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Municipal Market Update
As Muni Yields Take Flight, Investors Take Notice

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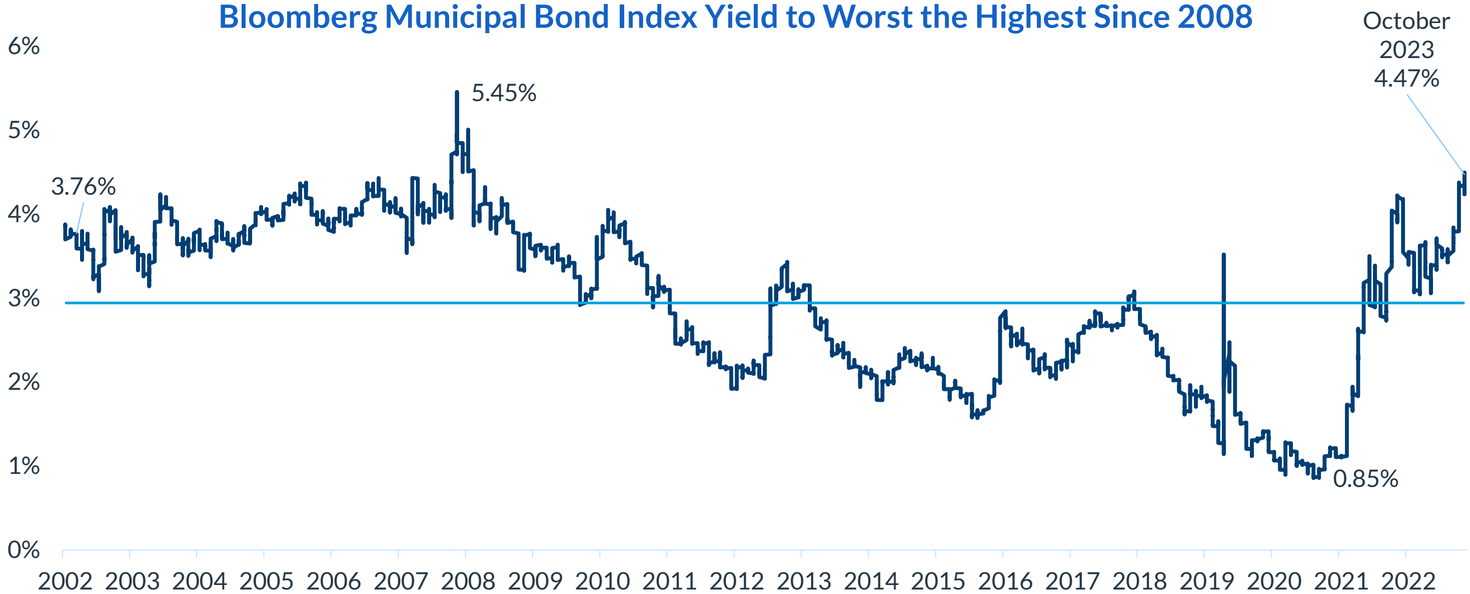
Fixed income markets have confronted formidable challenges over the past 18 months. With year-end 2023 in sight, should current performance trends persist, municipals will be handed their first back-to-back annual losses since the early 1980s. However, as prices decline, yields rise, which offers investors with a longer-term horizon an opportunity to lock in higher levels of tax-efficient income while positioning their portfolios for more favorable forward-return potential.

Here, we discuss several key themes to rationalize our view that municipal bonds deserve consideration within the framework of an overall asset allocation strategy, particularly for investors seeking diversification, capital preservation, and a predictable cash flow stream.

Absolute Yields Reach Hard-to-Ignore Levels

Since March 2022, the Fed has increased its overnight lending rate by more than 500 bps to combat accelerating inflation within an economy showing remarkable resiliency. The upward shift in the curve has resulted in US Treasury rates rising, with municipal bonds following suit. The yield-to-worst (YTW) of the Bloomberg Municipal Bond Index at the end of October was approximately 4.5%, the highest available yield since 2008 (the Great Financial Crisis). As recently as June 2021, the YTW of the index touched 85 bps, or 0.85%. The increased income potential is significant, with index yields up at least 350 bps over the past two years.

Bloomberg Municipal Bond Index Yield to Worst the Highest Since 2008



Source: Bloomberg Municipal Bond Index, as of October 31, 2023. Information is subject to change and is not a guarantee of future results.

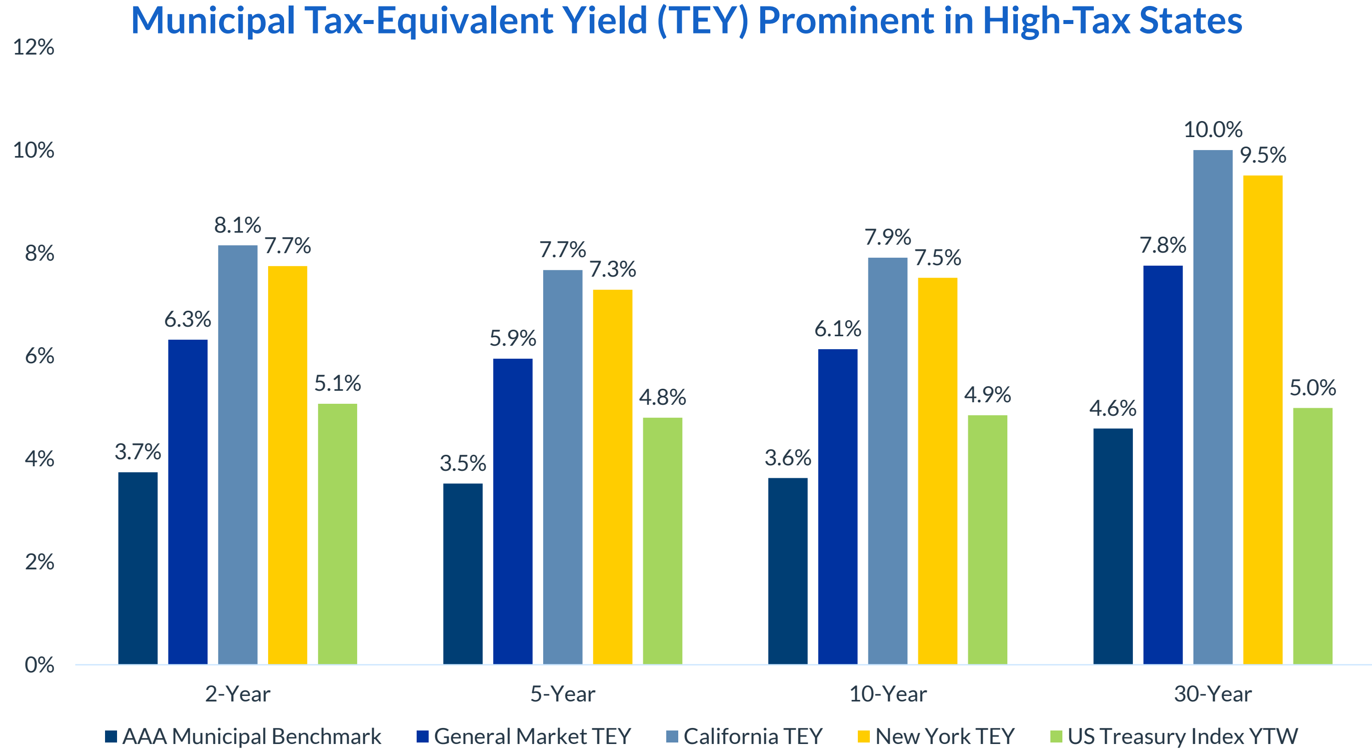
The Value of Muni Tax Exemption Is Compelling

As absolute yields rise, so does the value of the tax exemption for municipal investors. Most municipal bonds' interest income is exempt from federal taxes. Investors seeking to optimize their tax efficiency should consider municipal bonds as an investment option. The elevated levels of absolute yields translate into attractive taxable equivalent yields (TEY). The TEY levels the playing field when an investor compares a taxable and tax-exempt bond. If the yield on a taxable bond is less than the equivalent tax-adjusted municipal bond, the municipal bond provides more value. The TEY of the 4.5% YTW of the Bloomberg Municipal Bond Index is 7.6% based on a 37% top marginal Fed rate plus a 3.8% Medicare surcharge tax. The TEY could be greater depending on the credit quality, maturity, and security structure. For those investors domiciled in high-tax states, like California or New York, the tax benefits become more impactful when combined with the exemption of owning in-state municipal bonds. Nevertheless, the index TEY is currently out-yielding what an investor could earn from US investment grade corporates, the US Aggregate Index, and US Treasuries (as of October month-end).

Valuations Improving, Opening an Entry Point

A standard metric that the market uses to gauge the attractiveness of municipal bonds is the relationship between the yields of AAA municipals and comparable maturity US Treasuries. The higher the ratio percentage, the better the relative value buying opportunity of municipal bonds (all else equal). In market terminology, "cheap" or "rich" often accompany the municipal/Treasury ratio. Different market factors influence the yields of the asset classes, such as supply and demand, but trends within the relationship can signal advantageous entry points. As the municipal yield approaches the yield on a comparable Treasury (i.e., becoming cheap to Treasuries), it means that municipal investors are gaining more of the tax benefit

Municipal Tax-Equivalent Yield (TEY) Prominent in High-Tax States



Sources: Bloomberg BVAL AAA Callable Curve, US Treasury Actives Curve, as of October 31, 2023.
Taxable equivalent yields assume the following taxes: General Market: 37% Federal and 3.8% Medicare surcharge.
California: 37% Federal, 13.3% State and 3.8% Medicare surcharge, NY: 37% Federal, 10.9% State and 3.8% Medicare surcharge. Information is subject to change and is not a guarantee of future results.

of owning municipal bonds. In 2021, the 5, 10, and 30-year municipal/Treasury ratios reached their historic lows at 37%, 53%, and 67%, respectively. Fast-forward to today (October month-end), those ratios reached 74%, 75%, and 92%, respectively, with consistent improvement over the past few months. While current ratios are below their long-run averages, the rise from the expensive ratios of 2021 and current absolute yields make a case for a solid buying opportunity to put cash to work and lock in tax-efficient cash flows. When evaluating ratios of A and AA-rated municipal bonds vs. comparable corporate securities, the trends support incremental value in owning municipal bonds.

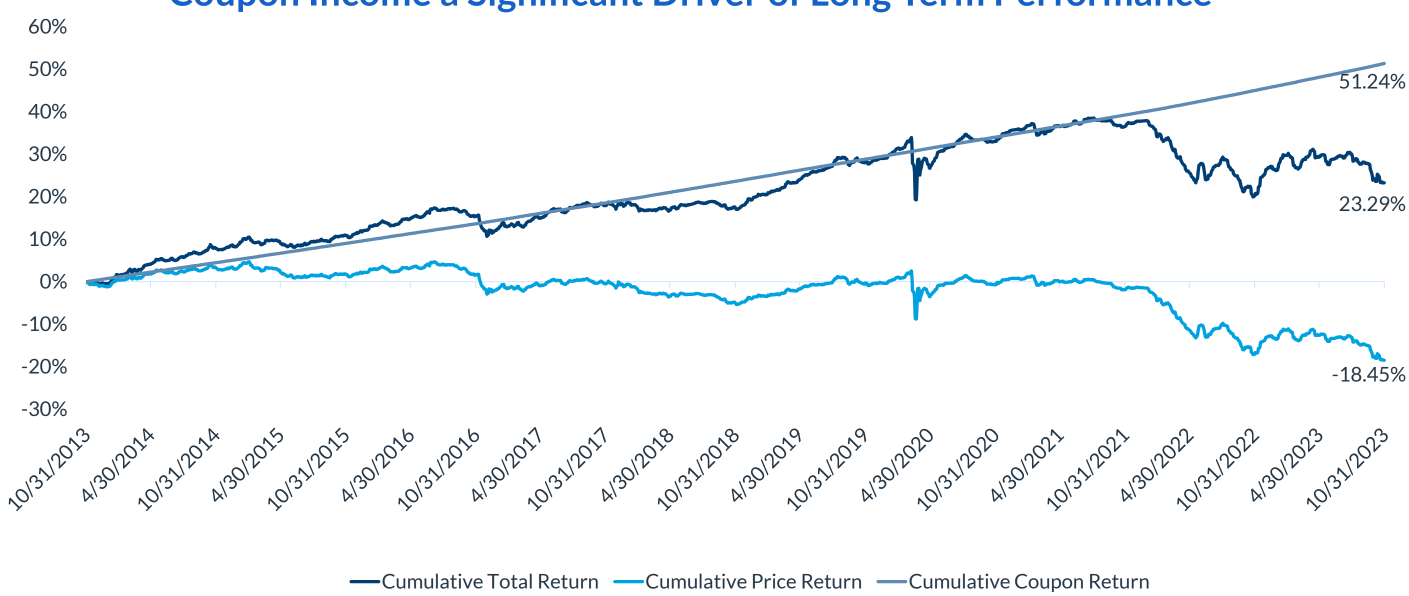
The Importance of Income Cannot Be Overstated

Apart from tax efficiency, another principal objective of municipal bond ownership is income generation. Coupon income plays a critical role in long-term total return because of the reinvestment of cash flows and the compounding interest nature of fixed income securities. Income could cushion price declines and interest rate volatility. Historical return data suggests that the accumulation of income accounts for a reasonably high proportionate share of total return. Given the significance of income contribution, projections for forward return potential could rise as yields climb.

Closing Remarks

The allure of generationally high municipal yields should not go unnoticed in a market that offers its investors the opportunity to earn a stable income stream along with the asset class's relative safety. Quality trends remain favorable and well-positioned for the months ahead while recent improvements in valuations further bolster the appeal of municipal bonds. With a sound history of resiliency, as evidenced by only three negative return years since 2000, municipal bonds could complement existing asset allocations with their defensive characteristics. As the Fed tightening cycle matures and the economy and markets evolve (e.g., the yield curve), municipal bond income and price support could help drive future performance.

Coupon Income a Significant Driver of Long Term Performance



Source: Bloomberg, as of October 31, 2023. The coupon/price/total returns represent the Bloomberg Municipal Bond Index. Information is subject to change and is not a guarantee of future results.

INDEX DEFINITIONS

The Bloomberg US Municipal Bond Index measures the performance of investment grade, US dollar-denominated, long-term tax-exempt bonds.

Treasury Curve: The Treasury yield curve, which is also known as the term structure of interest rates, draws out a line chart to demonstrate a relationship between yields and maturities of on-the-run Treasury fixed-income securities.

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