Building Better Outcomes

Stay Active to Capitalize on Municipal Bond Opportunities

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"In the face of expected increases in tax rates, likely rate hikes from the U.S. Federal Reserve and continued uncertainty around COVID-19 and broader market volatility, we believe that municipal bonds should remain an important and diversified component of a suitable investor's portfolio."

Boston – Heading into 2022, investors in municipal bonds may be questioning how to prepare for another year of uncertainty:

- After a record-breaking year for municipal mutual fund inflows, what might keep the flows going in 2022?
- Could recent infrastructure legislation — already passed and still under negotiation — raise muni issuance?
- How would potential changes to SALT,[1] BABs,[2] pre-refunding[3] and tax rates impact the muni landscape?
- What are yield-seeking muni investors to do when high yield spreads are so tight?

Recognizing what we know now, and what we don't know yet, we aim here to provide some viewpoints.

Municipal mutual fund flows have big shoes to fill in 2022

We saw record flows into muni mutual funds in 2021. LIPPER reports that through November 24, $96.1 billion went into muni funds — the largest amount on record since data tracking started in 1992. The appetite for tax-exempt yield, the threat of higher taxes on the horizon and the unprecedented stimulus from the Federal Government have all fueled the strong demand from investors.

We anticipate that inflows could continue into the new year as:

- Tax rates — both personal and a potential new "surcharge" — are expected to move higher, making the tax-exempt nature of the asset class even more appealing.
- Tax-exempt pre-refundings have so far been left off the table as part of any Infrastructure package, which could decrease the amount of new supply.

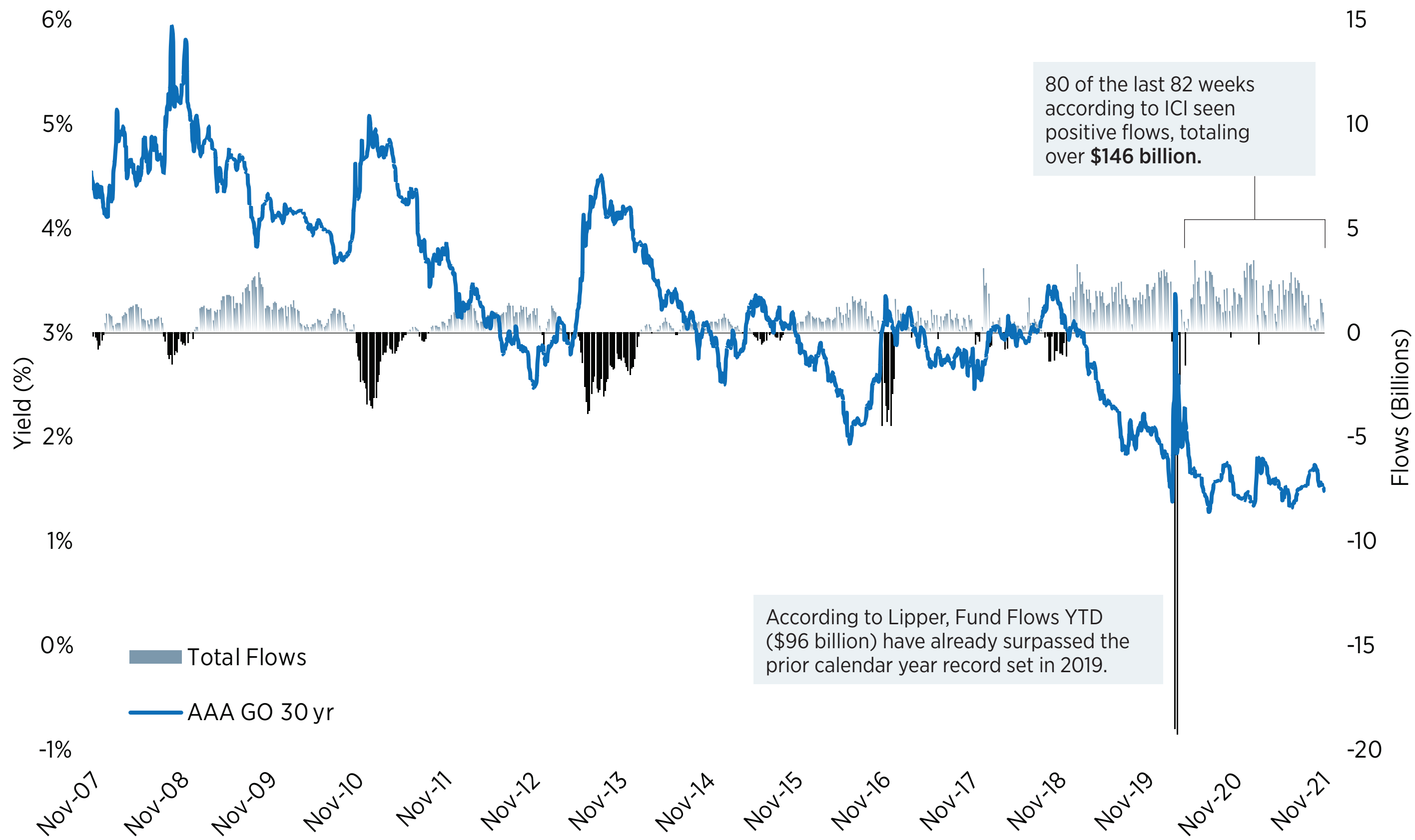
[1] Eliminating the $10,000 cap on the state and local tax (SALT) deduction could shift demand in high-tax states from in-state municipal issues to portfolios that are more diversified across the U.S.

[2] Reviving a permanent government subsidy — similar to Build America Bonds (BABs) created by the Obama/Biden administration back in 2009 — could help the taxable muni market grow. That temporary program was responsible for $181 billion in taxable muni issuance before expiring in December 2010.

[3] Allowing issuers to again refinance tax-exempt muni bonds with tax-exempt munis would likely increase tax-exempt supply relative to taxable issuance.

Exhibit A

Municipal flows and yield changes



Source: Thomson Reuters Municipal Market Data. Date Range: Nov 2007-Nov 2021. Flow data provided by ICI.

On the other hand, inflows could slow because of:

- **Yield fatigue.** Rates are low across all fixed income markets, and valuations are generally stretched. Will investors refuse to put new money to work for such low yields?
- **COVID resurgence.** Countries all over the world are implementing renewed lockdowns in response to the Omicron variant.
- **Federal Reserve misstep.** Inflation turning out be more permanent than transitory could widen credit spreads and cause investors to switch from inflows to outflows in the face of uncertainty.

While many outcomes are possible in 2022, we will keep an eye on investor demand for munis at these levels, along with potential tax changes and whether muni yields follow Treasury rates higher.

COVID stimulus and infrastructure funding have boosted municipal coffers

State and local governments became flush with cash after funds were disseminated from the March 2020 CARES Act, December 2020 COVID Relief Bill and the March 2021 American Rescue Plan. More recently, the November 2021 Infrastructure Investment and Jobs Act (IIJA) approved significant funding for much needed projects:

Exhibit B

Overview of legislation and municipal related spending in relief bills

	Infrastructure Investment and Jobs Act (Nov. 2021)	American Rescue Plan (Mar 2021)	COVID Relief Bill (Dec. 2020)	CARES Act (Mar. 2020)
Total Muni Market Support	**$550 million**	**$650 million**	**$157 million**	**$347 million**
States	$136	$408	$30	$169
Locals	--	$182	$30	$164
Community based orgs.	--	--	--	$1
Not for Profits	--	$0.8	$15	--
Healthcare	--	$13	$4	$108
Primary/Sec Education	--	$137	$58	$25
Higher education	--	$40	$26	$17
Airports/Ports	$42	$11	$2	$10
Surface transit	$110	--	$10	--
Mass transit	$39	$30	$14	$25
Other Transportation	$78	$2	$2	--
Housing	--	$39	$25	--
Utilities	$143	--	--	--

Source: U.S. Congress, J.P. Morgan. Note: Sum of individual sector amounts may not add up to aggregate total due to double counting, as much of the capital is shared across sectors.

With room for infrastructure improvement across the U.S., we think the IIJA is a strong step forward in helping to alleviate many of the most serious problems. Municipalities will likely be eager to put the money to work, albeit spread out over multiple years. We expect that will play for some time to come — especially if negotiations around expenditures and revenues in the budget reconciliation bill can be resolved, which would allow the passage of the Build Back Better (BBB) legislation to come in early 2022.

Opportunities and risks in the year ahead

Again, valuations in the muni market are mostly stretched, so we think investors would be better served by staying defensive on duration and credit. We still see potential opportunity in sectors that show wider spreads, such as hospitals and transportation. But generally speaking, taking a defensive stance is our view for 2022.

Taxable munis have been a major theme over the past couple of years and could once again prove to add value in portfolios as:

- Taxable equivalent yields on tax-exempt munis are below taxable yields on several parts of the yield curve.
- If tax rates rise, corporations and insurance companies could be buyers of taxable munis once again.
- Build America Bonds 2.0 have been left out of infrastructure negotiations so far, but as long as rates remain low, municipalities should continue to use taxable muni issuance for putting program funding to work.

Bottom line: We are cautiously optimistic on munis in 2022. Staying active and ready to capitalize on any market dislocations or opportunities could be vital in the months ahead. We appreciate that the rate environment is challenging. But in the face of expected increases in tax rates, likely rate hikes from the U.S. Federal Reserve and continued uncertainty around COVID-19 and broader market volatility, we believe that municipal bonds should remain an important and diversified component of a suitable investor's portfolio.

Risk Considerations

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

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Date-of Data: December 27, 2021

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