Q1 22 MUNICIPAL BOND MARKET

MARKET REVIEW AND OUTLOOK

Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

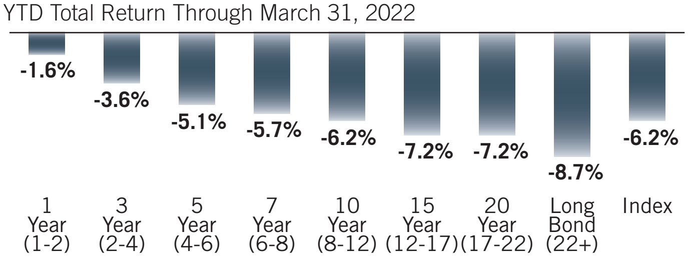
PERFORMANCE

Yields in the bond market rose sharply during the quarter as a result of the Federal Reserve's hawkish stance on inflation and the geopolitical situation in Ukraine. Municipal bonds saw the worst quarterly performance in over 40 years, with the Bloomberg Municipal Bond Index returning -6.23%. These yield moves were magnified as municipal bond mutual funds experienced outflows.

During this period, our higher-quality portfolio positioning outperformed, since longer maturing and lower rated bonds were the worst performing parts of the market. Investors became less interested in taking on additional interest rate and credit risk, even though municipal fundamentals are still on solid footing. This negative performance was the result of rate moves, not due to credit concerns.

PERFORMANCE BY MATURITY

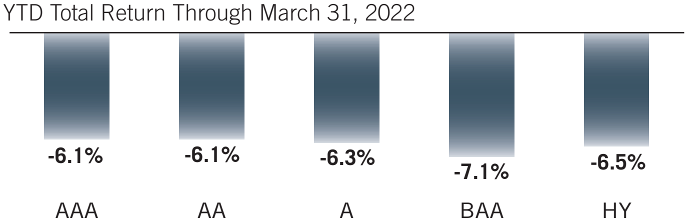
Bloomberg Municipal Bond Index
YTD Total Return Through March 31, 2022



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

PERFORMANCE BY QUALITY

Bloomberg Municipal Bond Index
YTD Total Return Through March 31, 2022



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

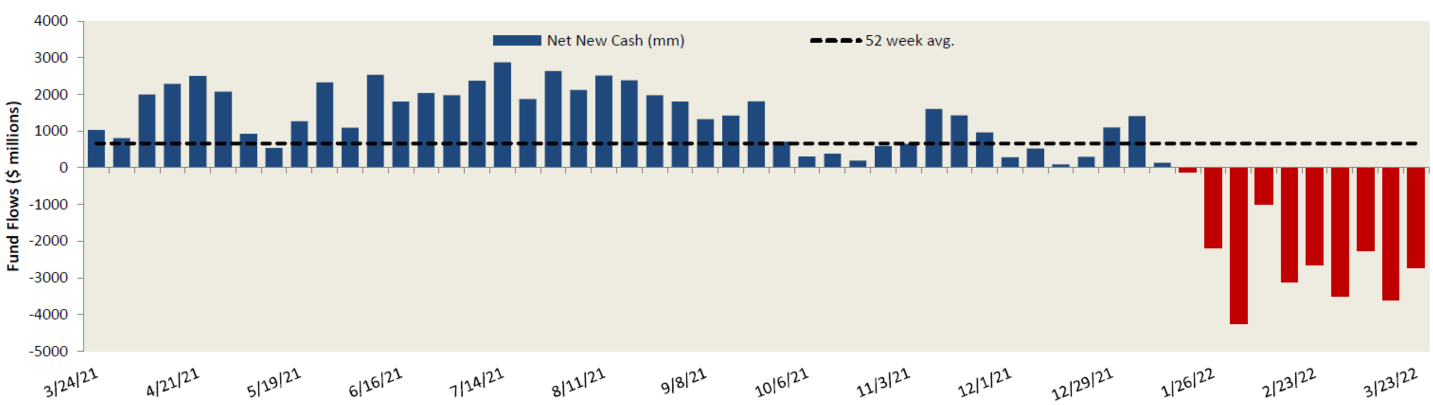
TECHNICALS

After seeing 86 consecutive weeks of inflows that created tremendous demand for tax-exempt bonds, the market has now seen 12 consecutive weeks of outflows to the tune of almost $22 billion. This change in demand resulted in intense selling pressure, causing the market to soften and yields to rise. Because investors aren't used to seeing negative returns in their municipal bond portfolios, this trend, which could continue if investors fear that rates will rise further, has the potential to become even more problematic for the market.

The good news is that the relative cheapening of municipals has created opportunity for some non-traditional buyers who hadn't focused on tax-exempt purchases until recently. Banks and insurance companies have begun to look opportunistically at municipal bonds as an alternative to other fixed income sectors due to more attractive taxable-equivalent yields. This new demand should lend support to the municipal bond market.

While demand has fallen, overall municipal issuance falls short of what the market saw last year. This is largely a result of a sharp drop in taxable municipal issuance as market volatility hampered issuers' ability to properly time refunding deals. On the other hand, supply for tax-exempt bonds has remained relatively flat from levels we saw at the start of last year. The market is expecting supply to accelerate as we move further into the year, but rate volatility and the recent geopolitical risk may change that sentiment going forward. For now, supply does not seem to boost or drag down the market.

MUNICIPAL BOND WEEKLY FUND FLOWS

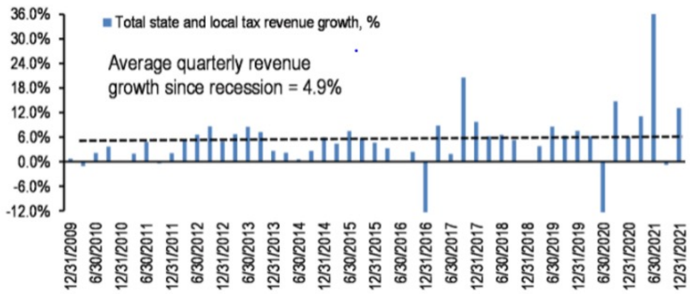


Source: ICI, Baird. As of March 23, 2022.

FUNDAMENTALS

Municipal credit fundamentals remain mostly on solid footing – especially coming off of the strong federal stimulus funding during the pandemic. According to the latest numbers from the U.S. Census Bureau, state and local tax collection receipts for income, sales, and property taxes showed growth of 13.1% for 4Q 2021 from 4Q2020.

TOTAL STATE AND LOCAL TAX YOY REVENUE GROWTH, %.



Source: U.S. Census Bureau, J.P. Morgan. As of December 23, 2021, seasonally adjusted results.

Inflation has inched higher in recent months, with year-over-year growth in the Consumer Price Index (CPI) hitting multi-decade highs. Rising inflation initially driven by pandemic-related imbalances that impacted the supply of labor, materials, and distribution networks has been exacerbated by the conflict in Eastern Europe and is unlikely to subside quickly or easily. Given historical trends, we expect ongoing elevated inflation to drive even higher tax collections as the cost of goods and services increase.

While there are increasing indications that an economic downturn looms, municipal credit has typically fared better in a recession than other investment options, as there is a lag between the onset of a recession and when municipalities really begin to see their financial positions challenged. That is especially relevant for local municipalities that rely on property tax revenues – the sizeable increases in housing values across the country should provide stronger revenue.

OUTLOOK

Following an unprecedented quarter of negative returns, municipal bonds are now showing better relative value than they have in quite a while. The market experienced large yield moves that it hadn't seen since 2008, at the onset of the Great Recession. Fortunately, these yield moves weren't driven by credit issues as they were back then, but were rather a result of fund outflows, higher Treasury yields and a catch-up from overinflated valuations coming into the year relative to other fixed income alternatives. In times of lower retail demand and fund outflows, demand from non-traditional buyers such as banks and insurance companies can provide some much-needed support for the market.

We do expect that market volatility will likely continue until the market gains more clarity on the Federal Reserve's intentions to tame inflation and Treasury rates begin to stabilize. Should the economy begin to slip into a recessionary type of environment, it is important to remember that municipals have long been considered a high-quality investment, with defaults a rarity.

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.

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