U.S. Municipal Bond Market

First Half Public Finance Primary Issuance Down 20%, Foreshadows Potential Scarcity of Municipal Investment Options

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- Issuance was 20% lower in the first half of 2023 compared to the first six months of 2022.
- Activity averaged $29 billion a month, matching our expectation.
- Municipal mutual fund flows are turning, tells us municipal investor sentiment is strengthening.
- A scarcity of municipal bonds could develop because of the supply and demand dynamic in the near term, and because of federal tax policy in the medium term.
- The above dynamic, along with historically attractive municipals yields, reinforces the case we have been making to investors about the appealing nature of the municipal bond market.

Primary Market Volume Remains Below Average in First Half of 2023

Municipal bond issuance over the first half of 2023 was down 20% compared to last year. Over the last six months public finance entities sold $175 billion of municipal bonds. Last year they sold $218 billion over a similar length of time. This slowdown is not a surprise. We expected that lower economic growth and higher interest rates would cause activity to grind down in 2023. We forecast $350 billion of issuance for

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First Half Issuance of $175 Billion Matched Our Forecast

Ten Year Average '13 - '22	Month	2020 Actual	2021 Actual	2022 Actual	2023 Actual	% Change from 2022	Iss. Required for $350B in 2023	Iss. Required for $391B in 2023	HTS 2023 Forecast (Nov. 22)
$27	January	$33	$28	$26	$23	-12%	$23	$23	$25
28	February	42	37	32	21	-33%	21	21	25
35	March	20	48	46	34	-26%	34	34	30
34	April	32	37	40	33	-19%	33	33	30
34	May	31	35	37	29	-20%	29	29	25
40	June	52	50	38	34	-9%	34	34	40
32	July	48	38	28	-	-	29	36	30
37	August	43	45	42	-	-	29	36	30
33	September	54	45	27	-	-	29	36	30
43	October	73	42	29	-	-	29	36	35
32	November	21	37	26	-	-	29	36	25
34	December	35	41	20	-	-	30	36	25
$409	**Total**	**$485**	**$483**	**$391**	**$175**	**-20%**	**$350**	**$391**	**$350**

Source: Refinitiv, The Bond Buyer and HilltopSecurities.

the year back in November 2022 in Anticipating Municipal Issuance Will Remain Challenged Again in 2023: Our Forecast. In fact, the pace of activity that resulted in $175 billion through the first six month matches the monthly forecast we published on page 3. We believe this slowdown foreshadows a level of scarcity that is likely to exist for the rest of this year, into next year, and the scarcity of tax-exempt municipals in a worst-case-scenario could degenerate to an even greater extent after the November 2024 elections.

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Falling Supply and Strengthening Demand

It is worth reiterating once again that the supply and demand dynamic in the municipal market is typically a key driving force that influences the value of municipal bonds. Through the end of May almost $8 billion flowed out of municipal bond mutual funds per Lipper data. This tells us that municipals were out of favor to investors. Last year over the same amount of time $38 billion flowed out of municipal funds as investors grew nervous about Federal Reserve action. During the three previous years investor sentiment was relatively strong (just not in March and in the first half of April of 2020, unsurprisingly). Before investors were spooked by the Fed rate actions last year, they were piling investment dollars into municipal funds. We expect that positive investor sentiment is going to continue to intensify in the second half of 2023 and into the first half of 2024. We believe investor attitudes toward municipals should and will turn more confident. This recovery could be uneven at times, but it will build. In fact, the recovery in municipal bond investor sentiment has already begun. In June we saw two weeks of inflows and two weeks of outflows. The outflows only average -$140 million. The average weekly inflow/outflow last year alone was -$1.5 billion. The average weekly inflow/outflow through the first six months this year has been -$274 million.

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The scarcity of municipal bonds will continue in the second half of 2023 as issuance remains below average and investor sentiment recovers. During the beginning of June we reminded investors that the investment landscape in municipals was still appealing in Municipal Yields are Historically Attractive- Our view on How to Finish Out the Second Quarter of 2023. The technical and yield-related landscape looks very similar relative to about a month ago. Yields may remain relatively attractive in the next 12-18 months and the supply and demand dynamic may fall out of investors' favor. What will a more unattractive landscape look like for investors? If issuance remains challenged and investor sentiment strengthens, we expect it will be more difficult for investors to find bonds that match their portfolios' needs. It could be a replay of the years when investor sentiment was very strong like we saw in 2019-2021, but it will be a more difficult market to negotiate because issuance will be lower than average.

Improbable We See Issuance Recovering to Match Last Year

It is improbable that we see municipal primary market issuance recover to a level that totals $391 billion (annual 2022 issuance) in 2023. So far in 2023 issuance has averaged $29 billion a month. In order for activity to meet last year's annual tally, issuance would need to average $36 billion a month for the next six months. We do not think that it is very likely the pace of issuance rises by $7 billion a month. We just do not see a catalyst that would create that level of action. Issuance has not averaged $36 billion a month since the first six months of 2022, when the Fed's battle against inflation was

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still unclear. We think it is more probable that the pace of issuance remains close to what we have seen already this year.

Again, we do not anticipate any facilitator drives primary market issuance to a higher pace. Rising or strong economic growth is typically correlated with new money municipal issuance. If economic growth falls, or if there is an economic slow-down new money issuance could fall relative to this year. If interest rates remain elevated, as they probably will, refunding issuance will remain challenged as well. Our above reference to what could occur after the 2024 elections refers to our continued expectation that the municipal bond tax-exemption tax-expenditure will be increasingly at risk. For more detail about this please see, A New Decade & Threat to the Municipal Bond Tax-Exemption (Oct. 22, 2021). We continue to expect that the D.C. lawmakers quest for deficit reduction measures will lead them to consider cutting tax-expenditures, and that puts the municipal bond tax-exemption at risk.