U.S. Municipal Bond Market

The Fed is Not Changing Course, Reaffirms Our 2023 Municipal Outlook

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- The FOMC announced on Wednesday they are not changing course. Neither are we. This development reaffirms our 2023 expectations. Our issuance forecast for 2023 is highly dependent upon elevated interest rates like we see now. We continue to believe that 2023 primary municipal market issuance will come at $350 billion which is below the $384 billion we saw last year (2022.)
- A sense of optimism is returning to municipal investors. Flows into/out of municipal mutual funds have been positive three of five weeks to begin 2023.
- Credit quality continues to be an underlying strength in the municipal bond market. The Golden Age of Public Finance will continue into 2023, but we will be watching closely to make sure entities are reacting to the post-COVID 19 fiscal reality.
- Mass transit is too important to fail. We believe mass transit will be funded in coming budget cycles despite the headline risk.

The Municipal Market in 2023 Revisited

The Federal Open Market Committee (FOMC) unanimously voted to raise the target range for the federal funds rate to between 4.50% and 4.75%. This continues the FOMC's extraordinary path since the beginning of last year. FOMC action has been the main driver of activity in public finance and the municipal bond market since early 2022, as a result. Wednesday's announcement was the market-wide expectation. Fed chair Jerome Powell stressed, "There is more work to be done." Slight changes in the official statement from the FOMC indicate to us that, as of now, "The pace of hikes going forward will be 25 basis points" and that "the Fed expects to keep hiking," according to economic commentary published by Hilltop's Scott McIntyre and Greg Warner on Wednesday. This confirms to us that the FOMC is not likely to change course, and neither are we, as it relates to our outlook for public finance and the municipal bond market in 2023.

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Issuance is Relatively Down, Like We Expected

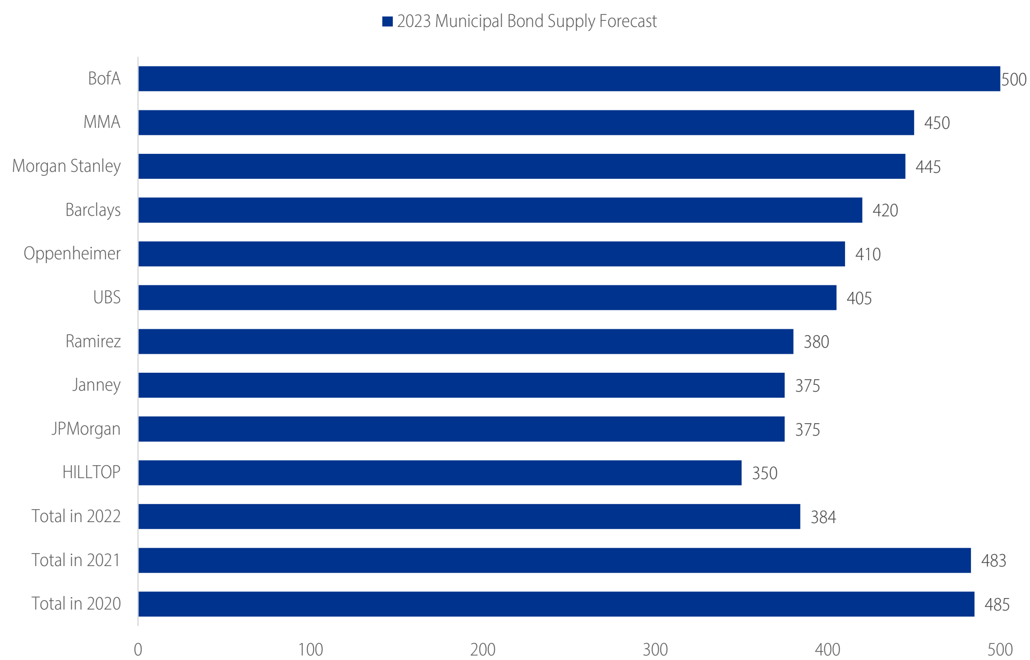
We are not questioning our public finance and municipal bond market outlook for 2023. The path the FOMC has been on is precisely what we expected, and we are not anticipating interest rates to significantly retreat this year. This will keep primary market municipal bond issuance well below 10-year averages. Monthly issuance has been below the 10-year average every month starting in August of last year. January 2023 issuance was only $21.9 billion. This is almost 17% lower than January 2022 issuance of $26.3 billion and just a tad higher than the 10-year January low of $21.5 billion in 2018. This is an extremely important comparison. There was a rush of issuance in October, November and December of 2017 because of a scare from Tax Cuts and Jobs Act of 2017 draft-legislation.

At the end of last year we projected (in a revision) that 2022 issuance would come in at about $383 billion. It was surprising to us that even as late as the third quarter of last year some thought we may still see a record amount of issuance in 2022. Interest rate sticker-shock was weighing on issuers planning as it related to new money issuance and most refundings just did not make economic sense. These important pressures will continue to weigh on issuance in 2023. We continue to expect that issuance will not be impacted by recent fiscal policy such as the Infrastructure Investment and Jobs Act and the Inflation Reduction Act despite the need for infrastructure upgrades in the U.S. and across almost all public finance sectors.

We also think 2023 issuance will be below 2022's total of $384 billion. Interest rates are going to be higher, much higher most likely for all of 2023 compared to 2022.

Therefore, primary market issuance will remain well below the numbers we saw in 2020 and 2021. We also think 2023 issuance will be below 2022's total of $384 billion. Interest rates are going to be higher, much higher most likely for all of 2023 compared to 2022. Economic growth in 2023 is also likely to be below what we saw in 2022. We just do not see how it is possible that 2023 issuance is higher than 2022 as a result. Our primary market issuance forecast of $350 billion, published in November 2022 if anything could be too high. Our forecast is not too low despite other forecasts.

We Believe 2023 Issuance Will be Below the $384 billion Sold in 2022



Source: Bloomberg, Refinitiv and HilltopSecurities. $ in billions.

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Municipal Bond Demand is Rising

One of the key reasons that primary market issuance activity is so important right now is because demand for municipal bonds is rising. Last year was an off year for most investment flows, including municipals. Billions of dollars flowed out of municipal mutual funds. However, in recent weeks investors have begun to slide money back into municipal funds. Lipper data released yesterday, Feb. 2, showed that $362 million flowed out of municipal funds. However, flows were positive in three of five weeks so far in 2023. We are not ready to completely say that municipal investors are optimistic about the asset class, but optimism is slowly returning. We think that investors could be disappointed if they delay their next municipal bond entry point as demand recovers and issuance remains below average. It is important that investors remember how

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difficult it was to source municipal bonds in 2020 and 2021. That dynamic could be returning as a result of the developing supply and demand dynamic.

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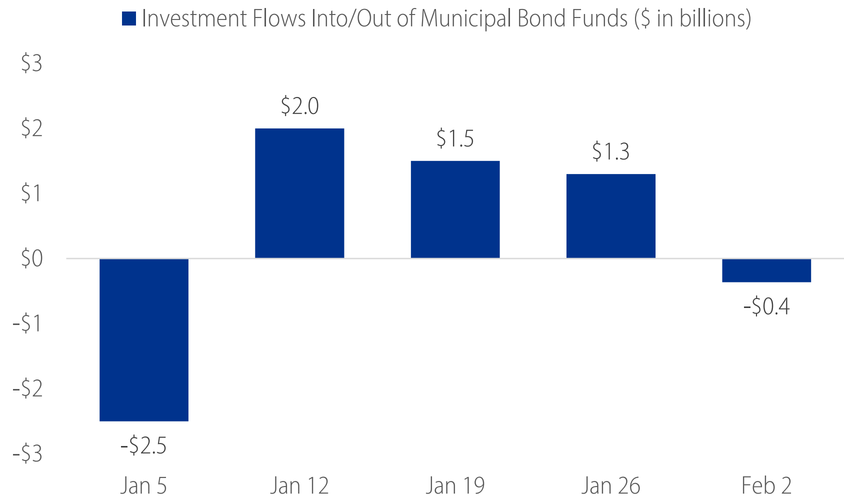
Investment Dollars are Beginning to Flow Back Into Municipal Funds



Source: Lipper and HilltopSecurities.

We are watching to make sure the public finance entities are reacting to the post-COVID-19 fiscal reality that includes less or no federal relief, inflation pressures, and changes related to work-from-home among other difficulties.

Golden Age of Public Finance

Credit quality continues to be an underlying strength for public finance and the municipal bond market generally. U.S. state government sector credit quality remains strong and most states are well positioned to withstand an economic downturn. We updated our Hilltop Municipal Sector Credit Outlooks recently and concluded that the Golden Age of Public Finance is likely to continue into 2023. We are watching to make sure the public finance entities are reacting to the post-COVID-19 fiscal reality that includes less or no federal relief, inflation pressures, and changes related to work-from-home among other difficulties.

We continue to think that investors should be using this credit-peak as an opportunity to trade out of state and local governments that are not likely to regain or possess structural balance after this wave of federal aid wears off. We like regions of the country where demographic trends are favorable and prefer individual state and local governments with well-funded pension plans. It is important investors use a realistic discount rate when looking at pension liabilities. Many of the revenue sectors have dual reasons why investors should be considering them. First, the COVID-19 recovery story is still showing up in results. Second, essential services typically remain imperative through economic slow-downs. Finally, we remain bullish on U.S. mass transit. Mass transit is too important to fail. In coming years will see headline risk related to budget negotiations, but through it all we believe mass transit will be funded through a combination of state and local government funding supplemented with higher taxes and fee strategies.

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Recent HilltopSecurities Municipal Commentary

- The Municipal Market in 2023, Hilltop's Municipal Sector Credit Outlooks, Jan. 17, 2023
- The Texas Permanent School Fund's Bond Guarantee Program Slows to a Roll, Jan. 18, 2023
- A Public Finance and Infrastructure Fiscal Policy Checklist and a Warning, Jan. 9, 2023
- Web3, Blockchain and U.S. Public Finance, Dec. 15, 2022
- The Texas PSF is Up Against a Federally Allocated Cap, Dec. 8, 2022
- State Credit Mainly Improved & Most Positioned to Withstand a Recession, Dec. 6, 2022

Readers may view all of the HilltopSecurities Municipal Commentary here.