U.S. Municipal Bond Market

Appealing Municipal Market Indicators and Strong Economic Data is Fueling the Golden Age of Municipals Despite Near-Term Uncertainty

Tom Kozlik
Head of Public Policy and Municipal Strategy
214.859.9439
tom.kozlik@hilltopsecurities.com

- Municipal yields have risen to some of their most attractive levels this year, and relative value indicators are also appealing.
- Housing prices turned positive in July. This, and other stronger than anticipated economic indicators are likely to extend the "Golden Age of Municipals." Therefore, overall credit quality has the potential to be stronger for a longer period of time despite hints of near-term economic uncertainty.
- Public finance upgrades outpaced downgrades again in the second quarter of 2023. We could see a record number of public finance upgrades in 2023. Upgrades are likely to outpace downgrades in 2024 as well.
- We still like credit-quality, the recovery story, and overall activity in the airport and toll road sectors. We also like Texas local governments.
- There are pockets of the municipal market that still have us concerned. It has been more difficult for select credits in sectors such as higher-education and healthcare with less resources to recover their fiscal balance.

Signs Indicate Municipal Bonds Attractive Again

The United States economy has proven to be more resilient than most expected in 2023, and this surprise has contributed to why we are bullish again on much of the U.S. municipal bond market. Peaking yields and attractive relative value measures are adding to our improved municipal bond confidence. It has been prudent for investors to tactically allocate investment dollars into the municipal bond market on a regular

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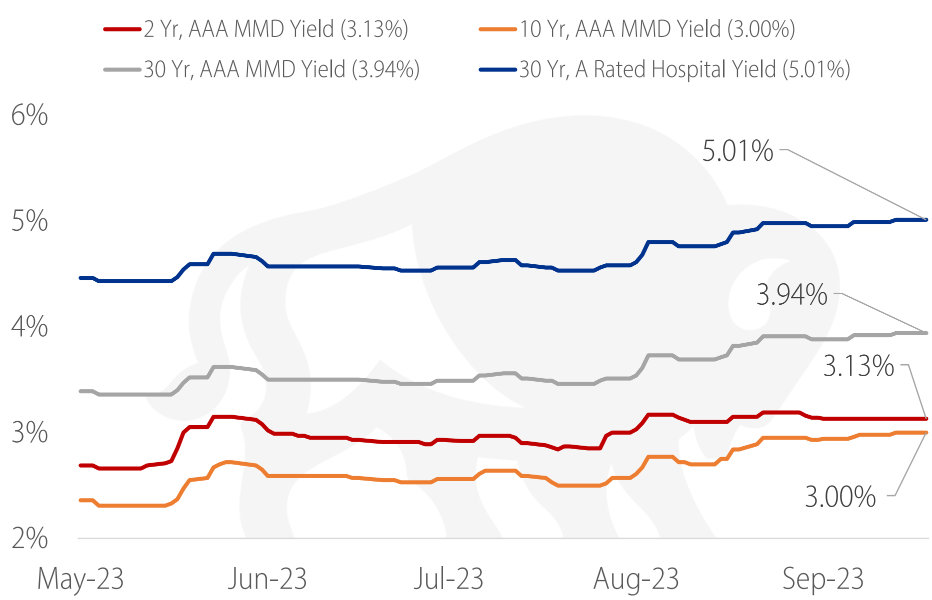
Most Municipal Yields are Peaking to End the 3rd Quarter



Source: Refinitiv and HilltopSecurities.

basis this year. We last indicated an opportunity existed for investors back at the beginning of June in Municipal Yields are Historically Attractive- Our View on How to Finish Out the Second Quarter of 2023. Another window for investors is open as the Federal Open Market Committee (FOMC) is set to meet this week on Sept. 19-20.

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Municipal yields are mostly at or near their peak for the year. AAA municipal benchmark yields have risen 40+ basis points in some cases. Back in June the Bloomberg U.S. Municipal Bond Index was at a 3.58%, and it has risen almost 30 basis points over the last three months to 3.87%. Many are expecting the FOMC to pause their interest rate hiking campaign this week. It is possible they could raise their target rate again at their Oct. 31/ Nov. 1 or Dec. 12-13 meetings, but it is likely that we are closer to the end of this cycle rather than the beginning.

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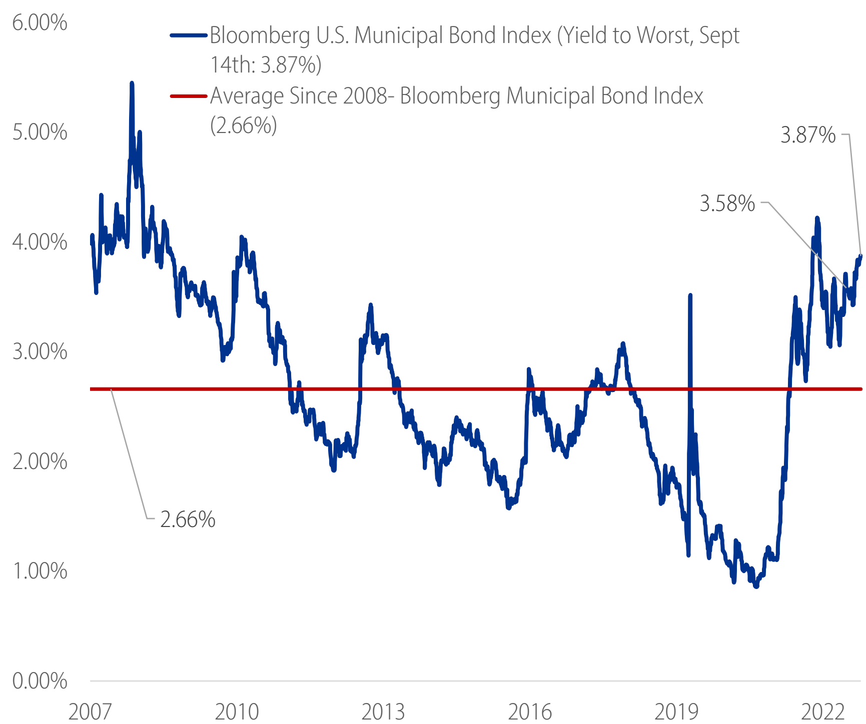
Municipal Yields are Historically Attractive, Again



Source: Bloomberg and HilltopSecurities.

M/T Ratios are Above the 2023 Average

The Municipal to Treasury Ratio or M/T Ratio is a key relative value indicator when comparing tax-exempt municipal bonds to taxable investments. Many M/T ratios are looking as attractive as they have looked all year now. The 10-year M/T ratio is now about 70%, close to where it was back in June and just above the 2023 10-year M/T ratio average for 2023 of 66.5%.

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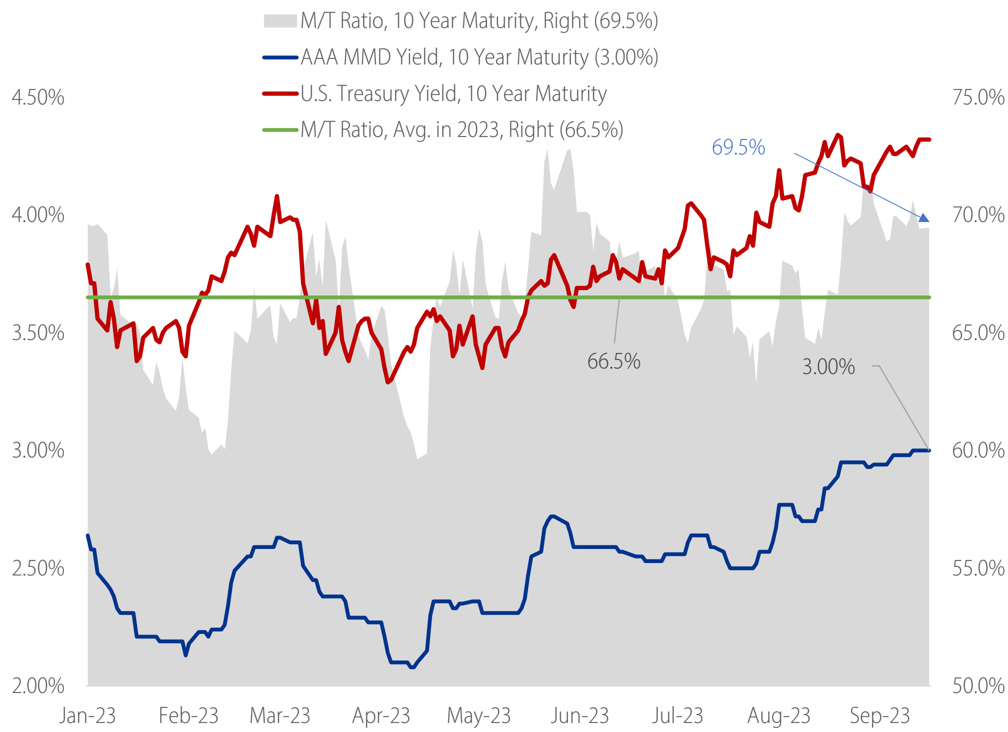
Municipal Yields & M/T Ratios are Attractive to Finish the 3rd Quarter



Source: Refinitiv and HilltopSecurities.

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Fueling the Golden Age of Public Finance

A financial reckoning was expected just a shade less than a year ago. Many were anticipating economic softening as the pendulum swung back after several years of above-average levels of federal stimulus combined with higher interest rates. An October 2022 Bloomberg article reported a Bloomberg Economics model forecast a 100% chance of an economic downturn developing by the end of 2023. The model seems to be off, at least for now.

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The U.S. economy has held up much better than expected through nine-plus months of 2023. We think the stronger than expected economic data is fueling the Golden Age of Public Finance. One category of economic data that has a profound impact on municipals is housing because of its direct relationship to property tax revenue.

A national housing downturn in prices began in February of this year after 11 years of positive home price appreciation going back to 2012. This year home prices fell for five straight months according to the National Association of Realtors. This had the potential to chip away at municipal credit quality, but the downturn was short-lived. Numbers released in July hinted that the worst of the housing downturn could be over. Home prices were reported to be up +1.9% in July year-over-year. New housing data for August is going to be released toward the end of this week as well. If the market survey expectation holds then we could see two straight months of home price appreciation, this would be an even stronger argument for a longer bullish stance on municipals.

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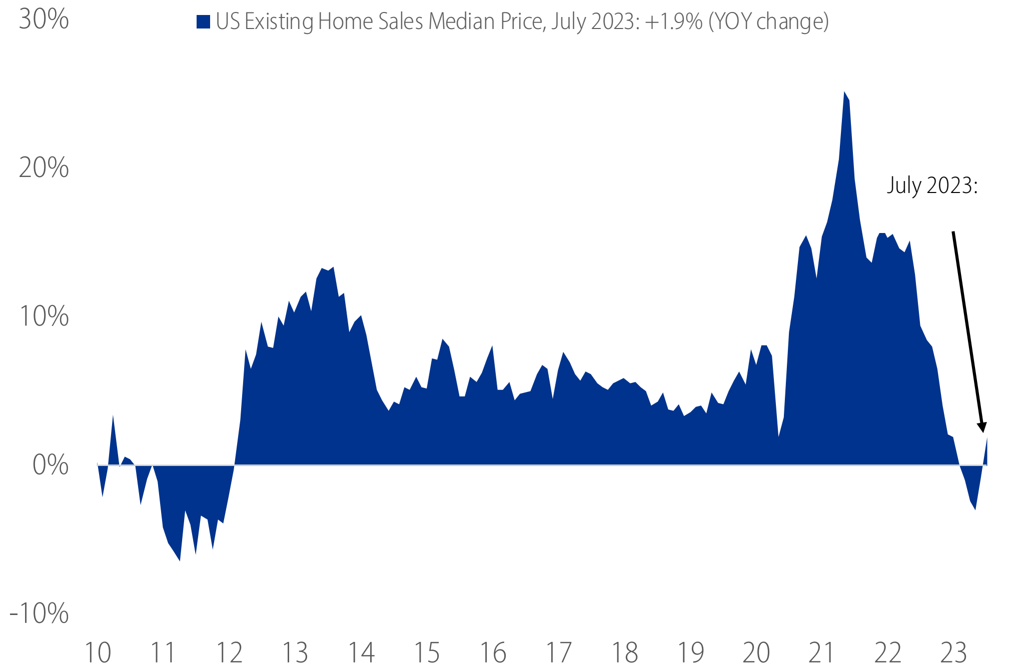
Quick Recovery in U.S. Housing Prices



Source: National Association of Realtors and HilltopSecurities.

Better than expected economic data is helping to fuel credit quality across the municipal bond market.

Better than expected economic data is helping to fuel credit quality across the municipal bond market. Local government sector upgrades are contributing most to the Moody's Investor Service public finance upgrade activity. We have already seen almost as many upgrades through the first half of this year as we did in all of last year. Therefore, we could be on pace to beat the 817 upgrades we saw back in 2021. Pennsylvania's (State of) general obligation rating outlook was raised (Sept. 8) by Moody's to "Positive" from "Stable" on the commonwealth's Aa3 underlying rating. Increases in Pennsylvania's rainy-day fund helped to boost the rating agency's credit outlook.

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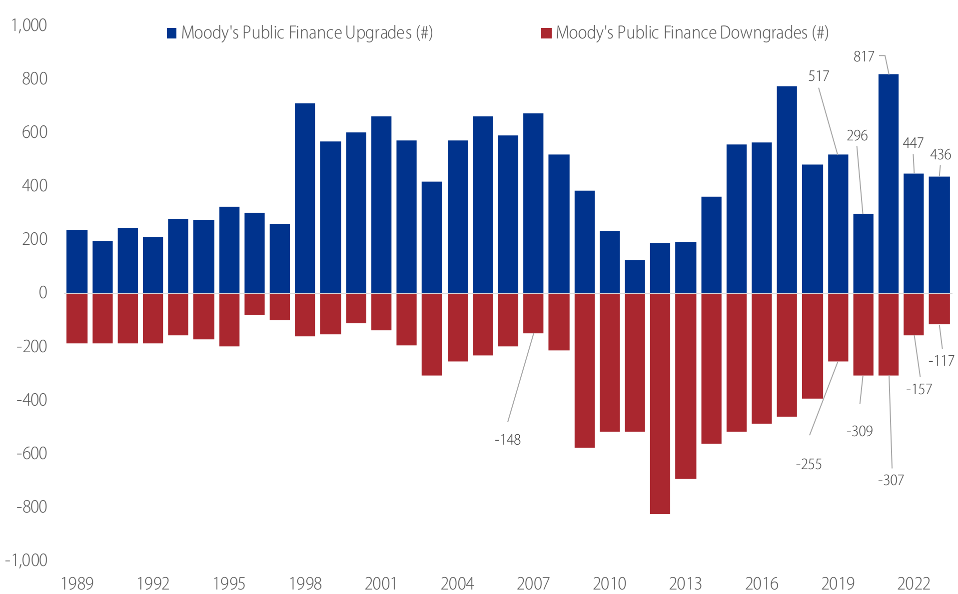
Public Finance Upgrades Outpaced Downgrades in the First Half of 2023



Source: Moody's Investor Service and HilltopSecurities.

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What Areas or Sectors of the Municipal Bond Market Do We Like Right Now?

Demand for U.S. travel continued through the summer months, and we do not expect it to tail off as long as the economy holds up. We have been seeing positive activity being reported in the form of enplanements in the airport sector and we continue to expect that airport activity and demand will remain strong. Therefore, the airport sector is one that we continue to think investors should consider. Transportation generally is an area we like, and the toll-road sector is one we like. We specifically expect toll-roads to continue to recover from the downturn and we also see value in this sector because we see it as a potential inflation hedge. We remain very bullish on the U.S. state and local government sectors, and school districts as noted above when we reiterated our positive expectation for the "Golden Age of Public Finance." The positive economic data is causing us to think that the "Golden Age" could last even longer than we originally anticipated.

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Not only do we think public finance upgrades are going to outpace downgrades for the rest of 2023, we think there could be a record number of public finance upgrades in 2023. We also now think that upgrades will outpace downgrades in 2024 as well. We find Texas local governments and K-12 school district bonds attractive now. An increase of Texas local government and K-12 school issuance in recent months helped to boost spreads, but credit quality remain in line with national levels.

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National & Texas Rating Comparison

Sector	Rating
U.S. State Median Rating	Aa1
Texas (State of) Rating	Aaa
Local Government	
National Local Govt. Median	Aa2
Texas Local Govt. Median	Aa2
K-12	
National K-12 Median	Aa3
Texas K-12 Median	Aa3
Texas Perm. School Fund Enh.	Aaa

Source: Moody's and HilltopSecurities.

If investors want to isolate their portfolios from uncertainty like D.C. politics, international geo-political affairs, or labor conflicts, investors should look to the highest quality general obligation and municipal revenue bonds. In the beginning of 2023 we saw investors gravitate toward the highest quality municipals when cracks in the banking sector developed. The financial strength of high-quality municipals is at or near the strongest they have ever been. They are an attractive option compared to other high-grade investments at this time. High-quality state and local government and high-quality revenue bonds are widely available at this time, and this is what we see most traditional municipal bond investors gravitating toward, as they should. Most traditional municipal bond investors are happy to isolate their portfolios from the latest uncertainty by staying with the highest quality options in U.S. municipals. High quality U.S. municipals are an

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optimal way to detach investment dollars from the day-to-day headlines and stresses that come and go.

We also continue to talk to investors about reviewing holdings on a CUSIP-by-CUSIP basis. This remains to be an optimal time to replace credits less likely to adapt to the revenue reality likely to take hold in two to three years with stronger quality credits.

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Where Should Investors Be Careful?

There are different inputs pressuring individual sectors and credits such as demographic shifts, and remote work activity. In most cases sectors and individual credit are able to adjust to changes such as these but in some cases these pressures are mounting and should be closely watched. This is especially the case for some credits in the higher education and non-profit healthcare sectors. In some cases some of the smaller entities in both of these sectors are among the most exposed. We caution investors to review holdings in these sectors and be especially vigilant with entities with less resources. Many in the nonprofit hospital sector have been hampered by rising costs and/or weak or negative operating margins recently. We are watching these closely as well.

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Recent HilltopSecurities Municipal Commentary

- Transformative Technology and its Economic Impact, Sept. 6, 2023
- Save the Tax-Exemption, A Call to Action for U.S. Public Finance, August 17, 2023
- First Half Public Finance Primary Issuance Down 20%, Foreshadows Potential Scarcity of Municipal Investment Options, July 5, 2023
- Municipal Yields are Historically Attractive – Our View on How to Finish Out the Second Quarter of 2023, June 8, 2023
- Debt Ceiling Deal Likely to Avert Default, Not Expected to Claw Back State & Local Govt. Fiscal Aid, May 31, 2023

Readers may view all of the HilltopSecurities Municipal Commentary here.