Q2 21 MUNICIPAL BOND MARKET

MARKET REVIEW AND OUTLOOK

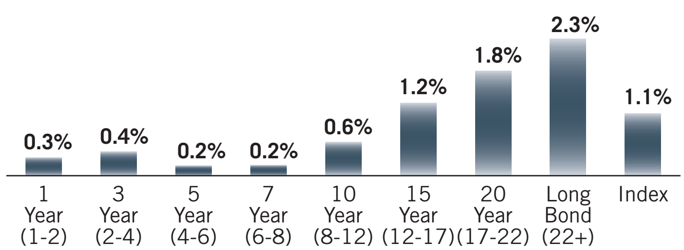
Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

PERFORMANCE

During the quarter, the municipal bond market continued to benefit from steady inflows into municipal bond funds, while new issuance remained manageable. This supply/demand imbalance, which has persisted for much of this year, once again provided a favorable backdrop for another quarter of solid returns, with the Bloomberg Barclays Municipal Bond Index posting a quarterly return of 1.42%. With municipalities continuing to benefit from record amounts of federal stimulus and an improving economy, investors are continuing to embrace risk. It was the longer-dated and lower-rated bonds that produced the best relative performance, while shorter-dated bonds and bonds with the highest quality ratings produced the lowest relative returns.

PERFORMANCE BY MATURITY

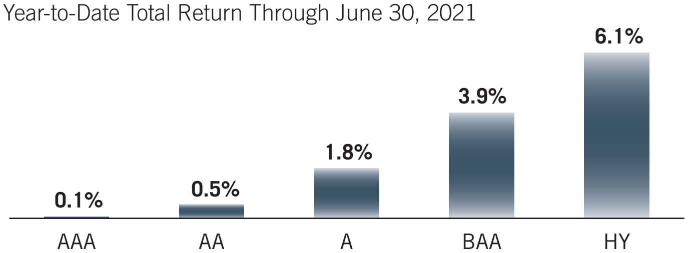
Bloomberg Barclays Municipal Bond Index
Year-to-Date Total Return Through June 30, 2021



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 June 30, 2021



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

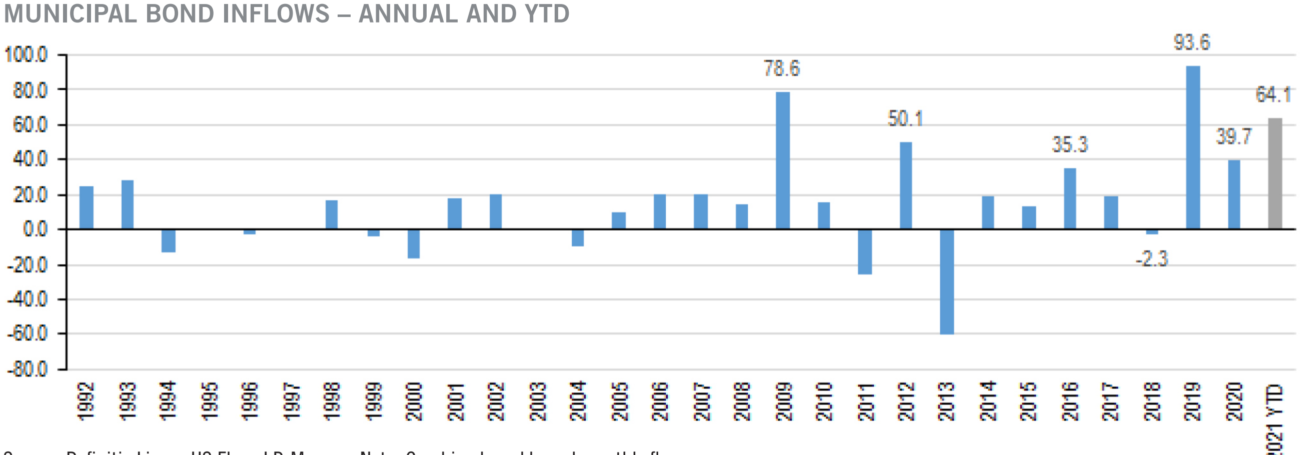
TECHNICALS

The enormous amount of federal stimulus that has been distributed across the country and the prospects of higher taxes has brought a spotlight on the municipal bond market and steady demand for tax-exempt income. While Washington seems focused on increasing various taxes to help cover the costs of this stimulus and a possible infrastructure plan, investors have been pouring money into tax-advantaged municipal bond mutual funds at a record pace. The $60 billion of fund inflows that municipal bond mutual funds have now seen through the first six months of this year, as reported by Lipper, has created tremendous demand for municipal bonds. This demand has outpaced supply as municipalities appear on the sidelines waiting for the possibility that Washington will restore their ability to advance refund outstanding tax-exempt debt with new tax-exempt debt, or reinstate a Build America Bond-like program to help fund the large infrastructure plan that is being proposed. In addition, municipalities are benefitting from a rebound in tax collections as the economy rebounds from the pandemic, also minimizing the need for municipalities to issue new debt. While we expect demand for tax-exempt bonds to continue, higher valuations may cause some investors to temper their interest, especially if tax increases are not as steep as expected.

FUNDAMENTALS

The more cautious tone that defined the market for much of last year has given way to a more bullish attitude among investors. As the economy reopens following the pandemic, municipal credits are benefitting from improved tax collections as individuals are spending, travelling, and buying homes. The federal government has infused unprecedented amounts of liquidity in the system to aid the recovery, and municipalities have greatly benefited. The improving economy and the federal support to both state and local municipalities during the pandemic have helped to avert possible credit issues, allowing municipalities to replenish their rainy-day

MUNICIPAL BOND INFLOWS – ANNUAL AND YTD



Source: Refinitiv Lipper US Flow, J.P. Morgan. Note: Combined weekly and monthly flows.

funds and push most credit concerns aside for now. There seemingly appears to be an absence of municipal credit concerns by investors, as the market is experiencing record flows into long-term and high yield funds as investors search for higher yield. In addition, bond rating agencies seem increasingly favorable on credit with many issuers experiencing upgrades and most sectors seeing outlooks returned to stable. While we believe that market fundamentals have improved dramatically, valuations of lower-rated credits, in many cases, are approaching overvalued levels. Credit risk spreads, or the additional yield received for buying a lower-rated bond, have returned to pre-pandemic levels as a result of tremendous demand for yield, and now seem priced to perfection. As we take a longer-term view in our purchases, we believe that pension challenges, climate change, and other revenue challenges will likely resurface, thereby creating pricing volatility.

OUTLOOK

While much of the past quarter was a mirror image of the first, where strong demand of tax-exempt income was the driving force for municipal bonds, we look to Washington for direction for the second half of the year. The Biden administration continues to have an ambitious agenda as they look to pass an infrastructure plan to upgrade the nation's aging infrastructure. For a market that has been starving for supply, this may be the answer as municipalities look to finance projects with tax-exempt bonds. While we still hold out hope that some form of infrastructure bill gets passed, it is not a guarantee given the connection with other progressive initiatives. Another important consideration to the municipal bond market will be how this ambitious spending gets funded. Currently, the market is pricing in the likelihood of higher taxes, which has been the driving force for richer valuations, resulting in minimal relative value versus other fixed-income investment alternatives. This relative value dynamic needs to be monitored closely as it will likely impact municipal demand going forward, especially if taxes do not increase as aggressively anticipated. Should investors begin to see more attractive relative value away from municipal bonds, this could create an environment of higher municipal yields and greater volatility, signaling a potential 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.

The **Bloomberg Barclays U.S. Aggregate Bond Index** is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS. The **Bloomberg Barclays Municipal Bond Index** is a market-capitalization-weighted index that measures the long-term tax-exempt bond market. The **Bloomberg Barclays High Yield Municipal Bond Index** consists of noninvestment-grade, unrated, or below Ba1 bonds. The indexes are calculated on a total return basis. They are unmanaged, returns do not reflect any fees, expenses, or sales charges, and are not available for direct investment.