U.S. Municipal Bond Market

Municipal Bonds are an Exceedingly Appealing Fixed Income Opportunity Right Now

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- Municipal yields have risen substantially since the beginning of 2022. Some income seekers are noticing and we do not want investors to miss the opportunity.
- A traditional relative value indicator, the Municipal to U.S. Treasury Ratio (M/T Ratio) is attractive on a historical basis. M/T Ratios have risen above their averages going back to the beginning of 2010.
- The municipal credit backdrop remains strong. The Golden Age of Public continues, and public finance upgrades remain poised to outpace downgrades in 2022. We are watching closely to see if an economic downturn could spoil this expectation.
- Remote work is a theme to watch as it relates to U.S. public finance. Kastle Systems data still at just 43% of the pre-COVID-19 level is likely close to the new normal, we think. Municipal finance will need to adjust.

Income Seekers are Noticing, Don't Miss the Opportunity

The U.S. Federal Reserve's aggressive interest rate hiking campaign disoriented the financial markets' landscape for much of the first four months of 2022. Most recently at the beginning of May Federal Reserve officials announced the first half point rate hike since 2000, pushing the overnight rate target to a range 0.75% to 1.00%. They also communicated a plan to reduce its balance sheet; beginning on June 1st with permitted runoff of $47.5 billion, doubling to a maximum of $95 billion per month by September. Consumer Price Index (CPI) data that was released today is not likely going to change the Fed's outlook. The next FOMC meeting is scheduled for June 15th, which is five days after the May CPI release.

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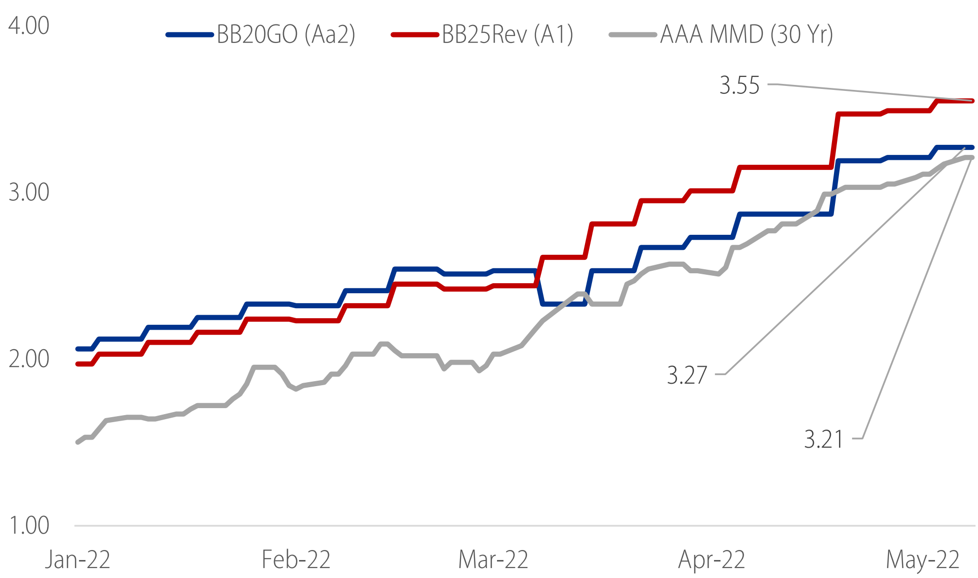
Municipal Yields have Soared in Recent Months



Source: The Bond Buyer, Bloomberg, Refinitiv and HilltopSecurities.

Municipal investors have reacted negatively for most of 2022 to date. Fund flows in (or out) of municipal bond mutual funds have been negative for 15 of the 18 weeks through the first week of May. So far over $31 billion has flowed out of municipal bond mutual funds. This dynamic is a major change from recent years when billions of dollars flowed into, not out of municipal funds. Results from our April 2022 municipal bond analyst survey indicate that 76% of analysts expect the negative flow activity to continue and a little less than half of analysts are expecting flows to be net negative for the entire year (see page 6 of that report).

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Now, municipal-specific yields, technical market and credit-related indicators are creating an opportunity for income seeking investors to take advantage of, at least while it lasts. In years past there was only a very small amount of available supply of municipal bonds to choose from for fixed income investors. Now, the high level of flows out of funds, and attractive municipal-specific yields offer an entry-point for income seeking and traditional municipal bond investors that does not present itself very often.

Attractive Municipal-Specific Yields

The municipal bond market is offering an exceedingly appealing fixed income option right now. We believe investors looking for fixed income investments should begin adding to their municipal positions, or begin to accumulate municipal positions now and throughout the Fed's interest rate hiking campaign which is likely to continue through this year.

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Others, including a HilltopSecurities general market strategist have recognized this opportunity. Back in February Hilltop's Justin Hoogendoorn expected municipals to perform "brilliantly" after difficult periods consisting of negative investor sentiment. He outlined his constructive thoughts about the municipal asset class in Municipal Rebound? Yes. We've Seen this Movie Before. The drum beat in favor of municipals grew louder in recent weeks as well. In April Blackrock's municipal team indicated that "municipals look attractive after the Q1 correction," in their April municipal monthly update. The May Blackrock monthly outlook reiterated their April opinion, where they wrote, "Valuations look increasingly attractive relative to other fixed income asset classes."

A key reason why we (and others) have indicated or reiterated this opinion is simply because municipal-specific yields have continued to rise to more attractive levels. We will start with outlining what has happened with the standard AAA municipal benchmark known as the AAA MMD (Municipal Market Data) yield in the 30-year maturity (please see the line chart on page one). 30-year AAA MMD began the year at a very low 1.50%. The AAA municipal benchmark has since risen to a 3.21% as of the beginning of this week. The Bond Buyer US Weekly 20 General Obligation index began the year at a 2.06% yield but most recently was set at a 3.27%. The index's rating is considered in the Aa2 category and the average maturity is 20 years. The last item that we included on our line chart is The Bond Buyer 25 Revenue index which was 1.97% at the start of January and most recently hit a 3.55% yield. The Bond Buyer 25 Revenue index rating is considered slightly lower at A1, with an approximate maturity of 30 years.

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The Investment-Grade Extra Yield Story in the Municipal Health-Care Sector

We wrote about the compelling relative value play in the municipal health-care sector back in our REVISED: the Municipal Market in 2022, due to the COVID-19 Paradigm Shift (Feb 7, 2022). Yields for "A" rated hospitals were closing in on the psychologically important 3.00% yield at the time - they were a 2.45%. Investors will be pleased to learn that "A" rated hospital yields have risen over 150 basis points since then to a 4.02%. This is over 100 basis points above that psychologically important 3.00% barrier. We therefore believe the extra yield available in the investment-grade municipal health-care sector is an important opening for investors willing and able to take that level of credit risk.

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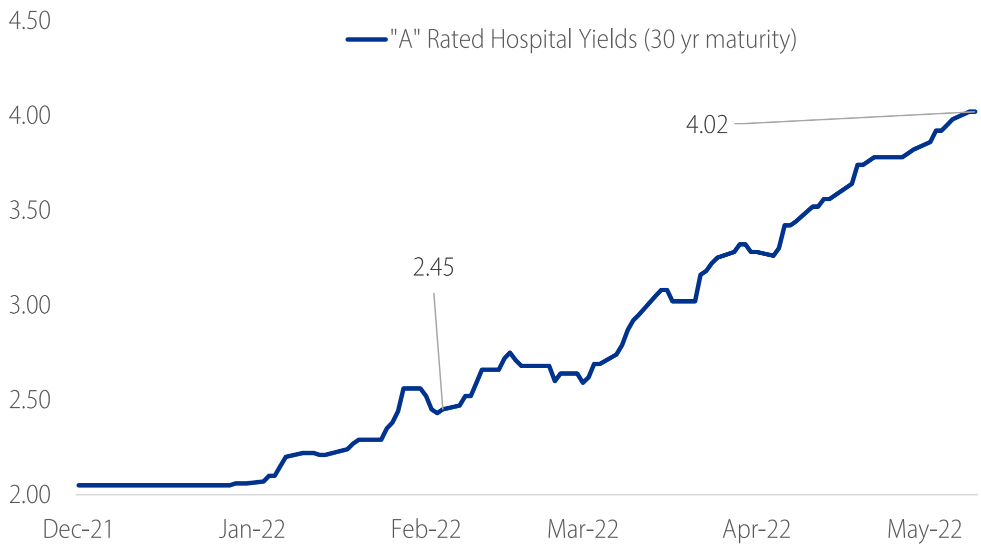
"A" Rated Hospital Yields Jumped Since February



Source: Refinitiv and HilltopSecurities.

Municipal to Treasury Ratios Improved

The municipal to U.S. Treasury ratio (M/T Ratio) is a traditional relative value investing indicator some fixed income investors use to gauge the attractiveness of municipals compared to taxables. M/T Ratios have generally not been at attractive levels since the COVID-19 Crisis began in the beginning of 2020. They were well below the average we have seen going back to 2010. The average 10 Year M/T Ratio is currently a 92% and the average 30 Year M/T Ratio is a 99% going back to the beginning of 2010.

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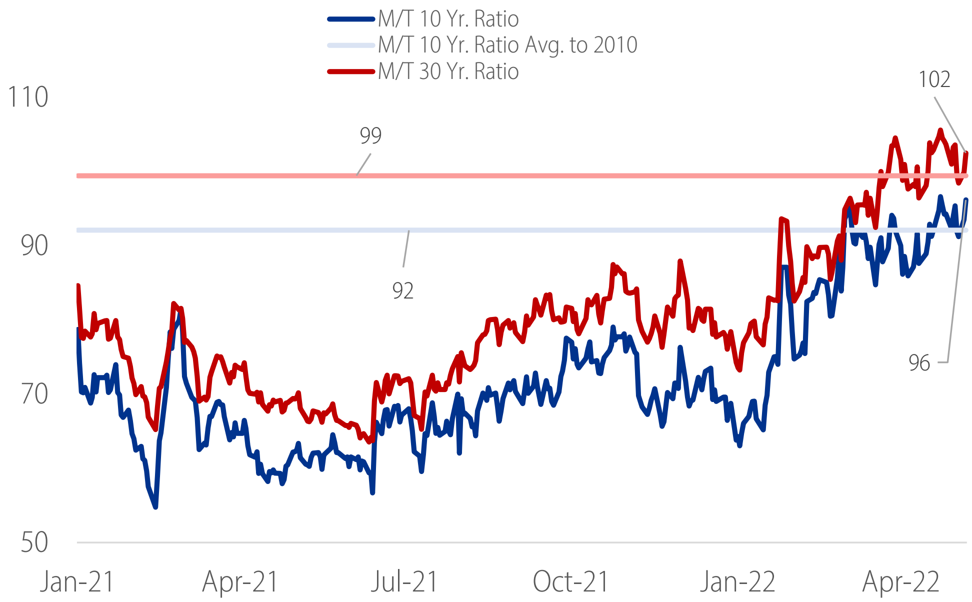
M/T Ratios are Attractive Now Compared to Their Average Going Back to 2010



Source: Refinitiv and HilltopSecurities.

M/T Ratios have been consistently trending higher since the beginning of 2022. In recent weeks they jumped just above their average going back to the beginning of 2010. In the above section we indicated that absolute municipal yields are rising and therefore we think municipals should be considered appealing as a result. This M/T Ratio relative value analysis is telling us that municipal are attractive as well. This is another argument why we think municipal bonds are an exceedingly appealing fixed income opportunity right now. We saw M/T Ratios rise in a similar fashion back in 2016, historically speaking.

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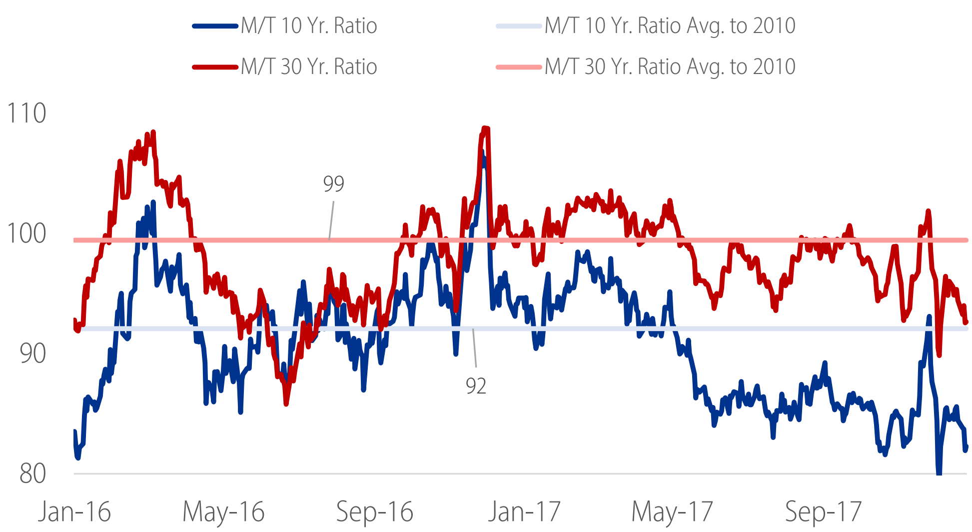
We Saw M/T Ratios Jump in 2016 as Well



Source: Refinitiv and HilltopSecurities.

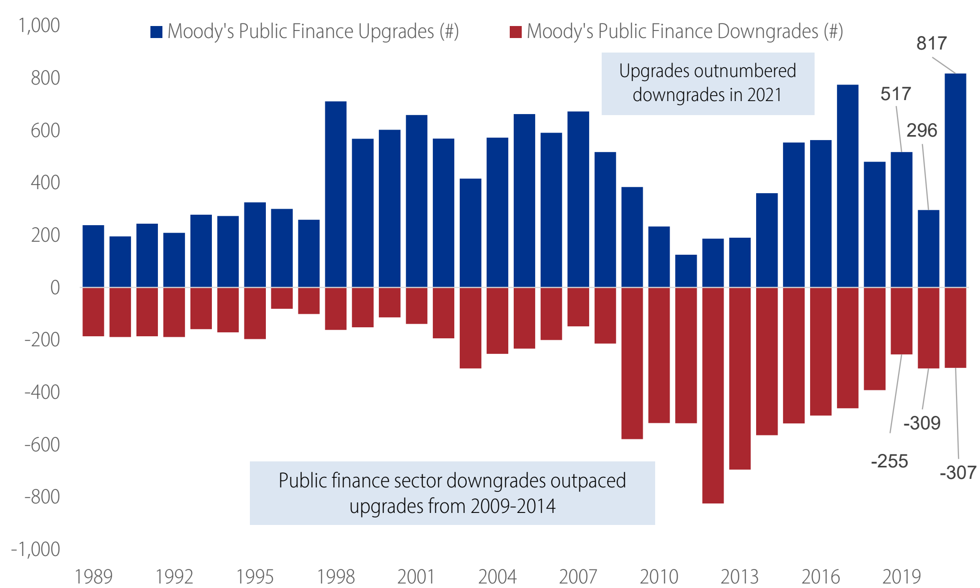
Strong Municipal Credit Quality, Public Finance Upgrades Will Top Downgrades

We began writing about the Golden Age of Public Finance starting in March of 2021 mostly because there was $650 billion of the federal government's almost $2 trillion 2021 Rescue Plan Act that was to flow to public finance sectors. We reiterated in December 2021 that the Golden Age of Public Finance would continue into 2022, and it has for sure.

We doubled-down on municipal credit at the beginning of 2022, in fact. We raised our municipal credit sector outlooks to "Positive" from "Stable" on the State, Local Government, and School District sectors in our REVISED: the Municipal Market in 2022, Due to the COVID-19 Paradigm Shift. Each of the outlooks by sector are listed on the title page of this Feb. 7th report. Please see the end of this report for our sector outlook definitions.

To get a clearer picture with what is happening on the credit landscape we often consult with the Moody's rating revision data that is published quarterly. Public finance rating upgrades substantially outpaced downgrades for all of 2021 according to Moody's Investor Service. There were a total of 817 upgrades and 307 downgrades last year. This was a turn-around compared to 2020 when downgrades (309) slightly outpaced upgrades (296). Upgrades continued to outpace downgrades in the first quarter of 2022 according to Moody's as well. Their April 29th report explained that there were 89 upgrades compared to 25 downgrades.

Moody's Public Finance Rating Upgrades Outpaced Downgrades



Source: Moody's and HilltopSecurities.

We are closely watching financial conditions to see if a financial downturn is likely. A downturn, and especially a severe recession, would very much remove the momentum we are seeing in municipal credit. For now, we are still expecting that public finance rating upgrades will outpace downgrades in 2022.

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Remote Work: A Theme That Will Impact Public Finance in the Near Term

A new normal as it relates to work habits is taking shape across the U.S. that is likely to impact state and local governments' and other public entities' budgets. The work-from-home experiment was successful for many, mostly higher-income workers and many of them want to continue this practice at least on a hybrid basis. We addressed this dynamic in more detail in an April 18th blog post titled: Technology Will Win the Remote Work Conflict. We also expect to devote more time and energy to this topic in order to uncover in more detail what the ultimate credit related impact will be for public finance.

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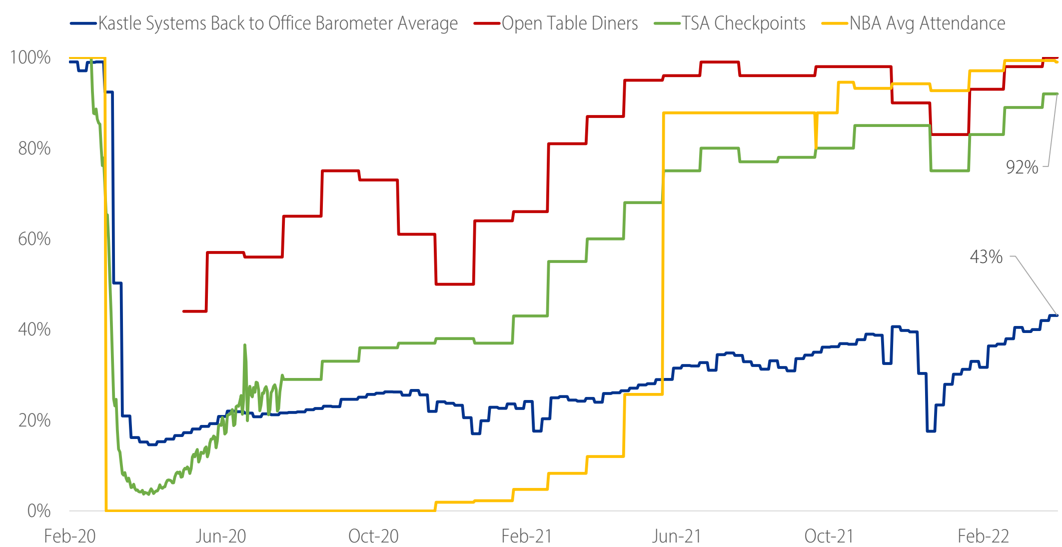
For now, we think it is important to point out that we have likely already begun the new normal remote work phase. This is closer to the reality of what we are likely to see going forward with regard to office usage. The accompanying line chart shows the Kastle Systems Back to Office Barometer which still shows that swipes into offices across the country are still only 43% of where they were compared to pre-COVID-19 levels. We are convinced that this 43% is closer to the new reality than some people think. A key reason we are convinced of this is because many other areas of activity are back to or very close to pre-COVID-19 levels. We included dining activity, TSA checkpoint numbers, and NBA attendance in the line chart for comparison purposes. We think this is a very convincing graphic.

Comparing How Different Elements of the Economy Have Recovered



Sources: Kastle Systems, Open Table, TSA, ESPN, and HilltopSecurities.

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Shifts related to remote work trends will have a profound impact of public finance across the country. There are some regions, municipal sectors and budgets more exposed to remote work trend than others. Overall, it is clear that adjustments are going to be required in some, if not many cases. We are watching this theme closely.

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Definitions of HilltopSecurities Municipal Sector Credit Outlooks

Positive: HilltopSecurities Municipal Research believes there are factors which point towards improving issuer or sector credit quality which may result in a higher level of credit ratings upgrades versus downgrades.

Stable: HilltopSecurities Municipal Research believes there are factors which point towards stable issuer or sector credit quality which are likely to result in an even level of credit ratings upgrades versus downgrades. Cautious: HilltopSecurities Municipal Research believes there are factors which introduce the potential for declines in issuer or sector credit quality that may result in potential credit ratings downgrades only slightly outnumbering upgrades.

Negative: HilltopSecurities Municipal Research believes there are factors which point towards weakening issuer or credit quality that will likely result in a higher number of credit ratings downgrades versus upgrades.

Recent HilltopSecurities Municipal Commentary

- FAQ: The Impact of ESG Disclosure on the U.S. Municipal Market, May 9, 2022
- 2022 Municipal Bond Analyst Survey, April 11, 2022
- Will War in Eastern Europe Lead to Cyber-Attacks on U.S. Public Finance & Infrastructure, Feb. 24, 2022
- REVISED: The Municipal Market in 2022, Due to the COVID-19 Paradigm Shift, Feb. 7, 2022

Readers may view all of the HilltopSecurities Municipal Commentary here.