August 2022

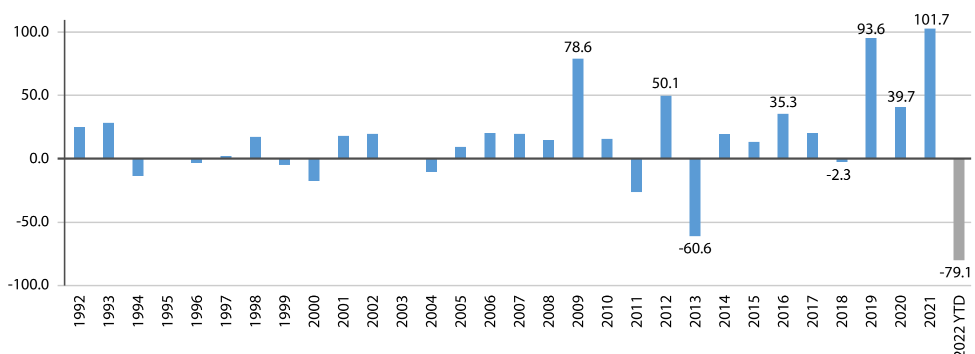
2Q 2022 Municipal Commentary

Thrill Ride

The municipal bond market has experienced considerable volatility in 2022. Through May, munis endured the worst rout in history, down more than 10%. This was followed by a powerful albeit partial summer recovery, with the Bloomberg Municipal Bond Index up 2.64% in July. Despite a major reversal of sentiment and performance in recent weeks, the market remains down more than 6.50% for the year.

What's been driving the volatility? Munis sold off in conjunction with US Treasury bonds during the first quarter and into early spring in light of inflation concerns and Fed tightening anxiety. Underperformance was exacerbated by 22 consecutive weeks of municipal bond fund outflows (according to Refinitiv Lipper) beginning in February, seasonal selling in anticipation of April 15 tax payments, and heavy new issue supply.

Cumulative Municipal Bond Fund Flows $bn



Source: Refinitiv Lipper

What's Changed?

- Market consensus has largely shifted from inflation hysteria to unease about possible recession. Not clear if the Fed is moving too slow to curb inflation, is on target, or will overshoot and snuff out economic growth.
- Fund outflows have tapered off and municipal bond mutual funds have even experienced moderate inflows for three of the last four weeks.
- Reduced new issue supply, typical for summer months. July issuance down 32% year-over-year.
- Tax season and its associated selling has passed, has alleviated pressure on the market.
- Mid-year rollover: reinvestment of proceeds from Jun/Jul/Aug maturities and coupon payments.

Scanning the Horizon

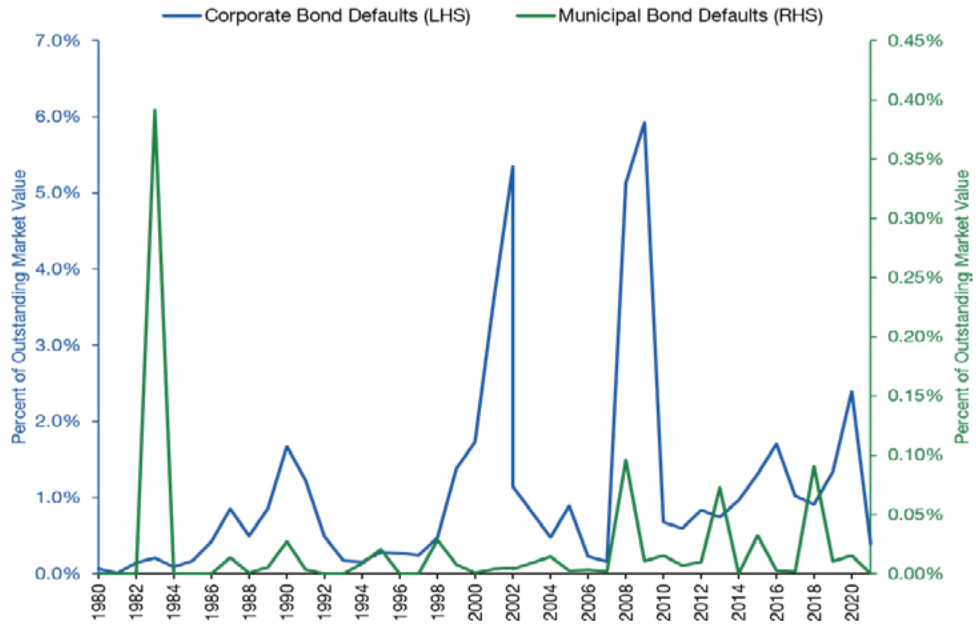
Poor performance of nearly every asset class has left state and local pensions, with the worst returns since Covid struck in 2020. Public pension funding levels are currently in the low-70%'s according to a recent report from Equable Institute.

- Increases in the costs of hiring and retaining employees to replace retirees will continue to impact state and local government budgets.
- Higher inflation and corresponding COLA increases will raise public pension payouts to retirees.
- Poor performance of nearly every asset class has left state and local pensions, with the worst returns since Covid struck in 2020. Public pension funding levels are currently in the low-70%'s according to a recent report from Equable Institute.
- Capital gains tax receipts are likely to slow in the second half of the year, given equity market correction.

Accentuating the Positive

Muni credit fundamentals are solid. Moody's rating upgrades have outpaced downgrades for five quarters through 1Q2022. Many municipalities have reined in spending, funded reserves, and are flush with cash. Defaults remain rare and negligible. State and local government revenue has been strong across a variety of tax sources including sales, income, property and capital gains. Federal fiscal stimulus received by muni issuers has also contributed to healthy balance sheets.

Municipal vs. Corporate Bond Default Rates



Source: Moody's Investors Service, as of 12/21/21

Muni valuations and yields have come a long way in 2022 and are considerably more appealing than they have been in recent years. One year ago, the 10-year muni ratio to UST was less than 70% and AAA yield was 0.82%. Presently the ratio is 85% and yield is 2.50%. Taxable-equivalent yields are especially attractive.

Munis have demonstrated outperformance during most Fed rate-hike cycles as the yield curve tends to flatten, benefitting longer duration. Quality credit from highly rated issuers is likely to hold value better in a potential recessionary environment.

Riverbend Capital and You

Riverbend portfolios are structured defensively, with reasonable duration and high credit quality. Investors can continue to achieve income and safety objectives with a proactive approach to portfolio management.

Riverbend portfolios are structured defensively, typically with reasonable duration and high-grade credit. Investors can continue to achieve income and safety objectives with our proactive approach to portfolio management. Bond selection is critical. Structure and execution are also important. It's worth consideration that municipal bonds have consistently outperformed during Fed rate hike cycles over the last 30 years. Ratios to taxable bonds declined during these periods. Portfolio duration is moderated with the inclusion of callable bonds.

The municipal bond asset class is fundamentally sound, has a low correlation with other fixed income securities, and continues to benefit from a favorable supply and demand outlook. The tax-exemption of munis mitigates interest rate volatility and generally provides stability. Muni yields are considerably higher and ratios to taxable securities represent more attractive relative value than last year. Periods of market volatility may create further opportunities.

Our portfolios adhere to a disciplined strategy and are primarily comprised of:

- Essential service revenue bonds (water/sewer/electric utility)
- General Obligation bonds from states, cities, and counties with strong balance sheets and in many cases, multiple layers of support
- Higher education bonds from nationally recognized institutions with positive enrollment trends and significant endowments
- Healthcare facilities that are part of larger networks with dominant market share
- Transportation issues with consistent revenue streams and solid credit profiles

The portfolios we manage are conservative, well-positioned for potential volatility and generate steady, predicable tax-free income in order to balance risk and offer stability in the midst of uncertainty.

Please feel free to contact us anytime if you'd like to discuss the topics cited in this update, or any others related to the municipal bond market.

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