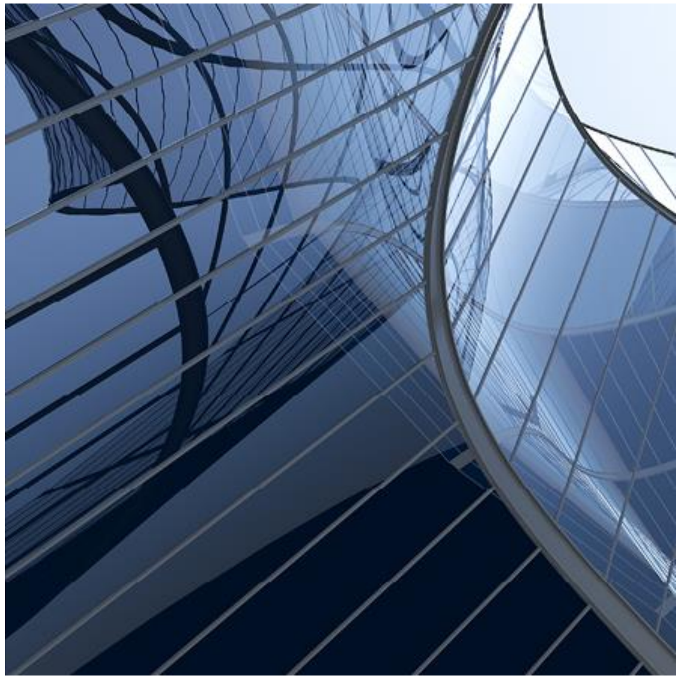
Morgan Stanley

INVESTMENT MANAGEMENT

Municipal Bond Market Monitor

Municipal Bond Group

Q2 2024



Q2 2024 Municipal Market Review

Strong June Leaves High Quality Indices Flat For The Quarter, While High Yield Municipals Shine

- Muni bond Index: -0.02% | HY Muni Index: +2.59% | Taxable Muni Index: -0.19%
- US Treasury: +0.10% | Corporate: -0.09%

Despite June Rally, Yields Higher Again in Q2

Q2 '24 AAA Muni

- 2-Year: 2.97% → 3.11% +14 bps
- 5-Year 2.54% → 2.89% +35 bps
- 10-Year 2.51% → 2.84% +33 bps
- 30-Year 3.68% → 3.72% +4 bps

YTD '24 AAA Muni

- 2-Year: 2.52% → 3.11% +59 bps
- 5-Year 2.28% → 2.89% +61 bps
- 10-Year 2.28% → 2.84% +56 bps
- 30-Year 3.42% → 3.72% +30 bps

Municipal Fund Flows Remain Positive

- After two negative years, YTD municipal fund flows are positive at $11.4 billion.
- YTD, Long Duration (+$14.1bn) and High Yield (+$7.4bn) flows are particularly strong, while Short Term flows (-$2.4bn) remain negative.

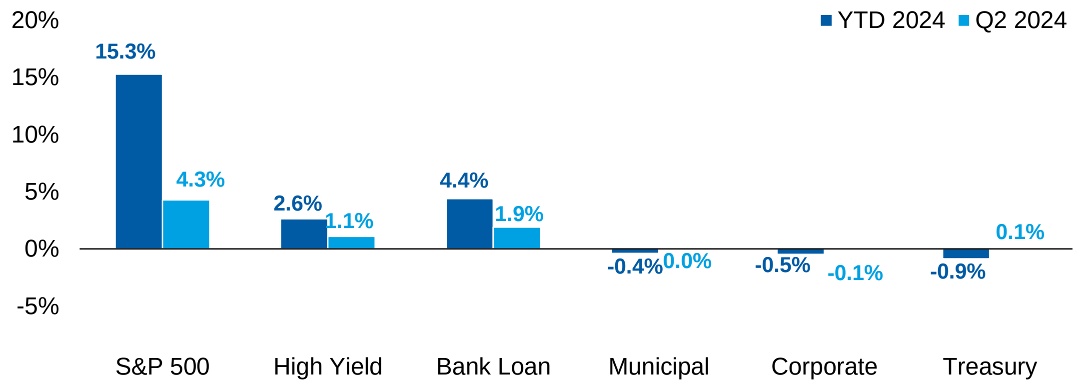
Past performance is no guarantee of future results. It is not possible to invest directly in an index. See end of report for important additional information. This commentary may contain statements that are not historical fats, referred to as "forward looking statements". Actual future results may differ significantly from those stated in any forward-looking statement, depending on factors such as changes in securities or financial markets or general economic conditions.

Source: Index Performance: Bloomberg, AAA YTD changes as of 6/30/2024. Fund Flows: Lipper, Ratios: Bloomberg

Overview

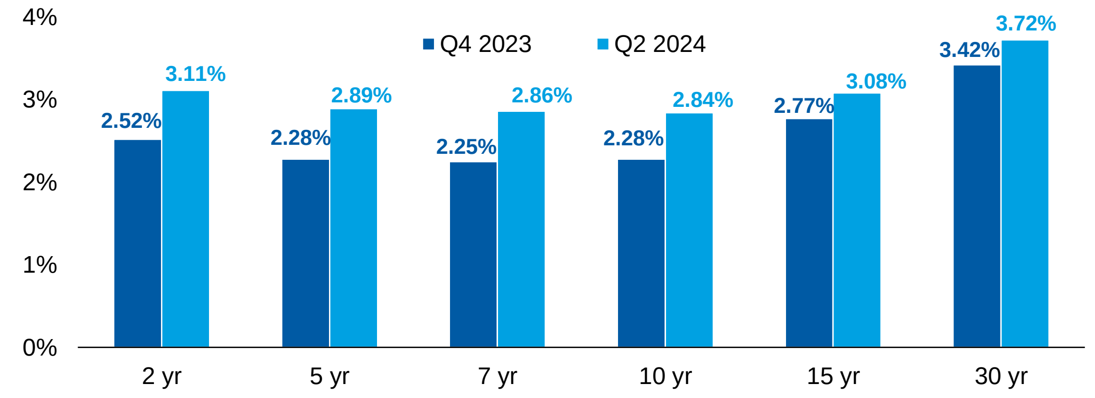
- The Fed last raised Fed funds almost one year ago, and policymakers have kept the benchmark rate at a two decade high of 5.25% to 5.5% for seven consecutive meetings.
- Data showing persistent inflation, a robust economy and strong labor market have sent yields higher as markets have adjusted to the prospect of higher for longer.
- In the second half, the cumulative impact of restrictive policy may cool the US economy and bring inflation closer to target. As a result, the first rate cut could occur in late 2024 or early 2025.

Major Asset Class Returns



- Treasury volatility persisted with yields rising 15-23bps. Year-to-date, treasury yields are approximately 50bps higher across the curve.
- 5yr (+35bps) and 10yr (+33bps) municipals underperformed, while 30yr municipals outperformed as benchmark yields rose only 4bps.

AAA Municipal Yields (%)

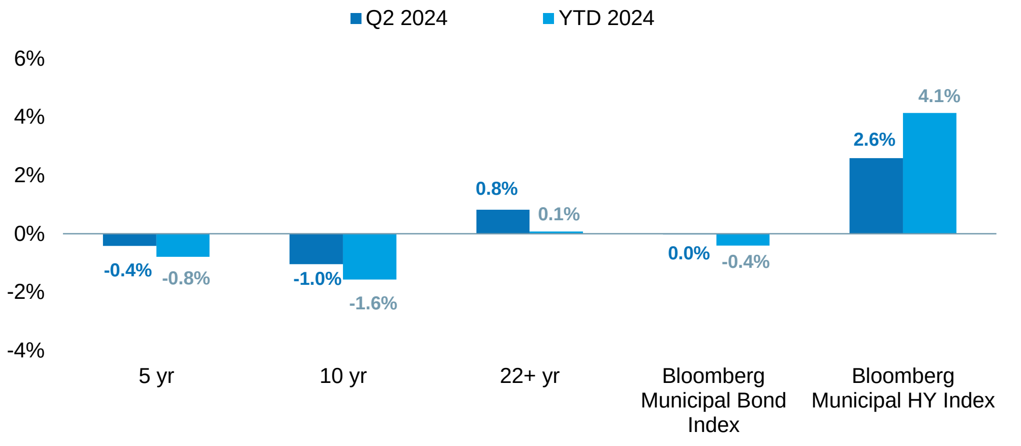


Source: Bloomberg and Thomson Reuters as of 6/30/24. **Past performance is no guarantee of future results**. It is not possible to invest directly in an index. See end of report for important additional information. *Basis points (BPS) is a unit that is equal to 1/100th of 1% and is used to denote the change in a financial instrument.

Index Returns

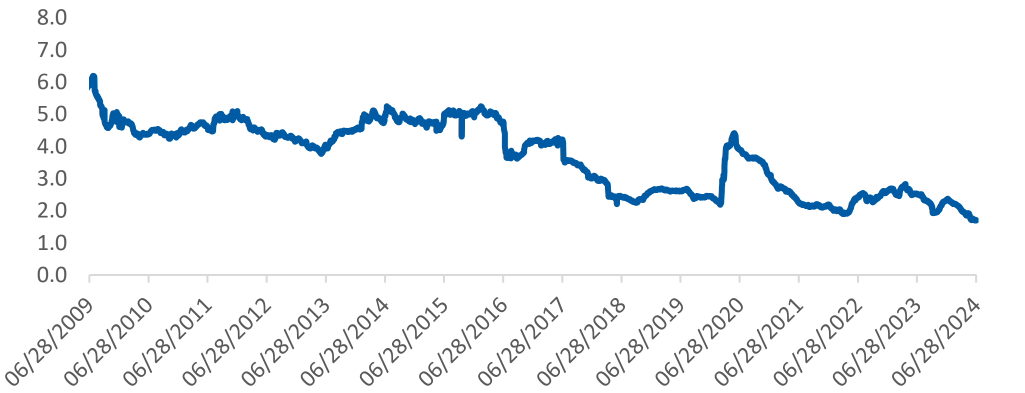
- The belly of the municipal curve underperformed with 5yr, 7yr and 10yr indices down the most. Meanwhile, the very short end and the long end of the curve produced positive returns.
- High yield municipals continued to outpace investment grade returning 2.6% for the quarter and 4.1% year-to-date.

Index Returns



- With the outperformance, high yield spreads tightened 30bps and finished the quarter at +171bps to the Investment Grade Index.
- We continue to believe that strong credit fundamentals, high absolute yields, and positive technicals could result in additional high yield outperformance.

High Yield Index vs IG Index Yield to Worst Spread

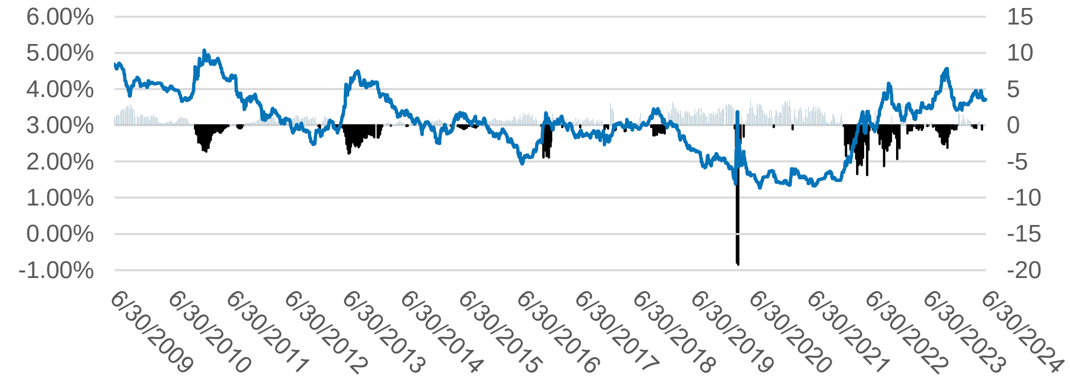


Source: Bloomberg, MMA and Morningstar Direct as of 6/30/24. **Past performance is no guarantee of future results.** Performance less than one year is cumulative. It is not possible to invest directly in an index. See end of report for important additional information.

Flows and Issuance

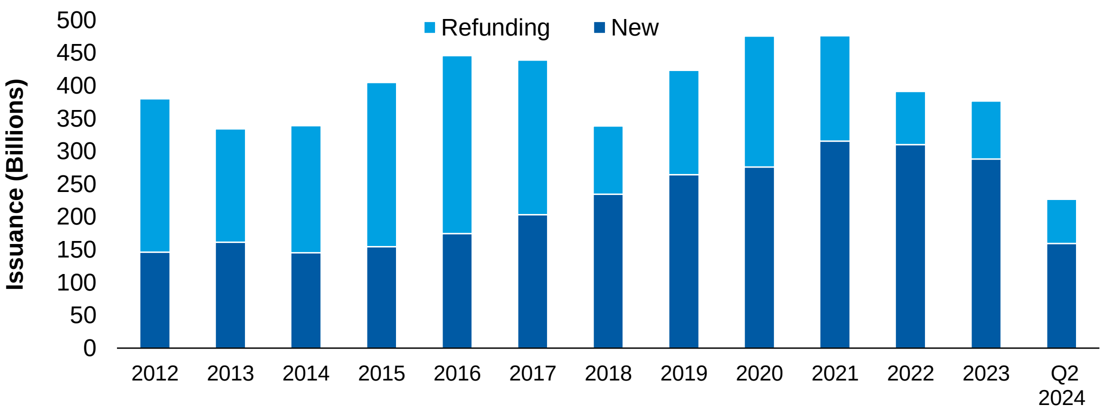
- YTD, fund inflows totaled $4.0bn for investment grade and $7.4bn for high yield.
- Meanwhile, year-to-date short term fund flows remained negative (-$4.0bn) while long term (+$14.1bn) and intermediate funds (+$1.3bn) remained positive.

Muni Mutual Fund Flows



- At $235bn, year-to-date issuance is up 37% year-over-year. Approximately 70% of issuance was new money and 30% refunding deals.
- At $16.6bn, taxable municipal issuance is down approximately 19% year-over-year.

Municipal Bond Issuance: New vs. Refunding

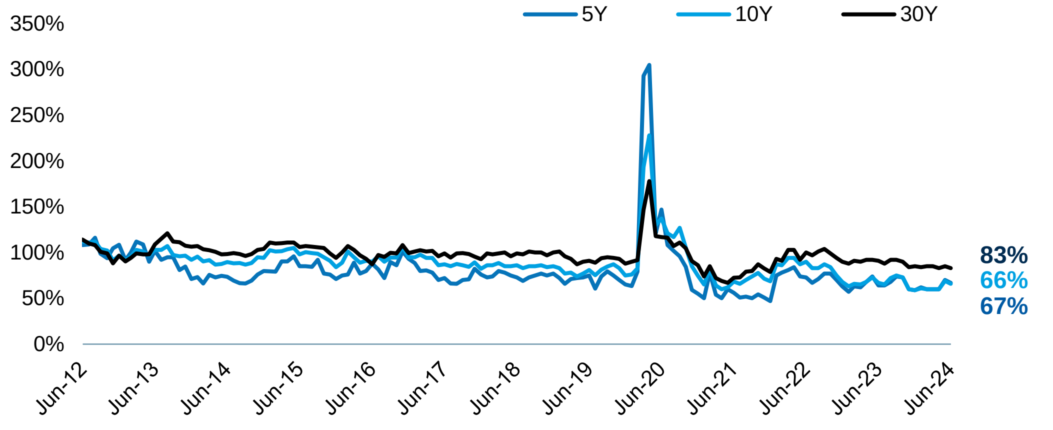


Source: Sifma, BofA Merrill Lynch Global Research, Thomson Reuters Municipal Market Data. Date Range: March 2009– June 2024.
Flow data provided by J.P. Morgan as of 6/26/2024. Municipal Bond Issuance data from SIFMA, Bloomberg Barclays Research as of 6/30/2024. Private placement issuance counted as new capital.

Muni-to-Treasury Yield Ratios

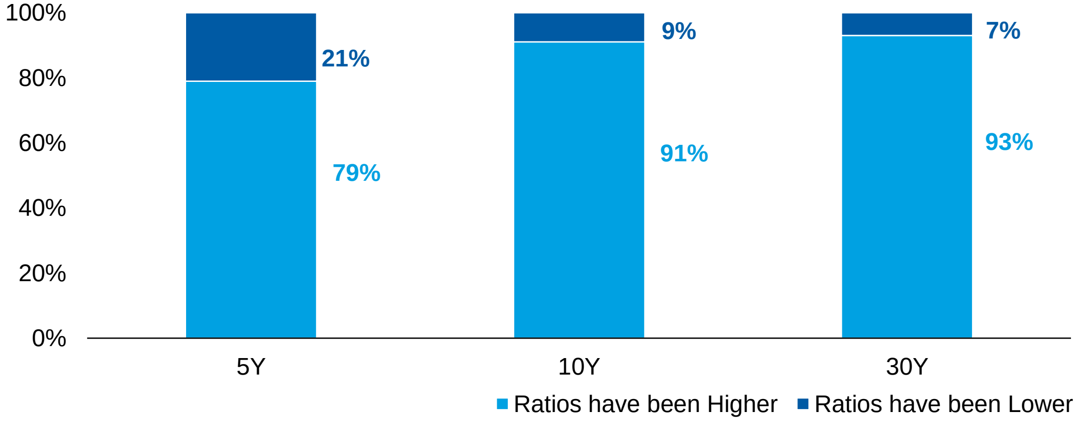
- With the exception of the 30yr, Muni/treasury ratios cheapened across the curve in Q2.
- Specifically, the 5-year muni/treasury ratio increased from 60% to 67%, the 10-year also increased from 60% to 66% while the 30-year decreased from 85% to 83%.

AAA Muni-to-Treasury Yield Ratios (%)



- Over the last 10 years, the 5-year, 10-year and 30-year muni/Treasury ratios have been lower (richer) approximately 21%, 9%, and 7% of the time, respectively.
- Despite the Q2 cheapening, we continue to believe investors should think about moving down in quality for more attractive value and consider actively managed strategies focused on both income and total return.

How Attractive Are Muni/Treasury Ratios vs. History



Source: Thomson Reuters as of 6/30/24, Bloomberg as of 3/31/24. **Past performance is no guarantee of future results.** It is not possible to invest directly in an index. See end of report for important additional information.

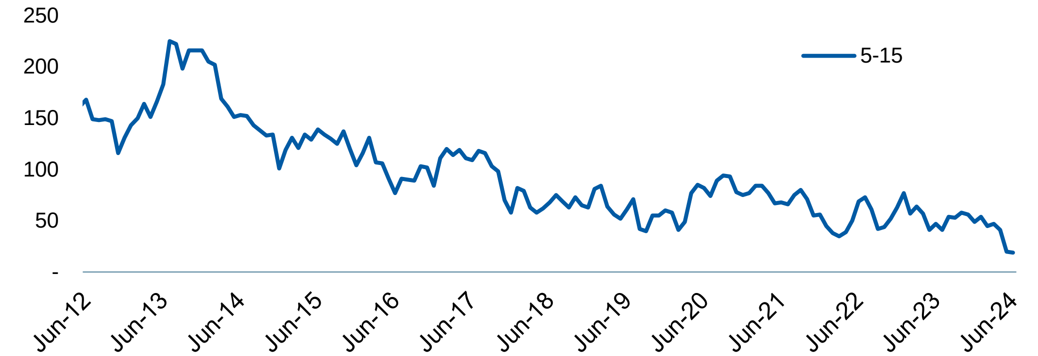
Municipal Yield Curve

- The municipal curve continued to bear flatten in Q2 as 2-year yields increased 14bps, and 30yr yields increased 4bps.
- Most notable was the underperformance of the belly of the curve as 5-year and 10-year yields rose 35bps and 33bps, respectively.
- While the entire muni curve (2yr-30yr) remains upwardly sloping, the treasury curve remains inverted as the 2-year yield ended the quarter at 4.77% while the 30-year yield finished at 4.57%.

2-Year / 30-Year Curve

- At quarter end, the five-to-fifteen year portion of the muni curve had flattened as 5-year yields increased 35bps while 15-year yields increased 10bps.
- At the end of the quarter, an investor picked up 78% of the yield available by going out 5 years and 83% by going out 15 years.

5-Year / 15-Year Curve

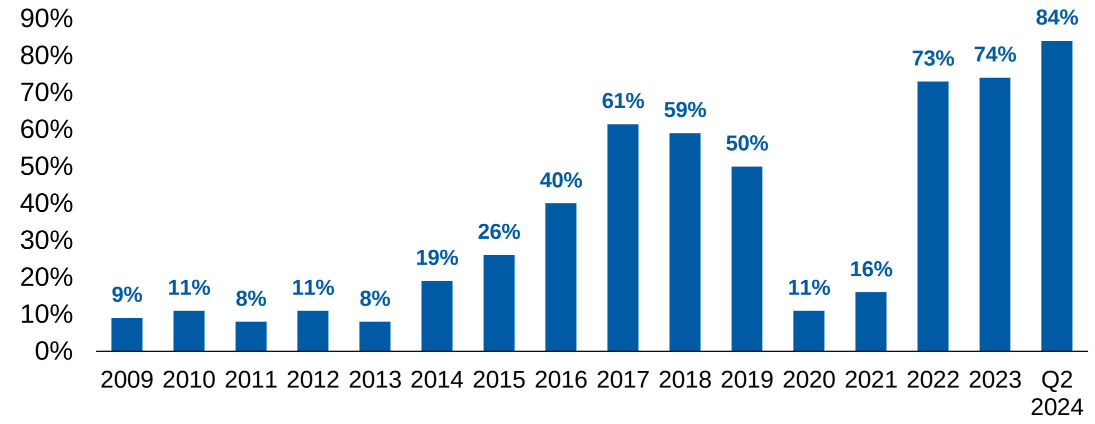


Source: Thomson Reuters as of 6/30/24. **Past performance is no guarantee of future results.** It is not possible to invest directly in an index. See end of report for important additional information.

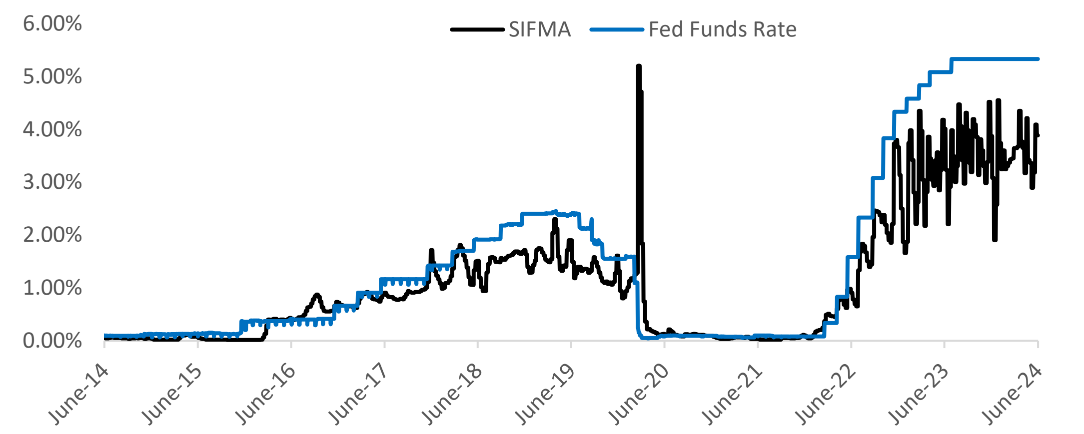
Municipal Yield Curve

- Since increasing its policy target 25bps in July 2023, the Fed has held steady at 5.25% - 5.50%.
- At quarter-end, the market is pricing in a ~58% chance of a 25bps cut at the September Fed meeting and a 93% chance of at least one cut by the end of the year.
- Fed Funds held steady and the SIFMA* Index ended Q2 at 3.88%, a 1bp increase from the beginning of the quarter.
- With attractive absolute yields on ultra-short and short municipals, we continue to believe investors should consider a barbelled approach by maintaining some short-duration exposure while thoughtfully adding duration.

Percentage of Entire Municipal Yield Curve Captured by 2-Year Municipal Bond



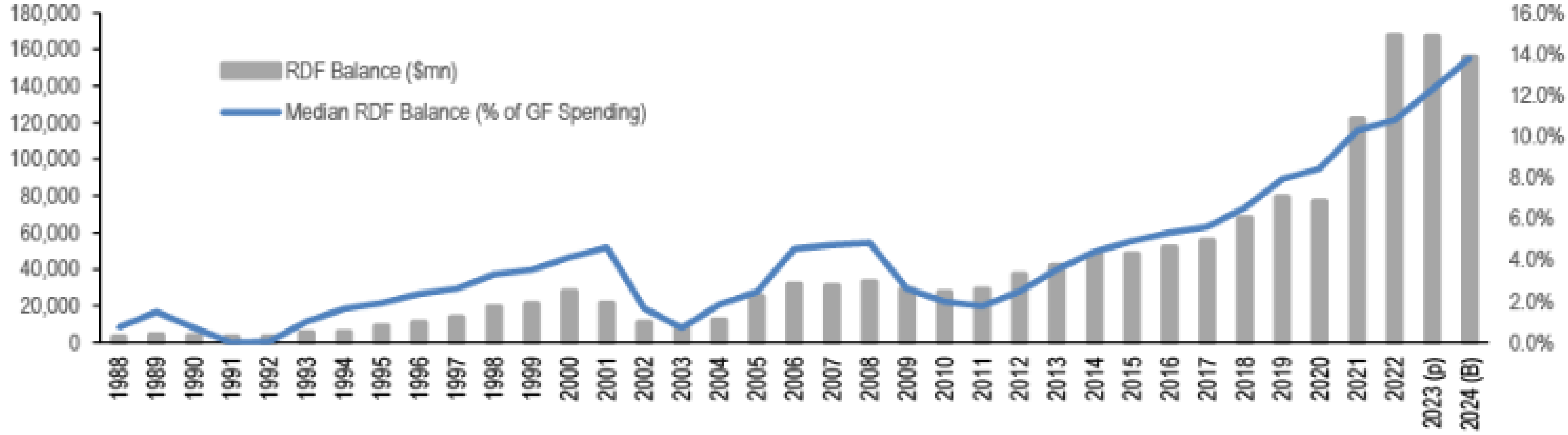
SIFMA & Fed Funds Yield (%)



Source: Thomson Reuters, Federal Reserve as of 6/30/24. *SIFMA is a seven-day high grade money market index comprised of tax-exempt variable rate demand obligations. **Past performance is no guarantee of future results.** It is not possible to invest directly in an index.

States Prudently Building Liquidity

Median rainy day fund balances were maintained in FY23. Slight moderation expected in FY24, but could reach a record high in terms of reserves as a % of general fund spending ($155bn/14%)



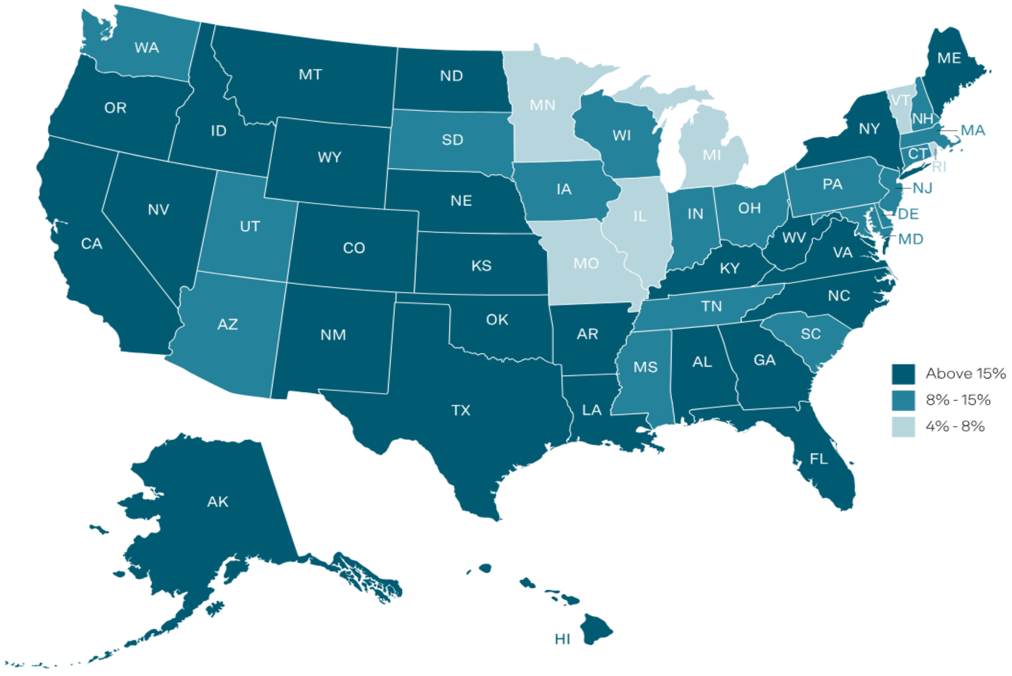
Source: National Association of State Budget Officers, J.P. Morgan

Source : National Association of State Budget Officers, State Rainy Day Fund Balance Historical Data Set, 1988-2024, J.P. Morgan.

High Levels of Reserves and Budget Discipline

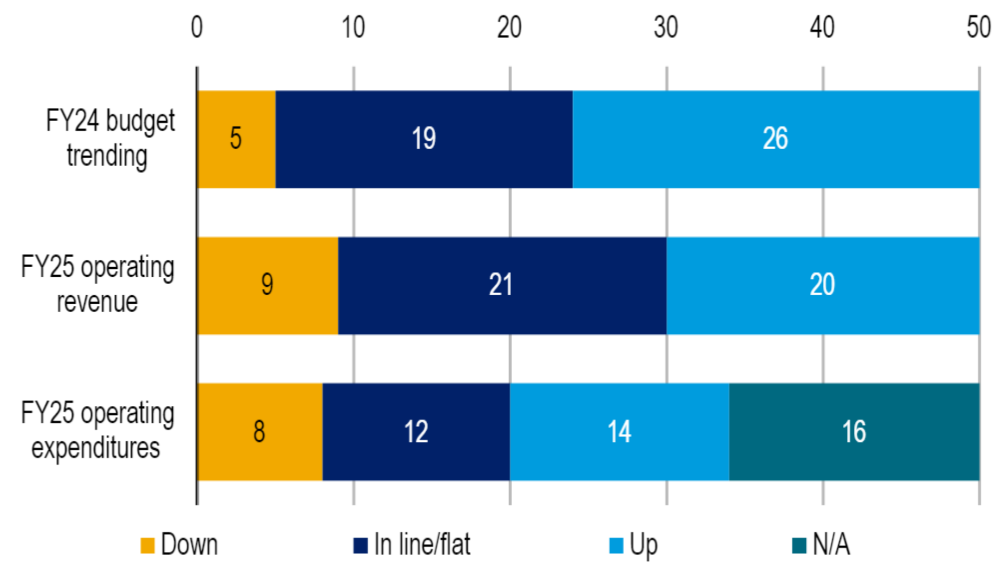
A large contingent of states have kept reserves in excess of 15% of FY2024 operating expenditures and state budgets appear to be in a strong place relative to expectations

Reserves as a % of 2024 FY operating expenditures (estimate)



FY--Fiscal year. Source: S&P Global Ratings.

FY24 state budgets better or in line w/ expectations



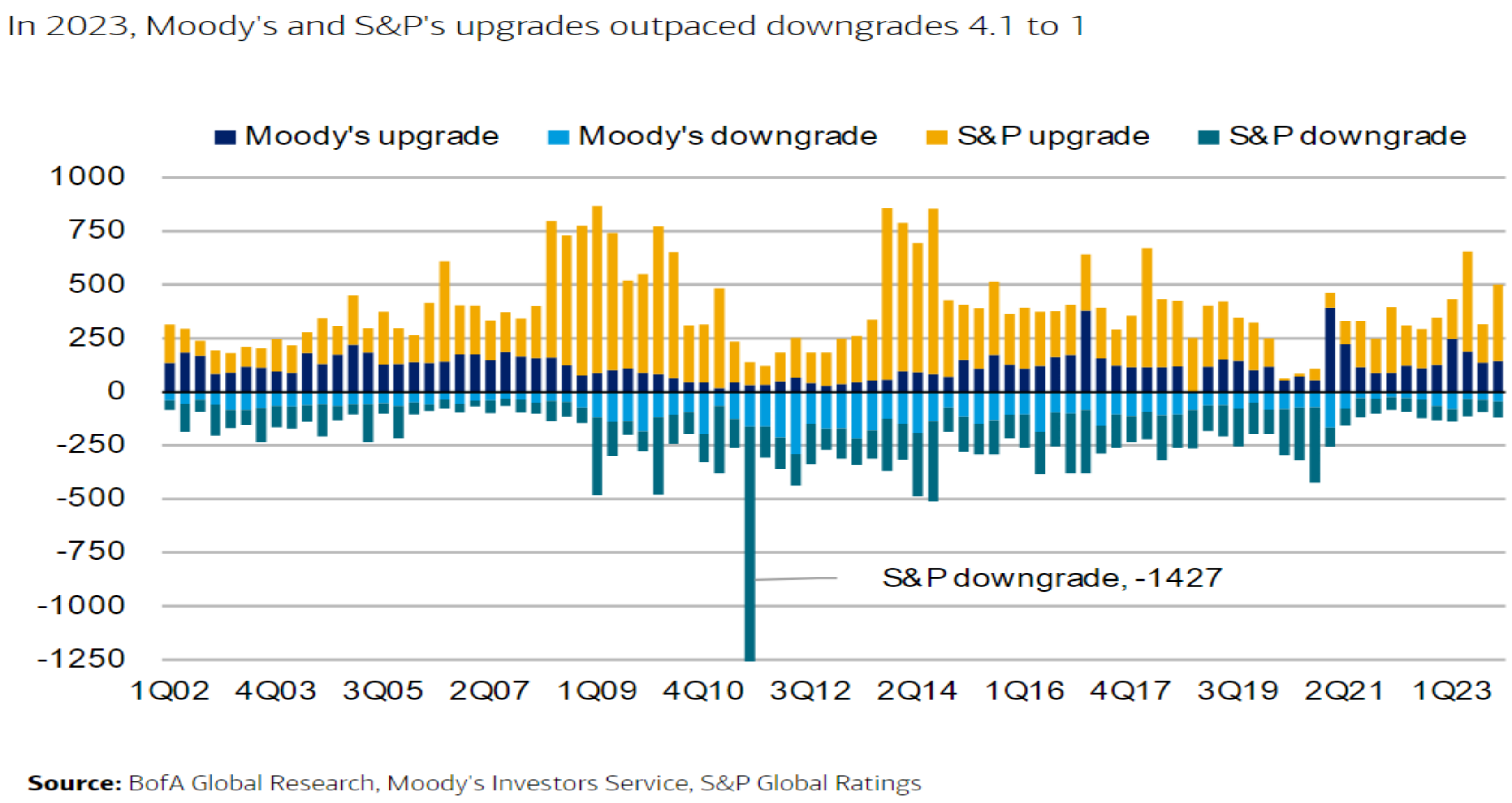
Source: S&P Ratings

Source: S&P Global Ratings. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

Credit Quality Remains Strong, but Seeing Some Weakness in Certain Sectors

Upgrades continue to outpace downgrades, with a moderating quarterly trend

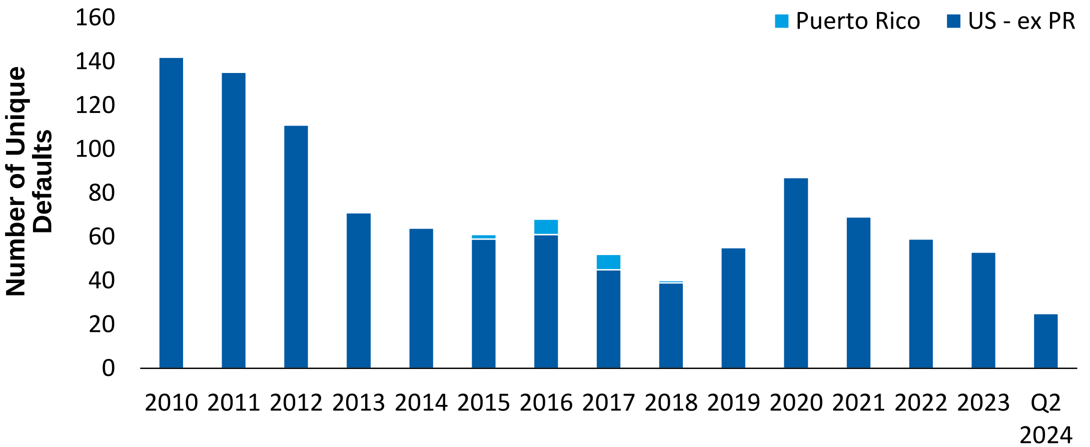
Moody's and S&P Count of Municipal Upgrades and Downgrades,



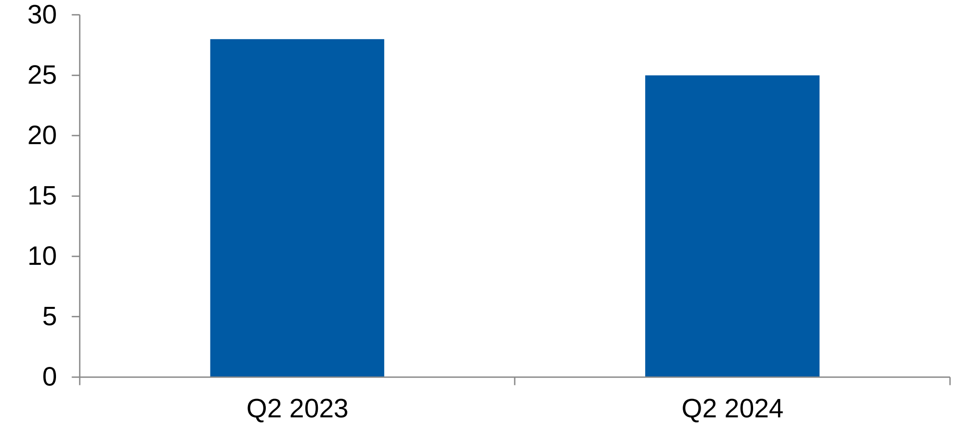
Source: Moody's Investors Service, S&P Global Ratings, BofA Global Research. Data through 4Q23.

Municipal Default Overview

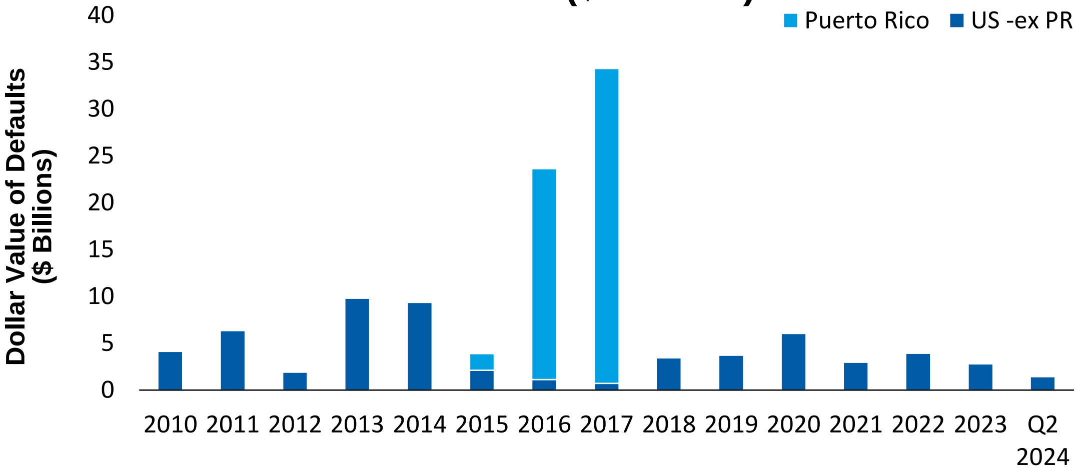
Number of Unique Annual Defaults



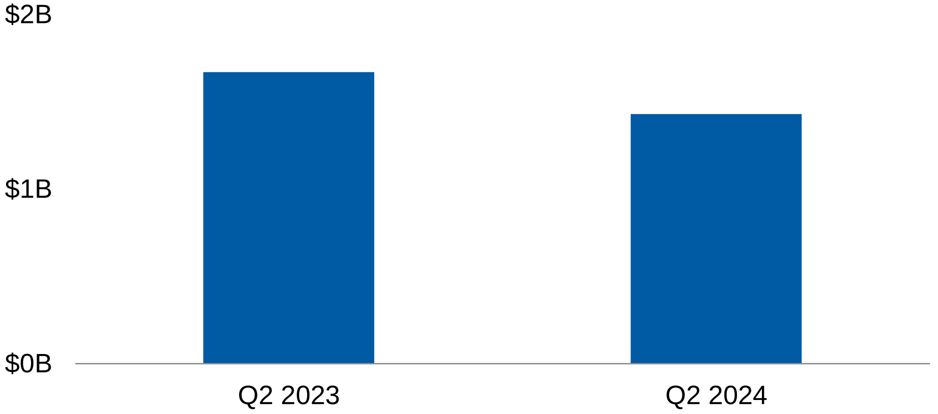
YTD Number of Unique Defaults was down 11% YoY



Dollar Value of Annual Defaults ($ Billions)



YTD Dollar Value of Defaults ($ Billions) Decreased by 14% YoY

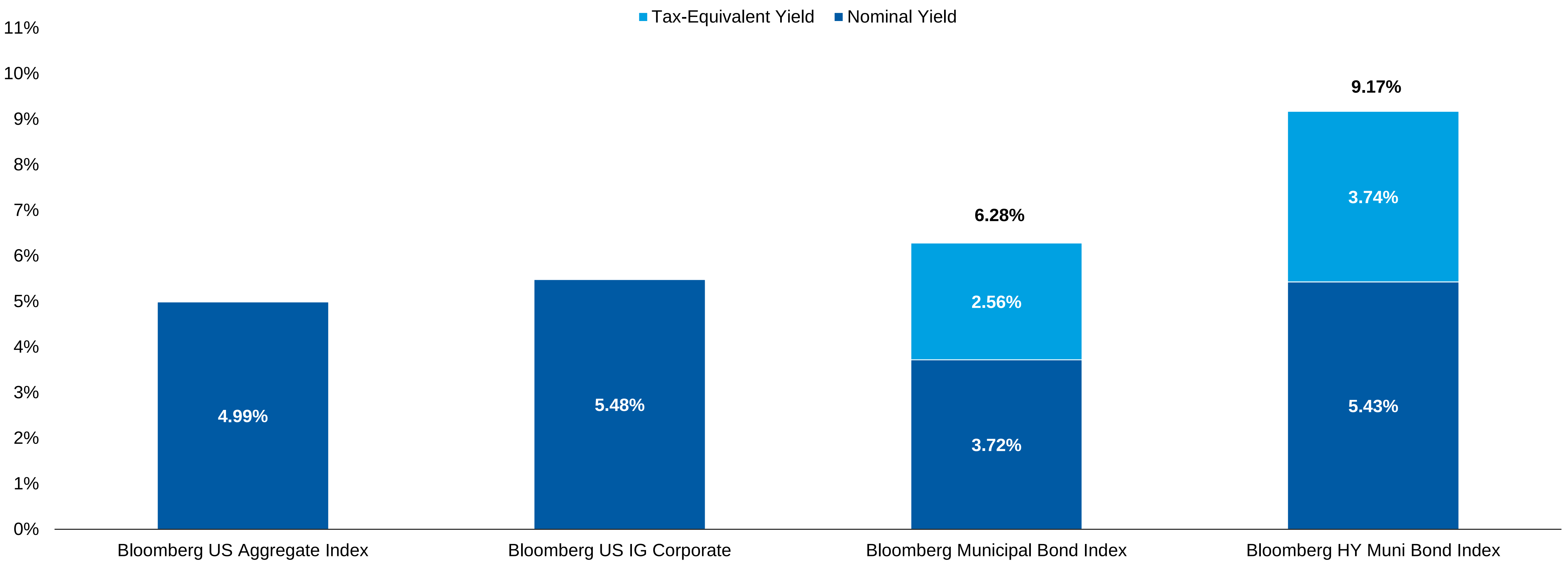


Source: MMA. Default data as of 6/30/2024

Taxable Equivalent Yields

Municipal taxable-equivalent yields appear very attractive relative to other high-quality options.

Taxable Equivalent Yields



Sources: Barclays Live as of 6/30/24, Tax Policy Center. This table is for illustrative purposes only and uses the highest current applicable federal tax rates plus 3.8% health care tax. **Past performance is no guarantee of future results.** It is not possible to invest directly in an index. See end of report for important additional information.

Municipal Market Outlook

- We remain focused on the Fed's ability to balance a tug-of-war between economic fundamentals and US Treasury issuance needed to fund a continually mounting deficit.

- Entering the second half, municipal yields are 30–60 bps higher since January. Tax exempt yields in the 3.0% to 4.0% range have kept buyers engaged as these levels equate to tax adjusted yields of 6% to 7% for higher tax bracket investors.

- We believe the combination of elevated yields and anticipated rate cuts will continue to drive net positive flows to the asset class in the second half of the year.

- The shape of the muni curve continues to provide a yield pickup over the front end by extending duration and we maintain our neutral to overweight duration positioning heading into H2.

- Given elevated front-end yields, inversion in the belly of the curve, and positive upward slope out longer, we believe a barbell approach may be an attractive way to deploy capital on the muni curve.

- Bottom line: Recent metrics around growth, inflation and the labor market suggest that US economy is beginning to slow. While the timing and pace of rate cuts remain data dependent, we encourage investors to consider stepping out of cash, assume more credit and duration risk, and lock in yields near decade highs.

Appendix: Additional Slides

Overview of Legislation and Municipal-Related Spending in Relief Bills

The below table provides a high-level summary of the fiscal support for municipals through the four most recent pieces of legislation passed by Congress. In aggregate, over $1.7 trillion of capital has been allocated to various parts of the municipal bond market.

	2021 Infrastructure Bill	American Rescue Plan	Dec. Federal Stimulus	CARES Act
Total Muni Market Support	**$550**	**$650**	**$157**	**$347**
States	$136	$408	$30	$169
Locals	--	$182	$30	$164
Community based orgs.	--	–	–	$1
Not for Profits	--	$0.8	$15	–
Healthcare	--	$13	$4	$108
Primary/Sec Education	--	$137	$58	$25
Higher education	--	$40	$26	$17
Airports/Ports	$42	$11	$2	$10
Surface transit	$110	–	$10	–
Mass transit	$39	$30	$14	$25
Other Transportation	$78	$2	$2	–
Housing	--	$39	$25	–
Utilities	$143	–	–	–

Source: US Congress, J.P Morgan. Note: Sum of individual sector amounts may not add up to aggregate total due to double counting, as much of the capital is shared across sectors.

RISK CONSIDERATIONS

An imbalance in supply and demand in the municipal market may result in valuation uncertainties and greater volatility, less liquidity, widening credit spreads and a lack of price transparency in the market. There generally is limited public information about municipal issuers. Investments in income securities may be affected by changes in the credit worthiness of the issuer and are subject to the risk of non-payment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. As interest rates rise, the value of certain income investments is likely to decline. The London Interbank Offered Rate or LIBOR, is used throughout global banking and financial industries to determine interest rates for a variety of financial instruments (such as debt instruments and derivatives) and borrowing arrangements. The ICE Benchmark Administration Limited, the administrator of LIBOR, ceased publishing certain LIBOR settings on December 31, 2021, and is expected to cease publishing the remaining LIBOR settings on June 30, 2023. The transition process may involve, among other things, increased volatility or illiquidity in markets for instruments that currently rely on LIBOR, such as floating-rate debt obligations. Investments involving higher risk do not necessarily mean higher return potential. Diversification cannot ensure a profit or eliminate the risk of loss. Debt securities are subject to risks that the issuer will not meet its payment obligations. Low rated or equivalent unrated debt securities of the type in which a strategy will invest generally offer a higher return than higher rated debt securities, but also are subject to greater risks that the issuer will default. Unrated bonds are generally regarded as being speculative.

Additional Information

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ADDITIONAL INFORMATION

Important Information and Disclosure

TERMS

Municipal-to-Treasury Yield Ratios are relative value indicators that measure the richness or cheapness of Municipal bond yields to comparable maturity Treasury bond yields.

Yield to Worst is a measure which reflects the lowest potential yield earned on a bond without the issuer defaulting. The yield to worst is calculated by making worst-case scenario assumptions by calculating the returns that would be received if provisions, including prepayment, call or sinking fund, are used by the issuer.

INDEX DEFINITIONS

Bloomberg Municipal Bond Index is an unmanaged index of municipal bonds traded in the U.S.

Bloomberg High Yield Municipal Bond Index is an unmanaged index of non-Investment Grade Municipal bonds traded in the U.S.

Bloomberg Taxable Municipal Bond Index is an unmanaged index of Taxable Municipal Bonds traded in the U.S.

Bloomberg U.S. Treasury Index measures public debt instruments issued by the U.S. Treasury.

Bloomberg U.S. Aggregate Index is an unmanaged index of domestic investment-grade bonds, including corporate, government and mortgage-backed securities.

Bloomberg U.S. Corporate High Yield Index measures USD-denominated, non-investment grade corporate securities.

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S&P/LSTA Leveraged Loan Index is an unmanaged index of the institutional leveraged loan market.

Standard & Poor’s 500 Index is an unmanaged index of large-cap stocks commonly used as a measure of U.S. stock market performance.

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