Building Better Outcomes

As Municipal Bonds Remain an Attractive Diversifier, Counteract Absolute Low Rates with Active Management

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New York – We go into 2022 knowing how hard it will be to surpass the outstanding returns investors saw in 2021, when municipal bonds outperformed every other fixed income asset class on a relative value basis. Among the obstacles investors will face are absolute low rates, richer valuations and the probability of some rate volatility in U.S. Treasurys.

Demand and supply drive municipal markets

Demand was a primary factor in muni bond outperformance in 2021, as the market witnessed the highest inflows on record going back to 1992. We anticipate that investor demand for the favorable tax treatment will continue to influence the asset class. While muni supply far exceeded expectations in 2021, it was nowhere near enough to satiate such record demand in the market.

With the recently passed infrastructure bill no longer including any components that would have impacted muni issuance, we believe that supply will take a backseat to demand in driving muni performance in 2022. One caveat is that those muni provisions may reappear in the Build Back Better Act, but we put the probability of that as fairly low.

Fed policy pivots to tackle inflation

The Federal Reserve has made a drastic pivot of late, acknowledging that a faster taper will be needed — and rate hikes possibly earlier than expected. This comes primarily from the U.S. economy experiencing the fastest pace of inflation since 1982, along with a quicker recovery in the labor markets. Uncertainty remains around the new COVID variant, and whether the Fed will help to prolong this economic recovery or stall it too soon.

We expect that the U.S. Treasury market will continue to adjust and price in different scenarios, leading to a more volatile rate environment than most investors are used to. Any sharp increase in rates has typically resulted in significant outflows from the municipal market, which is primarily owned by retail investors.

Credit fundamentals for municipal issuers remain solid

On the credit side, fundamentals are robust heading into the new year. States have been doing well, with revenues through September 2021 up about 17% on average versus 2020. Over the past 18 months, a total of $1.2 trillion of federal aid has gone to state and other municipal issuers, who will likely see more in the form of funding or grants from the infrastructure bill.

Defaults are down 25% in 2021 versus 2020, and the upgrade to downgrade ratio has averaged about two to one for muni issuers. A few sectors still face with long-term concerns, and individual issuers may not have fared as well during the pandemic, so we maintain our emphasis on professional credit oversight.

Muni bonds play a valuable role for taxable investors

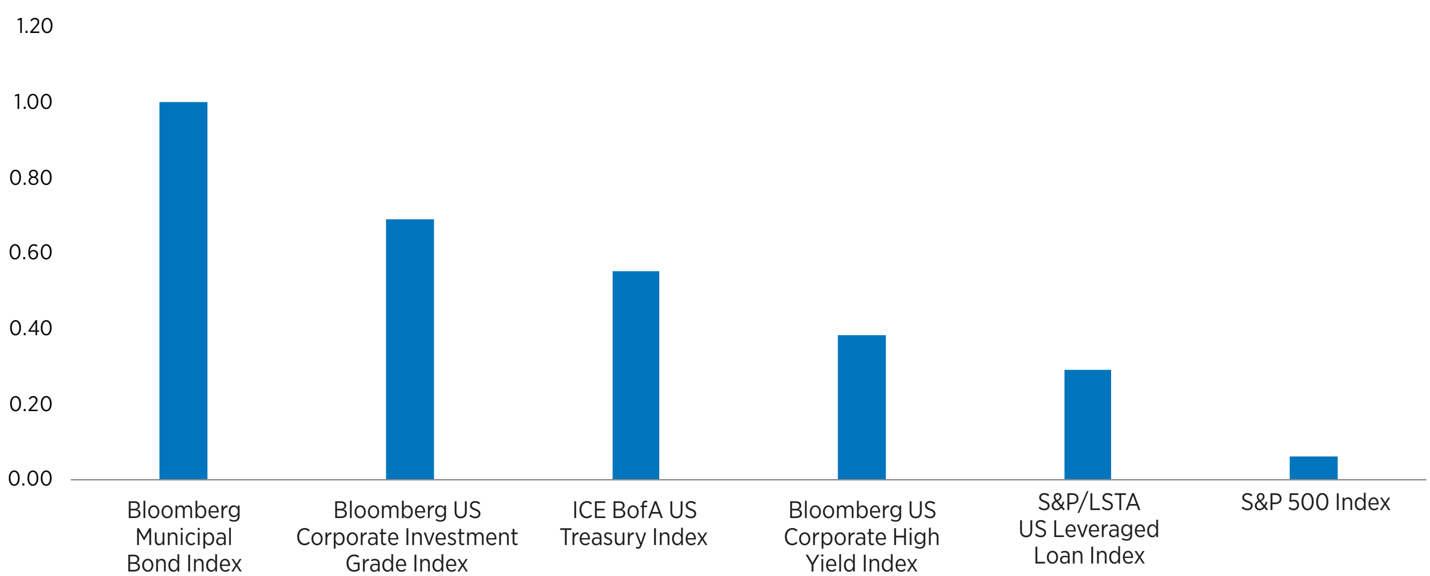
With equity markets continuing to reach new records, we would remind investors of the valuable role that municipal bonds can play as a diversifier — especially for individuals in high tax brackets. Munis have historically exhibited less volatility than other asset classes and low-to-negative correlations to equity and the equity-like risk found in certain fixed income sectors.

While the return upside may be mitigated by absolute low rates, there are other ways to enhance and protect a municipal portfolio. In a rising rate environment, tax loss harvesting[1] can create opportunities to reduce an investor's tax payments by harvesting losses throughout the year in a systematic way. In addition, the fragmented nature of the muni market and the heavy influence of retail investors tend to result in inefficiencies that may be exploited to achieve additional return through active management and relative value trading. For investors with long investment horizons, we would argue against dramatically shortening up at this time.

Bottom line: With the market consensus potentially shifting toward a correction as the Fed looks to tighten, municipal bonds may continue to act as a good portfolio diversifier. In our view, municipal bonds remain attractive — particularly for high tax bracket investors. Any weakness in the muni market throughout 2022 could serve as an entry point for added exposure to the asset class.

Exhibit A

Historical correlation of municipals to other asset classes over a 10-year time period



Source: Morningstar monthly data from December 2011 to November 2021.

[1] Tax-loss harvesting is a strategy for managing taxes in an investment portfolio. Selling a security that is trading at a loss creates a realized tax loss, which can be used to offset a capital gain realized in the same year.

Definitions

Bloomberg Municipal Bond Index covers the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and pre-refunded bonds.

Bloomberg U.S. Corporate Investment Grade Index is an unmanaged index that measures the performance of investment-grade corporate securities within the Barclays U.S. Aggregate Index.

ICE BofA U.S. Treasury Index measures public debt instruments issued by the U.S. Treasury.

Bloomberg U.S. Corporate High Yield Index is an unmanaged index of non-Investment Grade bonds traded in the U.S.

S&P/LSTA Leveraged Loan Index is an unmanaged index of the institutional leveraged loan market.

S&P 500 Index is an unmanaged index of large-cap stocks commonly used as a measure of U.S. stock market performance.

Risk Considerations

Investing entails risks and there can be no assurance that any strategy will achieve profits or avoid incurring losses.

Municipal Bonds – An imbalance in supply and demand in the municipal market may result in valuation uncertainties and greater volatility, less liquidity, widening credit spreads and a lack of price transparency in the market. There generally is limited public information about municipal issuers. Investments in income securities may be affected by changes in the creditworthiness of the issuer and are subject to the risk of non-payment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. As interest rates rise, the value of certain income investments is likely to decline. Investments involving higher risk do not necessarily mean higher return potential. Diversification cannot ensure a profit or eliminate the risk of loss. Debt securities are subject to risks that the issuer will not meet its payment obligations. Low rated or equivalent unrated debt securities of the type in which a strategy will invest generally offer a higher return than higher rated debt securities, but also are subject to greater risks that the issuer will default. Unrated bonds are generally regarded as being speculative.

Important Information

Date-of Data: December 27, 2021.

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