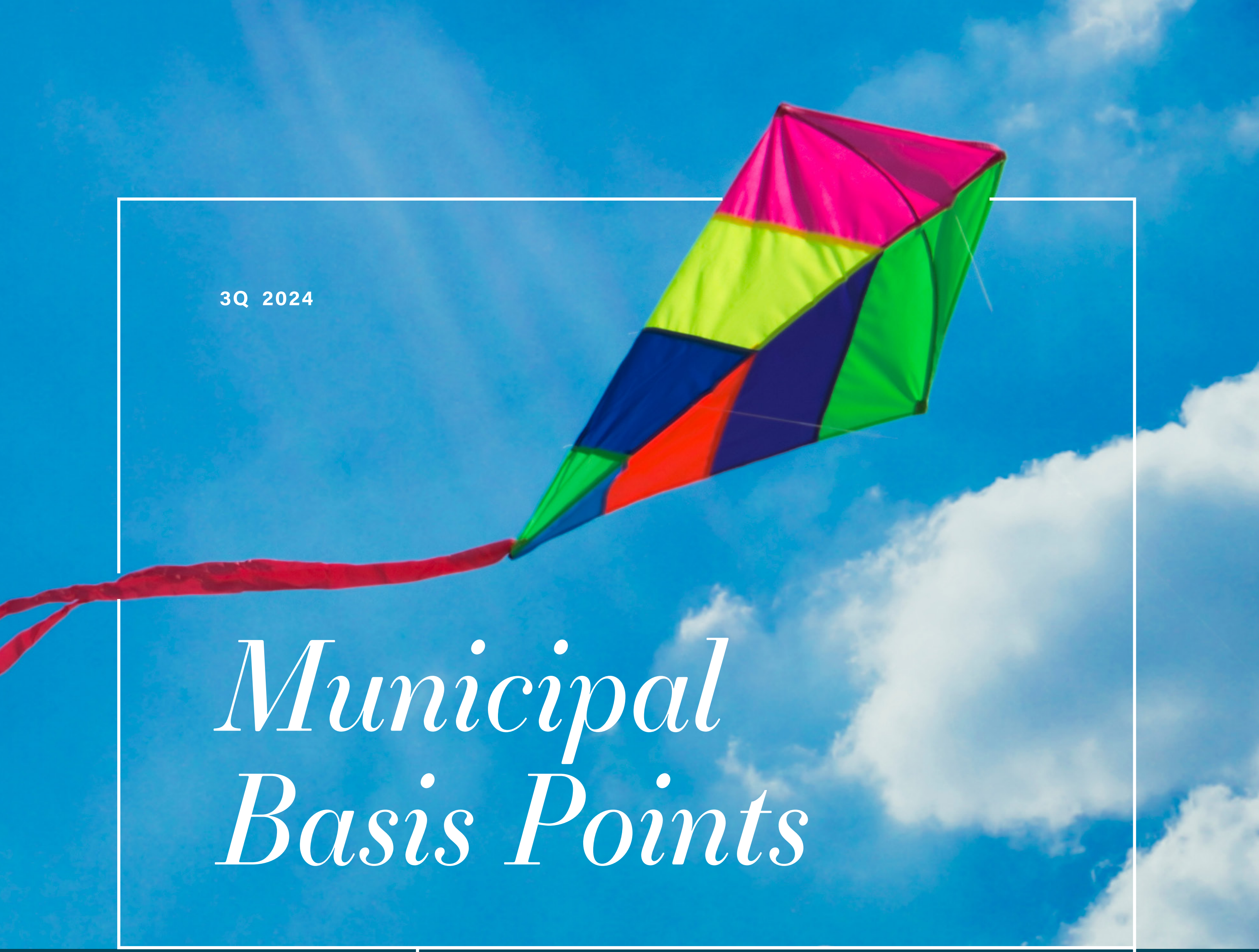


3Q 2024

Municipal Basis Points

MUNICIPAL FIXED INCOME TEAM

Tailwind From Rates and Supply?

- After a rise in municipal bond yields for much of the second quarter,[1] we now see a buying opportunity in the sector.
- Seasonal dynamics and the Federal Reserve's potential rate cuts could prove supportive as the year progresses, although market volatility is likely.
- We favor moving out on the maturity spectrum and emphasizing security selection, particularly in A and BBB rated bonds.

NB

PRIVATE WEALTH

Macro and Markets

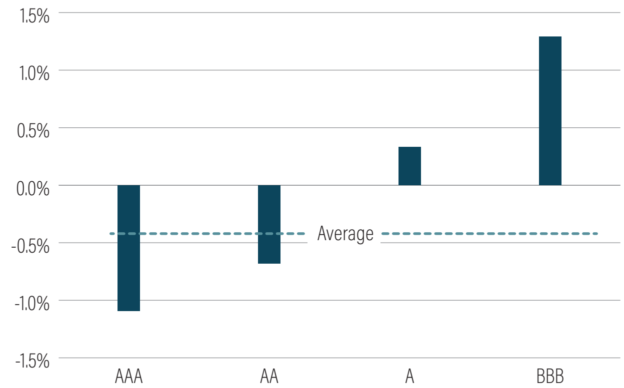
Shifting monetary policy, high yields and potential supply dynamics provide appeal, but the U.S. election could make things turbulent.

The market weakness that emerged in the first quarter of 2024 continued in April and May as market participants focused on stronger economic data and higher-than-expected inflation readings. As a result, U.S. Treasury rates continued to drift higher along with those of municipal bonds. An added pressure point for munis was continued heavy supply, highlighted by issuance in May that was 80% higher than a year ago. This caused municipal valuations to cheapen relative to Treasuries and, thus, underperform their taxable counterparts. However, economic data released in June began to show signs of a moderating economy, while inflation readings came in a bit cooler, which was likely a relief to Federal Reserve officials. Treasury rates ended the quarter with a rally in June and municipals followed suit. Higher absolute yields, cheaper valuations relative to Treasuries, and heavy seasonal reinvestment all helped to drive demand for munis.

With cheaper valuations and AAA yields across the curve that are now roughly 45 basis points higher so far this year,[2] we maintain a constructive long-term view of the municipal bond market. Intermediate investment grade munis ended the quarter yielding roughly 3.4%, which is a taxable-equivalent yield of around 5.74%, assuming a 40.8%[3] federal tax rate. Generous yields also serve as a cushion for investors during periods when rates are rising. This has been the case so far this year, as municipal total returns as represented by the Bloomberg Barclays Municipal Bond Index are essentially flat. We expect volatility to remain elevated during the summer and into the fall as investors pore over economic releases and react to developments in the U.S. presidential election. While the timing of the next move by the Fed continues to prompt debate, the strong consensus view is that it will be to lower rates. As investors become more convinced of an imminent decline, we believe cash will likely flow into longer-dated fixed income assets. In our view, a high-quality profile and attractive yields make the municipal market a compelling place for investors to be, in light of potential volatility in the months and quarters ahead.

ECONOMIC RESILIENCE AND ELEVATED SUPPLY HAVE BEEN HEADWINDS FOR MUNIS

Municipal Bond Returns by Segment, Year-to-Date



Source: Bloomberg, as of June 30, 2024. Bloomberg Barclays Municipal Bond Index.

[1] Source: Bloomberg, refers to AAA municipals.

[2] Source: Bloomberg.

[3] Consists of a federal income tax rate of 37% and 3.8% ACA tax on investment income. State taxes not included.

Strategy and Outlook

Cheap valuations could make municipal investors' hearts grow fonder.

Fair value, demand support. Over the course of this year, the municipal market has seen a rise in rates, driven by an increase in U.S. Treasury yields and a surge in new issue supply during the spring. At present, we believe AAA and AA rated municipal bonds are fairly valued relative to U.S. Treasuries, with strong investor demand persisting despite the new issuance.

Moving longer. In June, the Federal Reserve reaffirmed its intention to initiate rate cuts cautiously when appropriate, suggesting a potential tailwind for fixed income, particularly as it relates to intermediate to longer bonds. Since April, we have favored tactically extending maturities given current conditions.

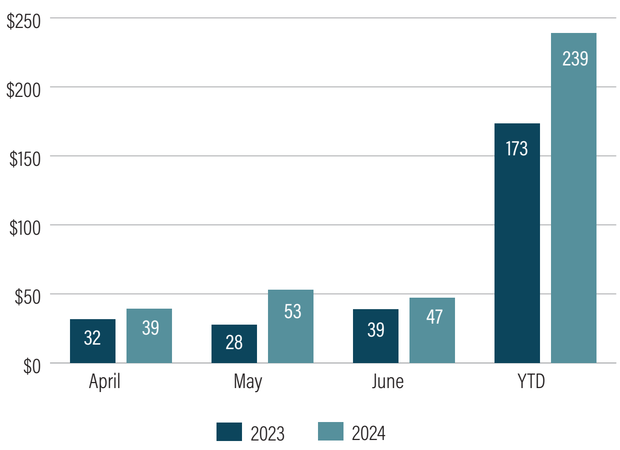
Selection is key. We believe that meticulous security selection will be critical to achieving robust performance this year, particularly within the A and BBB rating categories. Our portfolio management team leverages the expertise of our municipal research team to carefully select bonds that provide higher yields while maintaining strong credit quality.

Summertime technicals. Historically, the summer months have witnessed improved performance by municipal bonds, often driven by fewer new issues coming to market and investors reinvesting funds received from coupon payments and bond maturities. An anticipated imbalance between demand and supply is expected, with the cash returned to investors likely to exceed the volume of new issuances.

Should this favorable dynamic coincide with a reduction in interest rates, individuals now investing in long-term municipal bonds have the potential to experience gains and outperform those opting to keep their assets in cash or cash equivalents.

SUPPLY HAS BEEN ROBUST, BUT MAY EASE

$ Billions



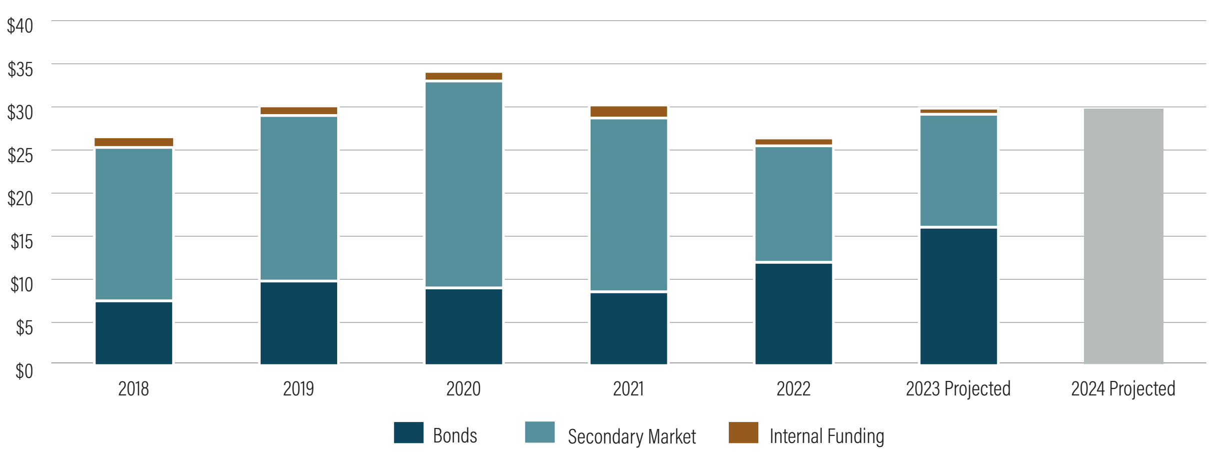
Source: Bloomberg, data through June 30, 2024.

Challenges in the housing market have recently garnered media attention in light of high interest rates, affordability and supply concerns. Still, while the conventional housing market has faced headwinds, we believe the state housing finance agency (HFA) sector retains sound credit quality and continues to provide attractive opportunities to capture yield.

State HFAs exist to provide affordable housing for those with low to medium incomes through access to the low-cost municipal market. With high home prices and elevated mortgage rates presenting a challenge for homebuyers, the demand for affordable housing has surged. HFAs have been able to capture market share by offering lower mortgage rates and other incentives such as downpayment assistance. Higher mortgage revenue from increased affordable home loan bond issuances in 2022 and 2023, elevated investment earnings supported by "higher-for-longer" interest rates, and increasingly de-risked portfolios through federal loan enhancements have helped state HFAs continue to exhibit strong investment-grade credit characteristics and, in our view, sound opportunities for investors to add yield.

HFA ISSUANCE IS BOOMING, BUT SECONDARY VOLUME HAS RECEDED

$ Billions



Source: Moody's Investors Service.

High conventional mortgage rates have made HFAs' low-interest-rate loans and downpayment assistance more attractive, allowing them to increase market share. This advantage has accelerated as interest rates have inched higher and the spread between conventional rates and HFA rates has widened. Increased demand for affordable housing is reflected in the roughly 40% and 34% growth in single-family home loan primary bond issuances in 2022 and 2023, respectively. We expect this growth to moderate but remain strong in 2024. Increasing market share should lead to higher HFA mortgage revenues, likely continuing over the life of the loans. Furthermore, HFAs' profitability should also be bolstered by increasing investment income from holdings in short-term investments that benefit from the high-interest-rate environment. This overall increasing revenue outlook bolsters the sector's credit profile.

While demand characteristics continue to support HFAs, another primary credit strength comes from an increasing concentration of loan enhancements within the portfolios. Many HFAs have materially increased their holdings of government-insured loans and mortgage-backed securities (MBS), making them more resilient against delinquencies as the risk in such investments is carried by highly rated government entities. This has materially improved HFA credit quality in recent years.

That said, HFAs assume full delinquency and repayment risk for most of their holdings. So, it's important to note that as home prices have increased, homeowners have maintained substantial home equity, reducing delinquency rates to post-pandemic lows, and drastically mitigating HFAs' risk from whole loans. In our view, HFAs remain in a strong position to capitalize on the current market as the demand for affordable housing continues to increase. This robust demand profile, coupled with the strong and improving financial conditions of the agencies, are supportive of our constructive opinion of the sector.

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