MUNICIPAL BOND MARKET

MARKET REVIEW AND OUTLOOK

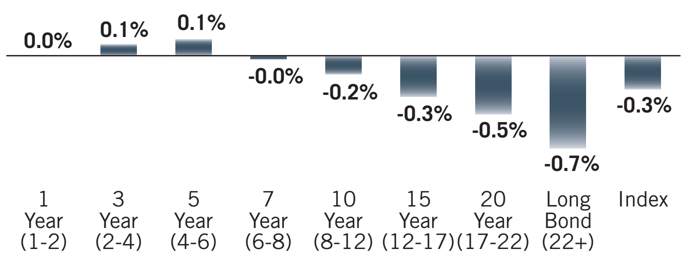
Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

PERFORMANCE

While municipal bonds continue to outperform the broader fixed income market, concerns over hints from the Federal Reserve that tapering "may be soon warranted," the debt ceiling debate, and the failure to pass the $3.5 billion infrastructure bill led to overall higher yields. Performance, which has benefited from strong technicals and fundamentals, began to erode just as the third quarter ended. Yields moved higher, particularly for bonds dated 10 years and longer, leaving the Bloomberg Municipal Bond Index performance at -0.27% for the third quarter. However, year-to-date index returns remain positive at 0.79%.

PERFORMANCE BY MATURITY

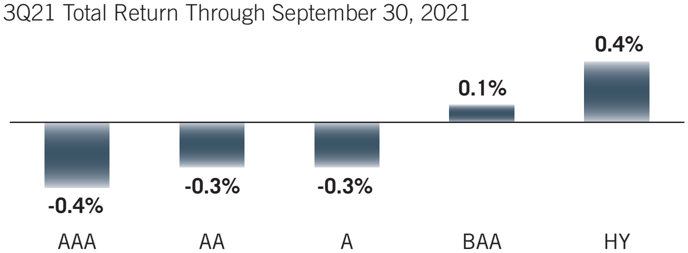
Bloomberg Municipal Bond Index
3Q21 Total Return Through September 30, 2021



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

PERFORMANCE BY QUALITY

Bloomberg Municipal Bond Index
3Q21 Total Return Through September 30, 2021



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

With yields of municipal bonds reaching historical lows earlier this year and performing with far less volatility than US Treasuries, the market seemed priced to perfection. Now, all eyes are on Washington D.C. as investors seek clarity on the infrastructure bill, tax increases, SALT deductions, and other critical issues that will likely affect this market over the coming months.

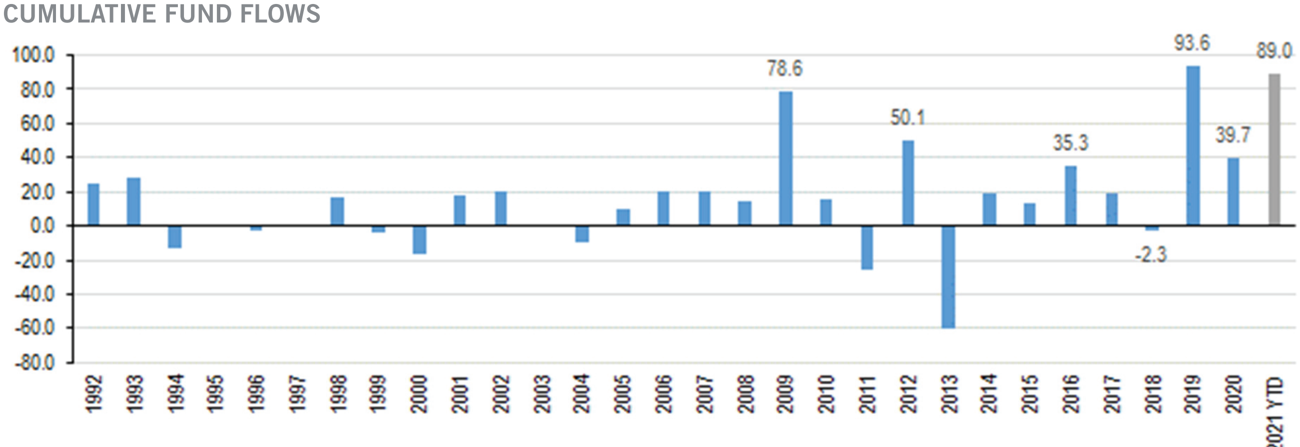
TECHNICALS

As politicians in Washington debate spending bills, investors have continued to buy municipal bonds at a record pace. The steady demand for tax-exempt income has been unprecedented. According to Lipper Analytics (below), municipal bond funds have seen inflows of $89 billion, remaining on pace for a record-breaking year. This is occurring when municipalities are flush with cash due to Federal stimulus money and improving revenue collections, causing demand to outpace supply, as issuers have fewer borrowing needs.

Issuers also appear on the sidelines, waiting to see if the ability to advance refund higher-cost debt with new tax-exempt debt will be reinstated. This provision is far from a given, as reinstating such a program would cost the federal government upwards of $15 billion (Source: Citibank's Municipal Market Update). While renewed refunding activity would likely cause new issuance of tax-exempt bonds to increase, we would not expect it to significantly weaken technicals given the current mutual fund flow demand.

Of course, if investors become leery of higher interest rates, tempered demand could cause mutual funds to experience outflows, and the market could materially weaken as funds are forced to sell bonds. We would likely see that as a buying opportunity. While we expect demand for tax-exempt bonds to continue, higher valuations may cause investor concern, especially if tax increases are not as steep as expected.

CUMULATIVE FUND FLOWS



Source: Refinitiv Lipper US Flow, J.P. Morgan.

FUNDAMENTALS

Municipal credit has been on solid footing due to federal stimulus money – it has not only filled municipal coffers, but also boosted consumer spending and increased tax revenue collections. Given how lower-rated bonds have performed this year, investors have shown little concern for municipal credit. Credit spreads have retraced to pre-pandemic levels and appear largely overvalued.

But as the quarter ended, signs of weakness in lower-rated credits did emerge as high yield municipal bond funds saw outflows for the first time since March. While this may be a temporary situation, it may also be a sign that the "yield grab" in the municipal bond market is slowing. Credit fundamentals will not show signs of weakness in the near term, but the market may be more closely defining where credit risk is priced.

Our investment strategy continues to focus on higher quality municipalities that show value for the long term. While the federal stimulus may have helped bolster the overall economy and municipal fundamentals, we believe that all credits are not created equally and need to be analyzed with a longer-term horizon. Municipalities face serious challenges in funding large capital expenditures to rebuild America's aging infrastructure, improve pension plan funding, and protect communities against climate change. A post-pandemic economy will also likely pose new challenges for municipalities, particularly as the federal government begins to pull back from its public support over the past eighteen months.

OUTLOOK

While we still hold out hope that some form of infrastructure bill gets passed, it is not a guarantee given its tie to other partisan initiatives. Depending on the direction Washington takes, policy changes could have lasting effects on this market. Should a large infrastructure plan be passed, it could boost economic activity, which may be bearish for rates, but bullish for the municipal market. A large spending plan will likely be accompanied by increased taxes, leading to greater demand for tax-exempt income, which would help stabilize the market. On the other hand, a smaller spending plan may not create a strong economic boost, but it should allow rates to remain lower. This could also mean lower increases to tax rates and ultimately less demand for municipal bonds.

Though the demand for municipal bonds has largely been driven by the prospects of higher taxes, the market must now contend with the possibility of higher interest rates as the economy normalizes and the Federal Reserve begins to remove their accommodative policies. Interest rate volatility may ensue as the market deciphers the latest talks out of Washington. However, we still believe 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 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 Municipal Bond Index** is a market-capitalization-weighted index that measures the long-term tax-exempt bond market. The **Bloomberg 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.