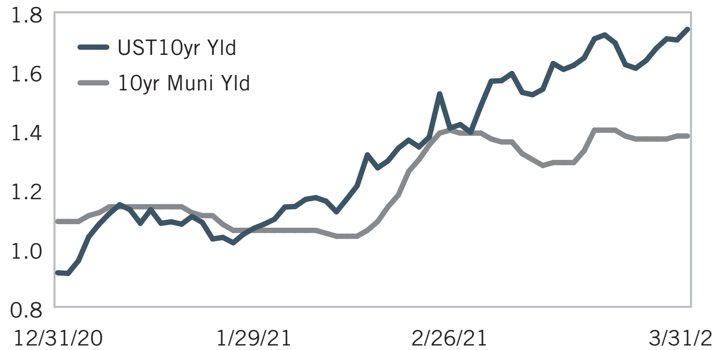
FUNDAMENTALS

While much has changed over the past year as effects of the pandemic have rippled through our lives, one thing that continues to resonate is the resiliency of municipal credit. Municipalities have a long history of low defaults, even in the worst of times, especially among those issuers that have a rating from one of the major rating agencies. This past year has proven no different. While the market has experienced an uptick in defaults, they have largely been concentrated in riskier sectors and by issuers that were never rated. We do not expect this to change. The federal government has given municipalities a fundamental boost through the distribution of direct aid to help mitigate the fallout from the pandemic. As a result, municipal credit will likely be on firm footing in the near term. In addition to direct federal aid supporting municipalities, revenue collections continue to improve as the economy seems to be in an upward trajectory as vaccinations accelerate and the labor market improves. Municipalities have also benefited from low borrowing costs, increased investment returns, an improved housing market, and access to capital as the municipal bond market has been favorable for issuers. These fundamental improvements have created tremendous demand, especially for lower-rated issuers. While we believe that municipal credit as a whole has improved as a result of the recent federal stimulus, we see many lower-rated bonds priced to perfection. As we take a longer-term approach in our purchases, we believe that pension challenges, climate change, and other revenue challenges will likely resurface and create pricing volatility.

TECHNICALS

During the quarter, the municipal bond market continued to benefit from strong demand for tax-exempt income while supply levels remained manageable. While much of the current rhetoric out of Washington is focused on increasing the corporate tax rate to 28% to help cover the cost of the infrastructure plan, the prospects of higher individual taxes created a demand component that caused municipal yields to dislocate from the broader markets. Demand for tax-exempt income outpaced the supply of bonds and, as a result, municipal yields reached historically rich levels during the quarter. While the supply of municipal bonds has been manageable, the market is monitoring the possibility that issuers will once again be able to advance refund outstanding tax-exempt debt with new tax-exempt debt, which could alter the amount of supply of tax-exempt municipal bonds going forward. In addition, the market is expecting the repeal of the state and local tax deduction (SALT) and the reinstatement of a Build America Bond program, all potentially affecting municipal supply and demand going forward. We would expect demand for tax-exempt bonds to continue, but richer valuations may cause some investors to temper their demand.

10-YEAR U.S. TREASURY YIELD VERSUS 10-YEAR MUNICIPAL YIELD

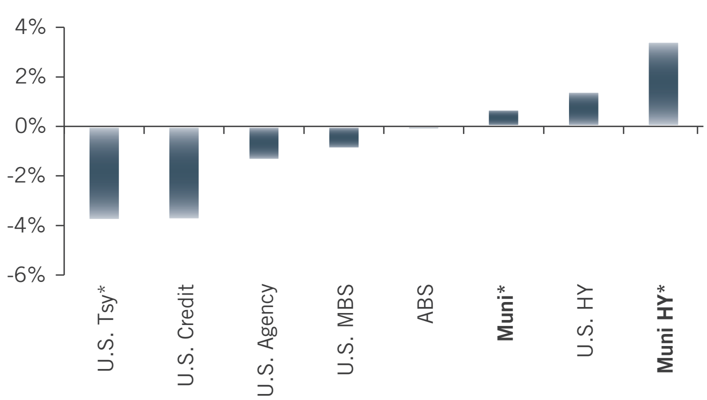


Source: Bloomberg L.P.

PERFORMANCE

The municipal market outperformed most other segments of the bond market during the quarter as the anticipation and ultimate passage of the $1.9 trillion American Rescue Plan Act was viewed favorably by municipal bond investors. This federal stimulus plan is expected to add liquidity to state and local municipalities, and other areas of the municipal market most affected by the pandemic. Not only did the stimulus plan calm credit concerns, it also stimulated demand for tax-exempt income as individuals anticipated increases in federal tax rates. During the quarter, the Bloomberg Barclays Municipal Bond Index posted a return of -0.35%, which compared favorably to the broader Bloomberg Barclays U.S. Aggregate Bond Index return of -3.37% for the same period. The market saw sustained demand, particularly for lower-rated investments, with the BBB rated portion of the municipal index returning 1.28% and the Bloomberg Barclays Municipal High Yield Index posting a 2.11% return.

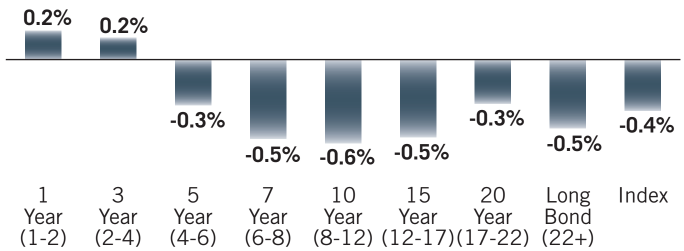
IG AND HY MUNIS SOME OF THE BEST PERFORMING U.S. FIXED INCOME ASSET CLASSES YTD



*Muni IG, Muni HY, and US Treasury indices are tax-adjusted.
Source: Bloomberg Barclays Indices, Barclays Research.

PERFORMANCE BY MATURITY

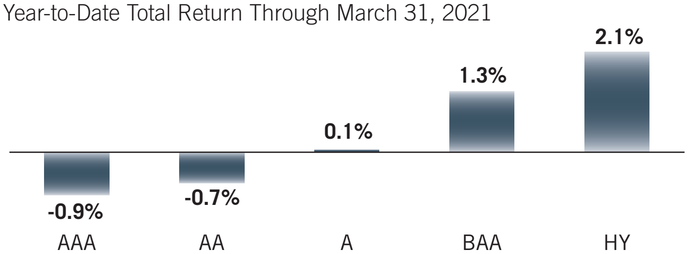
Bloomberg Barclays Municipal Bond Index
Year-to-Date Total Return Through March 31, 2021



Source: Bloomberg Barclays. **Past performance is no guarantee of future results.**

PERFORMANCE BY QUALITY

Bloomberg Barclays Municipal Bond Index
Year-to-Date Total Return Through March 31, 2021



Source: Bloomberg Barclays. **Past performance is no guarantee of future results.**

OUTLOOK

As we all look forward to getting back to a more normal lifestyle and economic activity improves, municipalities should benefit from a growing economy. However, there remain challenges for those credits hardest hit by the pandemic shutdowns. Airports, mass transit, and economies that depend on business travel are just a few of the areas that may take longer to recover. The federal government has infused unprecedented amounts of liquidity into the system to help the recovery. While we are quite constructive on the fundamental and technical aspects of the market, this has fostered a reduction in value. At certain points during the quarter, the reduction in municipal yields had caused municipals to become exceptionally rich, resulting in minimal relative value in tax-exempt municipal bonds. For individuals in the uppermost tax brackets, municipals should still appear attractive, but the corporate buyer may find better value in other taxable alternatives. This relative value dynamic will be important to monitor as it will affect the demand for municipals going forward. The municipal bond market is very dependent on retail demand, be it through mutual funds or ETFs, separately managed accounts, or even individual bonds. Should investors begin to see better relative value away from municipal bonds, this could create an environment of higher yields and greater volatility. We would likely view this as a buying opportunity. We still believe that our higher quality investment strategy, distributed across multiple sectors of the market, should provide good relative performance over the long term.

Authored by:

The Newfleet Municipal Bond Team

Newfleet leverages the knowledge and skill of a team of investment professionals with expertise in every sector of the bond market, including evolving, specialized, and out-of-favor sectors. The team employs active sector rotation and disciplined risk management to portfolio construction.

VIRTUS INVESTMENT PARTNERS