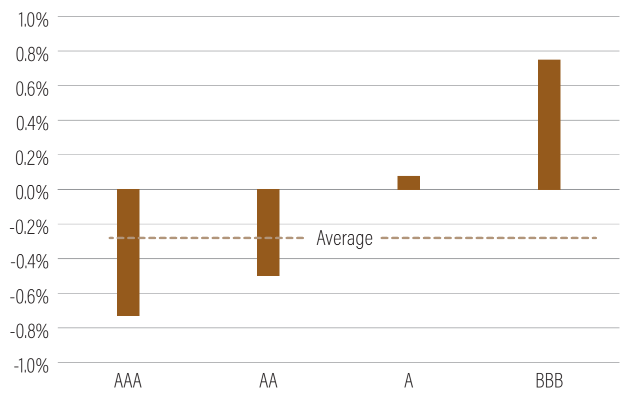
Balance of supply and demand. So far this year, the municipal market has experienced an increase in rates, tracking the rise in U.S. Treasury yields. Currently, we consider AAA-rated municipal bonds to be overvalued relative to U.S. Treasuries, with investor demand staying robust and the supply of new issues at a manageable level.

Security selection will likely be key. We believe that choosing the right securities will likely play a crucial role in achieving strong performance this year, especially in the A and BBB rating categories. As part of our approach, we seek to capitalize on deep fundamental research to find bonds that offer higher yields while maintaining strong credit quality.

Seasonal and price benefits. Looking ahead, the summer months have historically seen an improvement in the performance of municipal bonds. This positive trend is often attributed to a combination of fewer new issues coming to market and investors reinvesting the funds they receive from coupon payments and bond maturities. This creates an imbalance between supply and demand, with distributed cash likely to surpass the volume of new issuance by a substantial margin. If coupled with a cut in interest rates, this dynamic could benefit investors in long-term municipal bonds relative to those who remain in cash or cash equivalents.

LOWER-RATED MUNICIPALS LED IN THE FIRST QUARTER

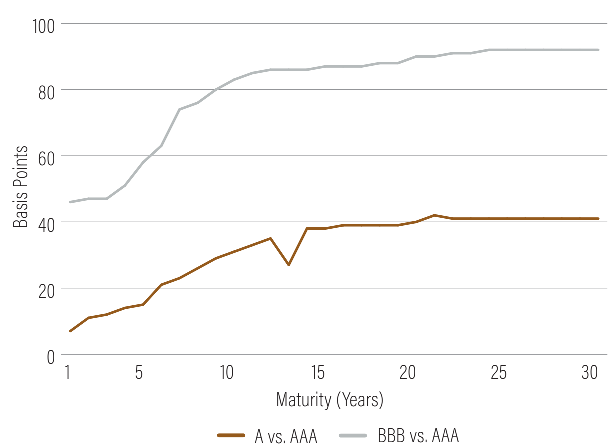
Municipal Returns by Credit Rating, 1Q 2024



Source: Bloomberg, as of March 31, 2024. Reflects performance of the Bloomberg Barclays Municipal Bond Index by credit rating.

YIELDS IN A AND BBB RANGE MAY BOOST REWARDS OF SECURITY SELECTION

Spread Over AAA Bonds



Source: MMD, as of March 31, 2024.

Deeper Dive

Utility districts are providing fertile ground for fundamentals-driven credit research.

Our municipal research group seeks investment opportunities that capitalize on growth trends across the country. One area we continue to target is land development in high-growth states that are benefiting from improving demographic and economic trends. Texas, in particular, has provided multiple investment opportunities that capitalize on land development and property growth.

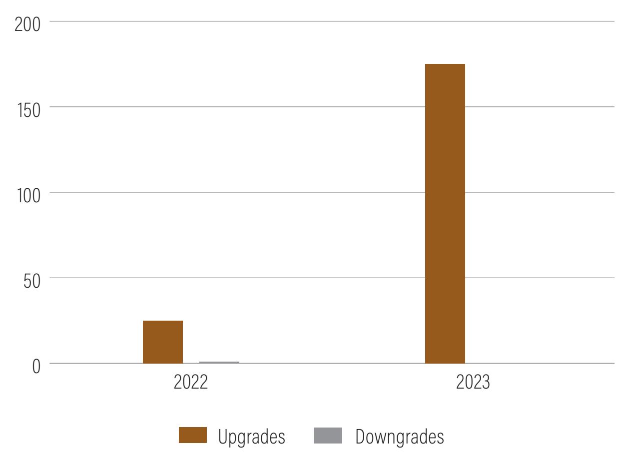
In Texas, land development is often financed through debt issuance from special municipal utility districts, whose purpose is to finance important utility and infrastructure functions. Subsequent to private capital investment from landowners, developers and builders, these special districts can finance the construction of public water, wastewater, drainage, parks, roads and firefighting facilities that may serve residential, commercial and/or industrial uses. The tax-exempt bonds that finance these improvements are repaid using ad valorem taxes levied on property within the district, providing a consistent source of revenue as assessed values increase. In our view, positive economic trends across Texas have had a positive impact on the credit fundamentals of these investments.

Broadly speaking, utility districts mirror the larger municipal market with credit profiles ranging from nascent to mature. While Texas and several of its cities have been growing rapidly, much of that expansion is dependent on successful land development within the districts. With the state's population growth of 4.5% between 2018 and 2022 (and 43.5% from 2000), this development method has provided many of the homes, roads and parks enjoyed by residents. As the display at right indicates, credit upgrades have significantly outpaced downgrades in recent years, reflecting improving quality across this segment.

Given the idiosyncratic nature of the overall municipal market, we are continually finding significant pockets like these special districts that are enjoying continued stability and growth, with sound underlying credit metrics, offering what we consider significant value to investors.

THE UPGRADE STATE

Texas Utility District Rating Upgrades/Downgrades by Year



Source: Standard & Poor's Financial Services LLC.

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