U.S. Municipal Bond Market

Municipals Seen as Quality Amid Bank Stress, Economic Uncertainty

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- The uncertainty experienced in the banking sector in recent weeks reinforced the idea that investors continue to see U.S. municipal bonds, especially in the state and local government sectors, as high-quality investments.
- Public finance upgrades continued to outpace downgrades in all of 2022 and we believe this trend is likely to continue in 2023 to be driven by local government and school district upgrades.
- We think the current landscape strengthens our call to trade up in quality when possible.
- The FDIC retained Blackrock to gradually and orderly sell the securities of Silicon Valley Bank and Signature Bank over time. We reviewed why banks increased municipal holdings over the last 10 years and believe some catalyst would need to materialize to cause them to unload current holdings in consequential numbers.
- President Joe Biden's veto of H.J. Res. 30 protected a Labor Department rule that removed obstacles for fiduciaries to consider environmental, social, or governance (ESG) factors when making investment decisions. Under the existing rule ESG factors can be considered but, are not required when making investing decisions.

Key Market Concern Shifted from Inflation to Safety, and Back to Inflation

Interest rates force adjustments in finance the way gravity regulates the physical world. To say U.S. interest rates have risen sharply since the beginning of last year would be an understatement. Rising rates began to unravel aggressive portfolio management in the financial sector and the outcome caused meaningful bank failures and spilled over to various capital markets in March. To set the stage let's revisit what has happened with interest rates for some perspective. The U.S. Federal Reserve upped its target rate nine times since it met on March 16, 2022 (including March 22, 2023). The Fed's path to fight inflation pushed 2-year Treasury yields up 428 basis points to 5.06% as of March 8, 2023.

We think the current landscape strengthens our call to trade up in quality when possible.

The U.S. Fed Seeks to Tame Inflation, 22-23 Rate Hikes

FOMC Decision Date	Rate Change (in bps)	Federal Funds Target Rate Range
Wednesday, March 22, 2023	+25	4.75% to 5.00%
Wednesday, February 01, 2023	+25	4.50% to 4.75%
Wednesday, December 14, 2022	+50	4.25% to 4.50%
Wednesday, November 02, 2022	+75	3.75% to 4.00%
Wednesday, September 21, 2022	+75	3.00% to 3.25%
Wednesday, July 27, 2022	+75	2.25% to 2.50%
Wednesday, June 15, 2022	+75	1.50% to 1.75%
Wednesday, May 04, 2022	+50	0.75% to 1.00%
Wednesday, March 16, 2022	+25	0.25% to 0.50%

Source: U.S. Federal Reserve and HilltopSecurities.com

Please see disclosure starting on page 9.

On the longer end of the Treasury curve the 30-year rose 200 basis points to a 4.02% as of the beginning of March. Municipal yields experienced steep increases since the beginning of 2022 too. The 2-year AAA Municipal Market Data (MMD) yield rose about 250 basis points to a 2.99% and the 30-year AAA MMD rose over 300 basis points to a 3.60% both as of March 3.

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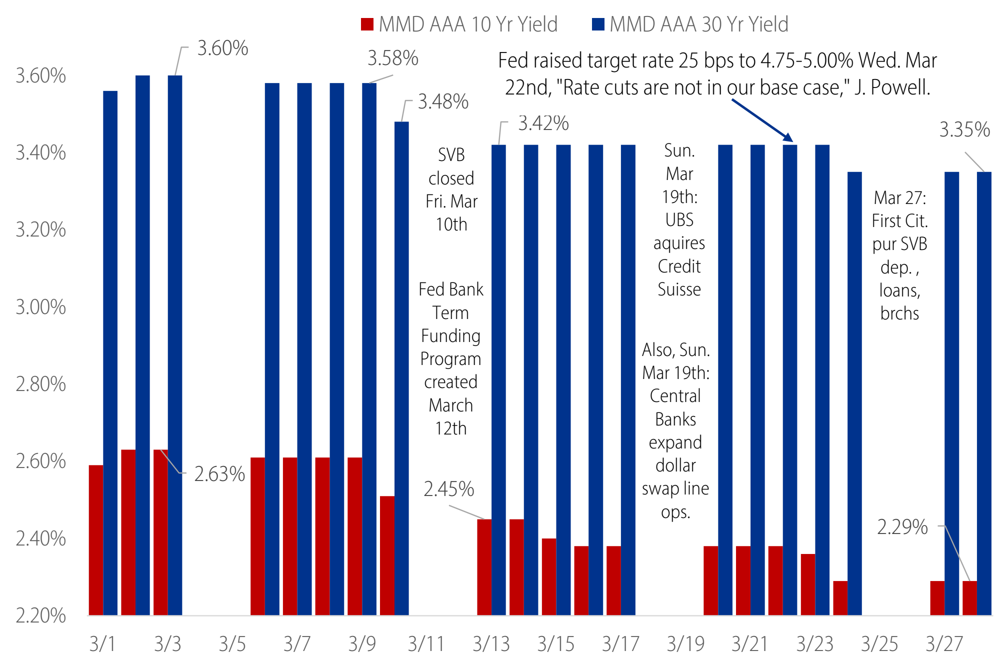
In recent weeks yields have fallen even amid the Fed upping their target rate once again this time by 25 basis points to a range of 4.75%-5.00% on March 22. Even so, the 2-year Treasury fell 105 basis points to a 4.01% (as of Monday March 27) and the 30-year Treasury fell about 26 basis points to a 3.76 also as of Monday March 27. Municipals yields dropped as well. The 2-year AAA MMD yield fell almost 60 basis points to 2.40%. The 10-year AAA MMD yield dropped 34 basis points to a 2.29% from a 2.63% and the 30-year MMD fell 25 basis points to a 3.35% both as of Monday March 27. All three AAA MMD yields continued to retreat since the end of March. The 2-year fell another four basis points between March 27 and April 4. While the 10-year AAA MMD fell another 8 basis points to 2.21% and 30-year AAA MMD fell 10 more basis points to 3.25%.

Municipal Yields Drop Because of Regional Bank Stress



Source: Refinitiv and HilltopSecurities.

Interest rates began to fall in recent weeks because of stress concerns in the U.S. and international banking sectors.

Interest rates began to fall in recent weeks because of stress concerns in the U.S. and international banking sectors. Rising interest rates took their toll on bank portfolios even before the calendar turned to 2023. At the end of February 2023 Federal Deposit Insurance Corporation (FDIC) Chair Martin Gruenberg warned of the impact higher rates could have on the bank sector generally and on bank unrealized losses specifically. Chairman Gruenberg highlighted on Feb. 28, 2023:

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> "Unrealized losses on available–for–sale and held–to–maturity securities totaled $620 billion in the fourth quarter, down $69.5 billion from the prior quarter, due in part to lower mortgage rates. The combination of a high level

> of longer–term asset maturities and a moderate decline in total deposits underscores the risk that these unrealized losses could become actual losses should banks need to sell securities to meet liquidity needs."

Less than two weeks later Silicon Valley Bank (SVB) and Signature Bank were forced to close their doors and later failed for reasons related to their portfolios and an inability to meet depositor demands. On Monday, March 13 Moody's Investor Service lowered its outlook on the U.S. banking system to "Negative" from "Stable" because of the "rapidly deteriorating operating environment."

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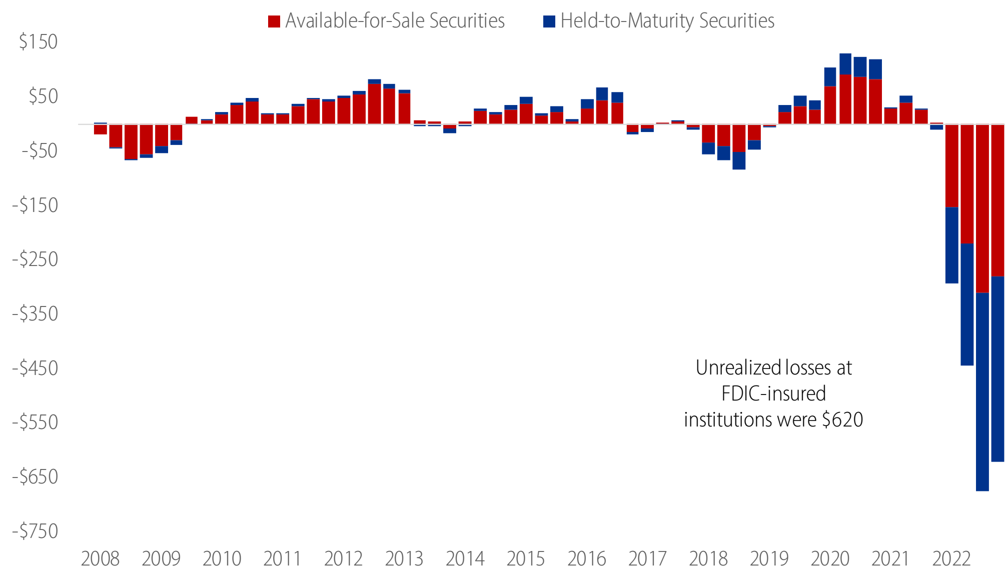
Unrealized Gains (or Losses) on Bank Investment Securities (all FDIC-Insured Institutions) $ in billions



Source: FDIC and HilltopSecurities.

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Policymakers Worked to Restore Confidence

The Federal Reserve announced the creation of its Bank Term Funding Program on March 12. This program allowed banks and other institutions to receive loans based on qualifying assets. This program would make it so banks would not have to sell assets at a loss in order to meet depositor demands. The Fed's new program helped to restore some confidence in the sector. Some confidence also returned after the FDIC announced that SVB depositors would "be made whole," per a March 13, 2023 FIDC statement. The Federal government also decided to stand behind deposits in Signature Bank. These actions in essence protected depositor amounts in these two institutions only which were above the stated $250,000 insured level. Later that week, on March 16 U.S. policymakers announced a group of 11 banks deposited $30 billion into First Republic Bank to shore up its finances. Treasury Secretary Yellen, the same day Fed Chair Powell announced a 25 basis point increase to the Fed Funds target rate, made clear that regulators were not seeking to provide blanket insurance to all depositors without consultation with federal lawmakers while speaking to a Senate subcommittee.

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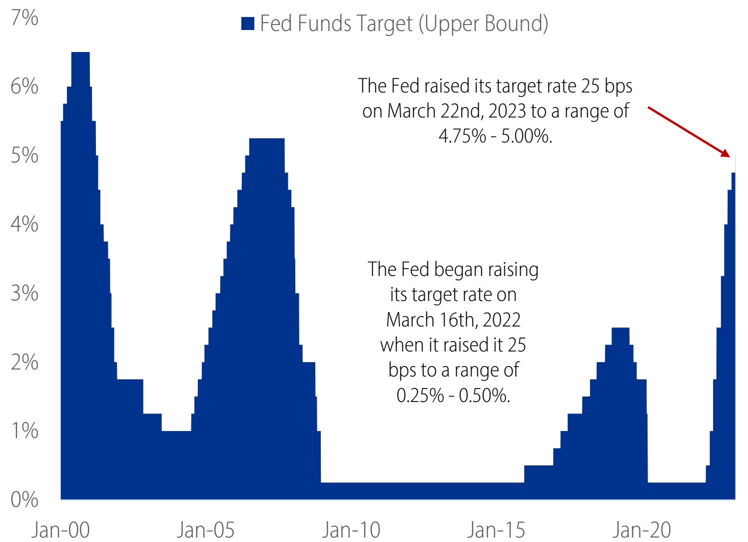
The Fed Raised its Target Rate Again March 22 to a Range of 4.75%-5.00%



Source: U.S. Federal Reserve and HilltopSecurities.

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Some Capital Markets Sectors Were Frozen, Not Municipals

A high level of uncertainty existed in the financial markets during the week of March 13-17. The failures of SVB and Signature were among the largest bank failures in U.S. history, many wondered if there was to be contagion like the markets experienced during the World Financial Crisis in 2007 and 2008. There was important capital markets activity that was essentially frozen from March 13-17. Investment-grade and high-yield corporate debt activity was sparse. Initial public offerings paused while mergers and acquisitions planning moved only slowly because of the uncertainty.

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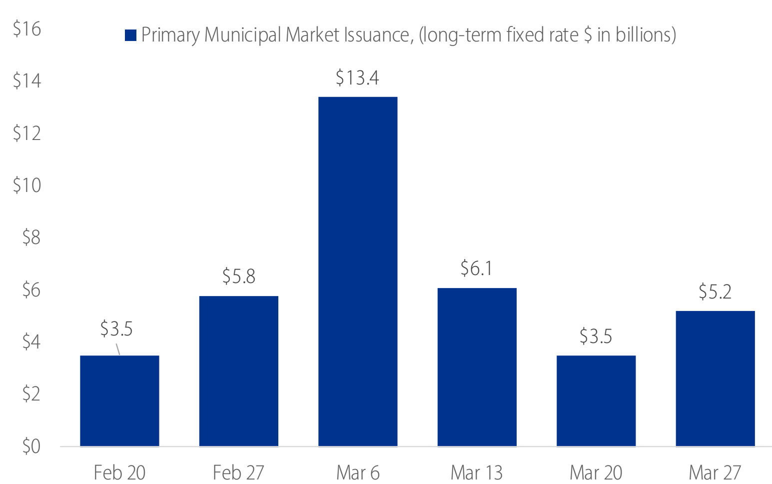
Primary and secondary market functioning in the U.S. municipal bond market was not negatively impacted. In fact, primary municipal bond market activity continued as planned for the week of March 13. A significant portion of the primary municipal market was put on hold during the worst of the COVID-19 uncertainty in March and April of 2020, in contrast. That was not the case during the week of March 13. Municipal investors did not panic, and so public finance entities were able access investors via the U.S. municipal capital markets.

Primary Municipal Market Pricings Continued Amid Banking Sector Stress



Source: HilltopSecurities.

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Flight to Quality

In fact, we saw that high grade municipals were very much part of the flight to quality activity during the week of March 13 in the secondary market. This is not at all surprising to us. Public finance entities have been enjoying a period we have deemed the Golden Age of Public Finance that has boosted credit quality in the sector. The latest Moody's Ratings Service data for all of 2022 showed that public finance sector upgrades outpaced downgrades again for the second year in a row. Moody's reported 447 upgrades compared to only 157 downgrades in all of 2022. The upgrade activity was concentrated mostly amongst general obligation issuers, especially local governments. This is largely because of the impact that the outsized amount of federal relief has had and continues to have on government budgets. The last time we saw a level of downgrades this low was in 2007 when there were 148 public finance downgrades.

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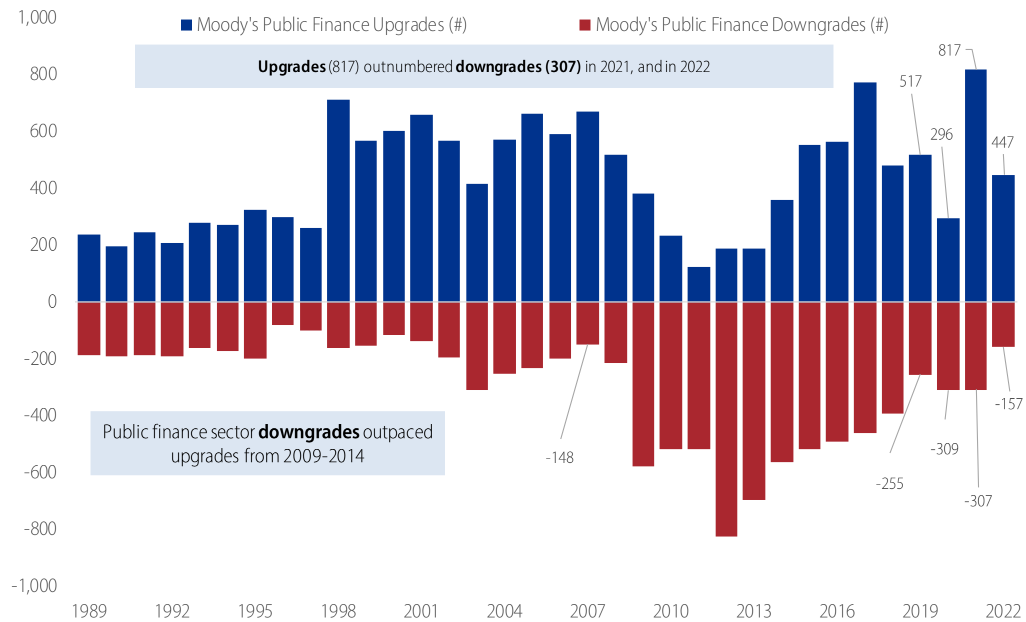
Moody's Public Finance Upgrades Continued to Outpace Downgrades in 2022



Source: Moody's and HilltopSecurities. $ in billions.

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Our Municipal Sector Credit Outlooks (Jan. 17, 2023) provide a credit summary of sub-sectors in public finance. We did lower our state sector outlook to "Stable" from "Positive" in January 2023 not because we are expecting credit deterioration but because most state credits that were likely to experience an upgrade were already upgraded by the rating agencies. We also noted that most states have strong total balances and are well positioned to withstand an economic storm that may develop in the near-term, in our Dec. 6 report, State Credit Mainly Improved & Most Positioned to Withstand a Recession. We still have "Positive" outlooks on the local government and school district sectors. This is mostly because we believe that upgrades are likely to continue to outpace downgrades in 2023. We continue to have a "Negative" outlook on both the investment grade and sub-investment grades areas of healthcare. We are split in higher education where we have a "Cautious" outlook for public higher-ed and a "Negative" outlook for private higher ed. Please see the details in our Jan. 17 report Municipal Sector Credit Outlooks for more. We include outlooks and commentary for 15 public finance sectors so as to further break down what is happening from a credit perspective in the municipal bond market.

We did lower our state sector outlook to "Stable" from "Positive" in January 2023 not because we are expecting credit deterioration but because most state credits that were likely to experience an upgrade were already upgraded by the rating agencies.

We still believe investors should use the current backdrop to trade out of issues that even though they have improved in credit quality via the recent metrics, may still have problems with attaining multi-year structural balance. This will further bolster the credit worthiness of investors' municipal portfolios before a time when the macro-economic environment could deteriorate.

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One of the potential outcomes from the banking sector stress that is likely to develop is that the availability of credit will tighten. This was happening from a big picture perspective even before the March 2023 bank failures. A tightening of the availability, especially amongst small and medium sized regional banks could directly impact public finance entities but at this time we are not expecting this to result in meaningful credit deterioration in the sector.

Bank Ownership of Municipals

Another area of focus that deserves attention is bank ownership of municipal bonds. The two big questions that exist where bank ownership of municipals is concerned are: 1) How will bank ownership of municipal bonds in general be affected? 2) Are we seeing troubled banks selling their municipal portfolios?

To answer the question about how bank ownership of municipal will be impacted we need to consider how bank ownership has evolved since the World Financial Crisis. Some perspective here is important. The bank sector almost doubled its holdings of municipal bonds over the last 10 years. In 2012 the financial sector owned about 9% of all outstanding municipals while at the end of 2022 the sector owned about 14%. There were two key reasons why banks increased their holdings of municipals between the Financial Crisis and the Tax Cuts and Jobs Act (TCJA) of 2017. The first was because of the 2009 Recover Act raised the bank-qualified limit. The second was because deposits continued to come into the door, but there were not as many opportunities for banks to make loans because a reduced level of economic activity. Banks are also very opportunistic where municipals are concerned. Some have specific reasons why they buy in certain sectors or even in different parts of the country. Many are also very much tied to relative value comparisons. So, for example if Municipal to Treasury Ratios rise above recent or historical averages banks oftentimes will participate in municipal financings.

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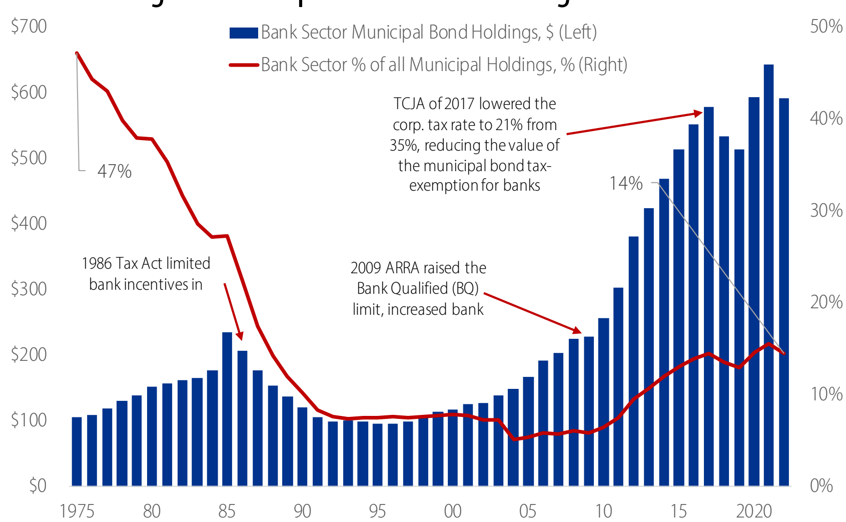
Bank Holdings of Municipal Bonds Rose During the COVID-19 Crisis



Source: US Federal Reserve and HilltopSecurities.

After the TCJA of 2017 bank ownership of municipals fell slightly. Reasons for this differed portfolio-to-portfolio but generally this was expected because of the reduced corporate tax rate. This shift was also expected because of how much municipal bonds banks added to their portfolios over the previous 10-plus years. When the COVID-19 crisis occurred, banks added to their municipal positions after 2020 mostly because there were times they took advantage of attractive technical indicators, but also because there was a high level of uncertainty about economic conditions in 2020 and 2021. We believe banks sought out municipals during this time, especially high-quality credits, because they were comfortable with the direction credit quality was headed especially because of the substantial federal relief and aid transferred to the sector from the federal government.

After the Tax Cuts and Jobs Act of 2017 bank ownership of municipals fell slightly. Reasons for this differed portfolio-to-portfolio but generally this was expected because of the reduced corporate tax rate.

Bank holdings of municipal bonds remain near a 20-year high, so it is probably unrealistic to expect them to rise substantially without a specific catalyst - something similar to those we noted above. We also, however, do not foresee a specific catalyst that would force a significant reduction in holdings either. We expect banks will be selectively involved in primary and secondary municipal activity when it fits their profile and investment strategies going forward. Overall, we expect banks to be attracted to municipal bonds because of the tax benefits and strong level of credit quality.

There is more uncertainty where the second question is concerned. Over the last month we have not seen meaningful selling of municipal bond holdings from the banks in question. This is a topic on the minds of the market because some banks in question have built sizeable municipal holdings.

Overall, we expect banks to be attracted to municipal bonds because of the tax benefits and strong level of credit quality.

First Republic Bank (FRB) for example as of the end of 2022 owned about $19 billion of municipal securities, mostly designated as "held-to-maturity." FRB's financial statements describe the municipal holdings in the investment portfolio as having an average credit rating of AA and an average issuer position of $39 million.

Silicon Valley Bank (SVB) holds municipal bonds as well, but not to the extent that we see in FRB's portfolio. At the end of 2022 SVB held a little over $7 billion of municipal bonds designated as "hold-to-maturity." Over half of SVB's municipal holdings are rated Aaa and the majority of the municipal portfolio is rated Aa3 or higher.

On Wednesday the Federal Deposit Insurance Corporation announced that it retained Blackrock to conduct an orderly process of portfolio sales for former Signature Bank and Silicon Valley Bank. The FDIC noted that the selling will "will be gradual and orderly, and will aim to minimize the potential for any adverse impact on market functioning by taking into account daily liquidity and trading conditions." We noted above that SVB owned about $7 billion of municipal bonds and we should note that Signature Bank owned about $250 million of municipals. We do not expect this process, particularly if it occurs over time, to adversely impact the day-to-day functioning of the market. This is especially true because of the lower than average amount of primary market issuance we are continuing to expect for the rest of 2023.

We do not think that investors have soured on municipals at this time. It is common to see flows out of municipals at this time of year for tax purposes.

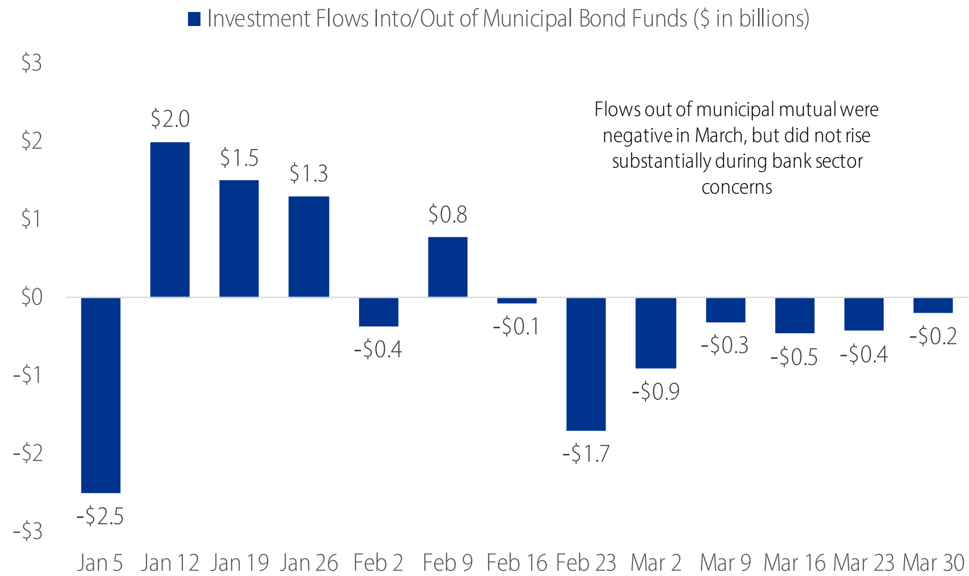
Investment Dollars Continue to Flow Out of Municipal Funds

Investors have withdrawn investment dollars from municipal mutual funds over the last seven straight weeks. A little less than $500 million was pulled during the week ending

Wednesday March 15, when the bank sector uncertainty seemed to be at its highest. We do not think that investors have soured on municipals at this time. It is common to see flows out of municipals at this time of year for tax purposes.

At the end of 2020 the U.S. Labor Department proposed a rule that would require those managing pension and 401k plans to put economic interests over non-pecuniary (non-financial) goals.

Investors Continued to Withdraw from Municipal Mutual Funds in March 2023



Source: Lipper and HilltopSecurities.

President Joe Biden in March vetoed H.J. Res. 30. The rejected measure could have repealed a November 2022 U.S. Labor Department rule, titled Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, that removed obstacles for fiduciaries to consider environmental, social, or governance factors when making investment decisions.

President Biden Vetoes ESG Investment Restriction Bill

Political maneuvering related to environmental, social and governance factors continues. At the end of 2020 the U.S. Labor Department proposed a rule that would require those managing pension and 401k plans to put economic interests over non-pecuniary (non-financial) goals. This proposal had not taken effect by the time President Donald Trump left office.

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the topic of ESG investing, which gained another level of prominence when former Vice-President published an op-ed in the Wall Street Journal, "Republicans Can Stop ESG Political Bias," in May of 2022, will likely continue to gain importance before the 2024 national elections.

We do not see any short-term market impact as a result of the President's veto. What the development does indicate is that the topic of ESG investing, which gained another level of prominence when former Vice-President published an op-ed in the Wall Street Journal, "Republicans Can Stop ESG Political Bias," in May of 2022, will likely continue to gain importance before the 2024 national elections.

Recent HilltopSecurities Municipal Commentary

- The Fed is Not Changing Course, Reaffirms Our 2023 Municipal Outlook, Feb. 3, 2023
- 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

Readers may view all of the HilltopSecurities Municipal Commentary here.