U.S. Municipal Bond Market

The Municipal Sector is Where Investors Can Wait Out the Uncertainty, Next Recession

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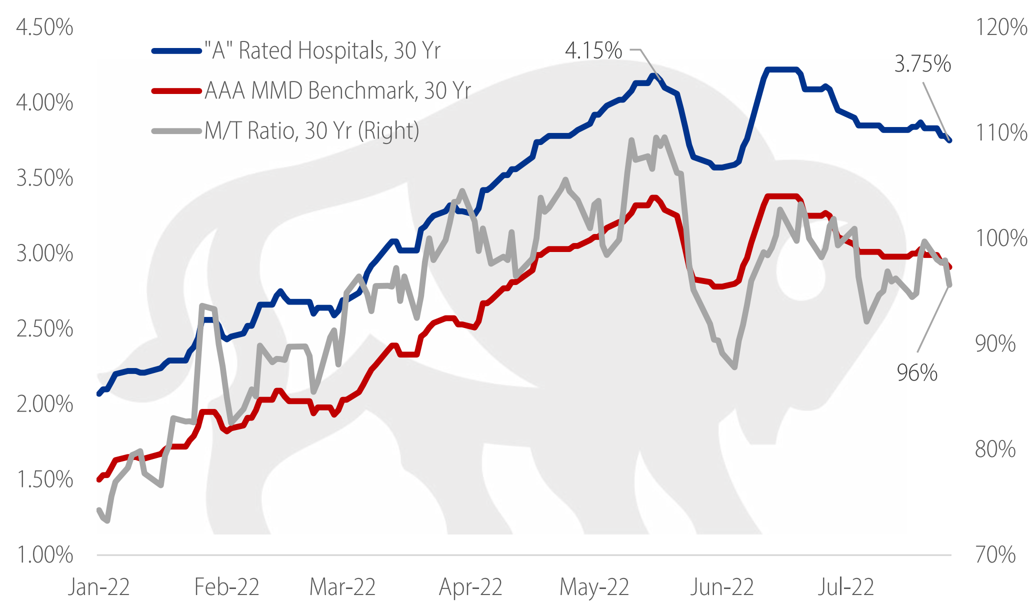
- We still very much like the municipal bond sector as a place where investors can wait out the economic uncertainty that is here. Whether we enter a post-COVID recession or not, U.S. public finance is ready.
- State and local government balance sheets are prepared (and preparing) for the economic storm that is developing. Our "Positive" credit sector outlooks remain on the state, local government and school district sectors.
- On July 28 Lipper reported $236 million flowed into municipal mutual funds.
- Investors should continue to put money to work in municipals – once positive fund flows return consistently it could be too late to find an investment edge.
- The newly proposed Inflation Reduction Act of 2022 does not include any municipal bond or public finance friendly elements and we do not expect them to be added. The Act's passage should also not be considered a done-deal despite recent press coverage.

Municipal Yields and M/T Ratios Remain Investable Here



Source: Refinitiv and HilltopSecurities.

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Historic Economic Action This Week

Some historic economic and monetary policy action occurred this week that under any circumstances should be highlighted. The U.S. Federal Reserve boosted their overnight Fed Funds target by 75 basis points on Wednesday, as most expected. The new target range is between 2.25% and 2.50%. Fed Chair Jerome Powell did not give specific guidance about what the Fed is likely to do in September stressing whatever happens on FOMC Day, Sept. 21 is going to be data dependent. We outlined some of the more important data points we and the Fed will be watching in the below table.

What Data Releases Do We and the Fed Most Care About?

Date	Data Release	Comments
June 15, 2022	FOMC Day	Raised by 75 bps (higher than initially expected)
July 8, 2022	Non-Farm Payrolls	Jobs data for June, +372k (higher than expected)
July 27, 2022	FOMC Day	Fed raised by 75 bps (mostly expected)
July 28, 2022	GDP	Fell 2nd Quarter in row, down -0.9%
August 5, 2022	Non-Farm Payrolls	Jobs data for July
August 10, 2022	CPI	How severe will inflation be?
August 17, 2022	Retail Sales	Rose 1.0% in June
September 2, 2022	Non-Farm Payrolls	Jobs data for Aug
September 13, 2022	CPI	Will inflation taper off by this time?
September 15, 2022	Retail Sales	Will activity deflate?
September 21, 2022	FOMC Day	Pace of Sept. tightening is data dependent

Source: HilltopSecurities

U.S. GDP fell -0.9% in the second quarter of 2022. This result was significantly weaker than the +0.4% median forecast and follows a -1.6% decline in the first quarter of the year. Two consecutive down quarters of GDP does not necessarily mean the U.S. economy is in recession. Potentially, the National Bureau of Economic Research (NBER) will make the official call months from now based on a number of variables. Labor market and consumer data are still too strong for a recession to exist, most likely.

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The Municipal Sector Should Been Seen as a Shelter Through the Economic Storm

The economic landscape is deteriorating even though labor and consumer numbers have not fallen off a cliff. Public sentiment is leaning toward the idea that a recession is coming. A recent survey found that 70% of Americans think a recession is coming. Even if a recession develops in coming months or quarters, we think investors should view the municipal bond market as shelter they can use to make it through this coming economic storm.

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Our view should not be a surprise, because we have been stressing for months that public finance credit quality remains strong (see pages 8-9 of our recent playbook.) Public finance upgrades will outpace downgrades in the near term. State and local government balance sheets remain very healthy. We raised our outlooks on the state, local government and school district sectors in February to "Positive" from "Stable." Governments have cut spending in recent quarters and slowed municipal bond issuance in preparation. They are doing what they can to prepare for a downturn. Their fiscal status is much stronger right now than before we entered the Great Recession, for example. Whether we enter a post-COVID recession or not, U.S. public finance is ready.

Even if a recession develops in coming months or quarters, we think investors should view the municipal bond market as shelter they can use to make it through this coming economic storm.

On Thursday July 28 Lipper reported $236 million flowed into municipal mutual funds but mostly this year municipal investor sentiment has been supremely negative. We still think that investors should take advantage of the current environment while they can. When fund flows turn consistently positive it will be too late for investors to find opportunities and receive the bump in spreads available now. Yields also may be lower.

Spreads to municipal benchmarks remain wide relatively speaking across almost all sectors and credit segments. Even AAA-rated Texas Permanent School Fund issues are pricing and usually trading at above historical spreads. Through this year we have been regularly talking with investors about "A" rated healthcare, those yields are still healthy and around a 3.75%- at least (see the line chart on page 1).

Proposed: The Inflation Reduction Act of 2022

Senate Democrats, led by Majority Leader Chuck Schumer and Sen. Joe Manchin surprised almost everyone by proposing an almost $500 billion tax package that would focus on energy and climate change related spending. It is being called The Inflation Reduction Act of 2022.

The newly proposed Inflation Reduction Act of 2022 does not include any municipal bond or public finance friendly elements and we do not expect them to be added.

The spending would be paid for mostly by a 15% corporate minimum tax, and IRS enforcement. Democrats still do not have all needed votes in the Senate or the House. Members of the House are still at issue with the State and Local Government Tax (SALT) cap and we do not yet know if that remains a deal breaker for support in the House. The newly proposed Inflation Reduction Act of 2022 does not include any municipal bond or public finance friendly elements and we do not expect them to be added.

Recent HilltopSecurities Municipal Commentary

- A Playbook to Navigate Municipals in the 2nd Half of 2022, July 15, 2022
- Municipals Still Investable in Front of Fed's June 2022 Announcement, June 14, 2022
- REVISED: Our 2022 Municipal Bond Issuance Forecast, June 13, 2022
- School District Credit Quality is Strong, Former Mayor Bloomberg is Overreaching, June 2, 2022

Readers may view all of the HilltopSecurities Municipal Commentary here.