

MUNIWATCH

FIXED INCOME MARKET UPDATE



- › The Muni curve steepened in the third quarter, slightly underperforming U.S. Treasuries, in very quiet trading activity.
- › Flows into Muni Mutual Funds continued their torrid pace as increased taxes become more certain.
- › The reopening economy has benefited Munis, too.
- › Part 1 of our Muni Market Education Series: Why the High Coupon?

Muni Yields Move Higher

Muni yields were virtually unchanged for the majority of Q3 but moved higher by up to 20 basis points in the last two weeks of September (graph, top-right), moving in line with the U.S. Treasury market after the Federal Reserve's September statement was more hawkish than expected. Looking at the quarter as a whole, Munis underperformed Treasuries, with the 10-year Muni to Treasury yield ratio increasing from 68% to 75%.

Muni Mutual Fund Inflows Continue

As investors grow more and more convinced of future tax increases, cash has piled into Muni Mutual Funds at an unprecedented pace. In Q3, funds took in over \$28 billion, increasing the year-to-date total to over \$88 billion (graph, middle-right). Funds have seen inflows every week this year and in all but one of the last 72 weeks. This unprecedented amount of cash flooding the market this year has led to strong demand and rich valuations.

A Quiet Summer

Muni yields spent the summer stuck in a narrow trading range. The market was stuck in a state where the only buying seemed to be forced buying by the aforementioned cash-flush Muni Mutual Funds and many investors sat on the sidelines waiting for higher yields that never appeared. As a result, trading volumes dropped to historic lows over the summer (graph, bottom-right).

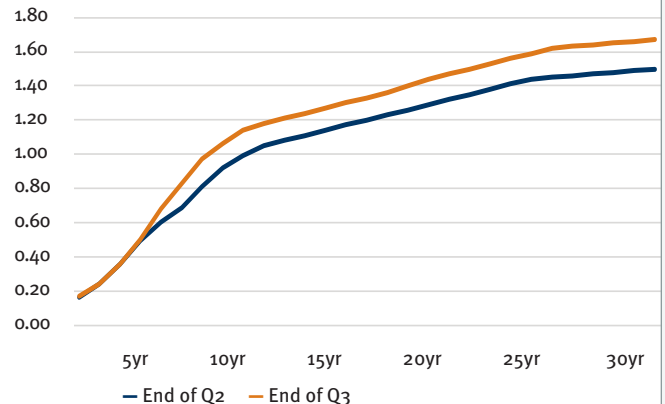
Q4 Outlook

We expect a better investment environment in the fourth quarter as the aforementioned trading activity returns to more normal levels as seasonal issuance picks up and yields to continue to push higher. For the past five years, the fourth quarter has been the busiest for new issuance activity, accounting for an average of nearly 29% of annual issuance, according to *The Bond Buyer*¹. We expect this trend to continue this year, leading to potential weakness in the market and better opportunities for entry.

1. "A Decade of Municipal Bond Finance", Data as of 9/30/2021.

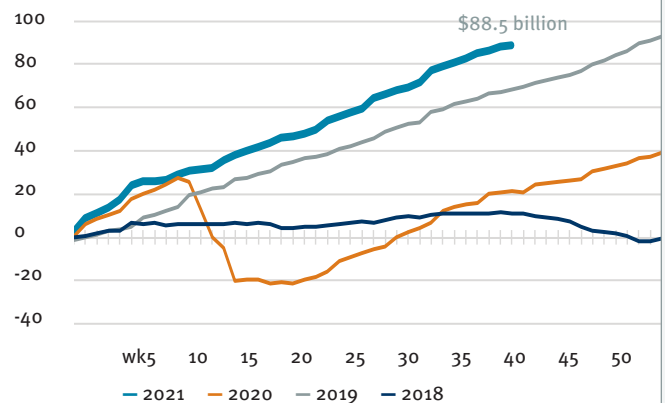
AAA MUNI YIELD CURVE

Source: Refinitiv TM3. Data as of 9/30/2021.



CUMULATIVE MUNI MUTUAL FUND FLOWS (BILLIONS)

Source: Refinitiv Lipper. Data as of 9/30/2021.



MSRB MUNI SECONDARY MARKET TRADE VOLUME (BILLIONS)

Source: Bloomberg. Data as of 9/30/2021.

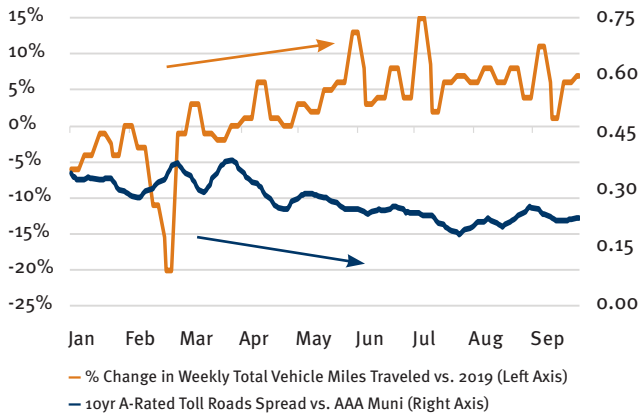




REOPENING ECONOMY BENEFITS MUNIS, TOO

CHANGE IN VEHICLE MILES TRAVELED VS. TOLL ROADS SPREAD

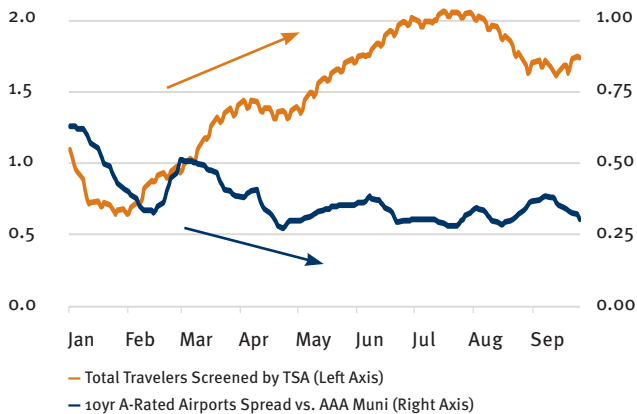
10-day Moving Avg. Source: WCA, Bloomberg. Data as of 9/30/21.



Have you noticed the increased traffic on your local roads? As total vehicle miles traveled, measured by the Department of Transportation, has increased, spreads on the toll road sector have decreased.

AIR TRAVELERS SCREENED (MILLIONS) VS. AIRPORTS SPREAD

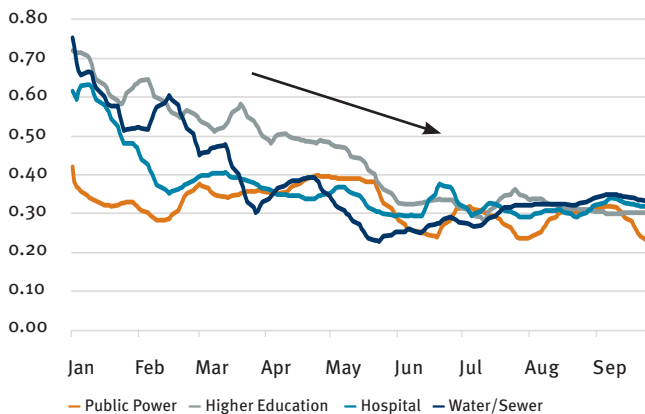
10-day Moving Avg. Source: WCA, Bloomberg. Data as of 9/30/21.



Airports are also more crowded. As total air passengers screened by the TSA has increased, airport spreads have decreased.

SELECT SECTOR 10YR A-RATED SPREAD VS. AAA MUNI

10-day Moving Avg. Source: WCA, Bloomberg. Data as of 9/30/21.



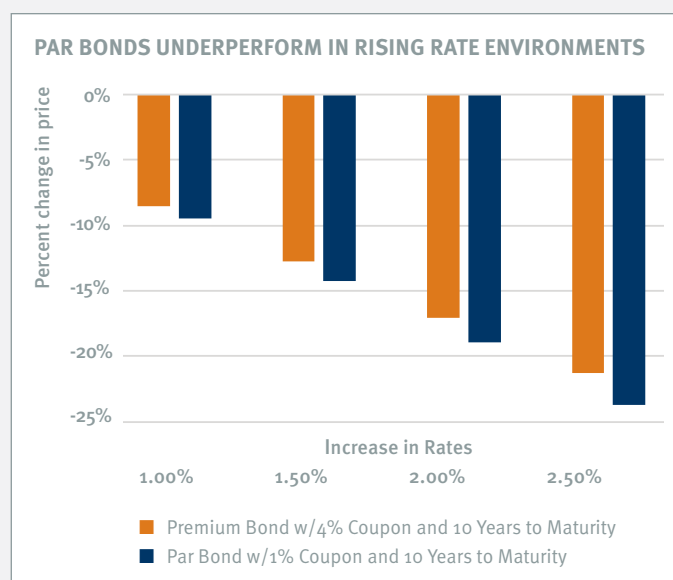
The benefits of the reopening economy are not limited to only these sectors. Spreads on virtually all revenue-backed sectors have narrowed since the beginning of the year.

Market Convention Favors High Coupons

- **The Majority of Municipal Bonds Are Issued at a Premium with a High Coupon:** As of June 30, 2021, the average coupon of the Bloomberg/Barclays U.S. Municipal Index constituents is 4.46% and 88% of the index constituents have a coupon of 4% or higher. In comparison, only 4% of the index constituents have a coupon of 2% or lower (Source: Bloomberg).
- **High Coupon Bonds Offer Better Price Stability and Increased Cash Flow:** While high coupons mean high prices, the increased interest payments from a higher coupon can deliver cash flow at a faster pace. Price sensitivity of principal may also be dampened by a high coupon as a higher portion of total return comes from interest payments. In our view, this is best expressed by measuring a bond's price sensitivity to changes in interest rates, its duration. Duration is the measure, in years, of the amount of time for an investor to be paid a bond's total cash flows. It also measures a bond's price change given a change in underlying interest rates (Illustrative Example 1, below).

Potential Tax Consequences Decrease Liquidity*

- **Low Coupon Bonds Are Potentially Subject to Negative Tax Consequences and Poor Liquidity:** Municipal bonds are subject to the *de minimis* tax rule. This rule, enacted in 1993, states that if a bond is purchased at a discount of more than 1/4 point for each year until maturity, the accretion of the discount to par or sale price is treated as ordinary income instead of a capital gain. Prices of low coupon bonds have the potential to “drop off a cliff,” often depreciating drastically as they approach the *de minimis* cutoff as the market recognizes these tax implications (Illustrative Example 2, below).
- **But My Muni Portfolio is Buy and Hold:** Although many municipal bond investors employ a “buy and hold” strategy, a sale could become necessary due to deterioration in an issuer's credit quality or an investor's unforeseen cash need prior to maturity. The *de minimis* rule's potential impact on liquidity and market pricing is an important factor even in buy and hold portfolios.



Source: WCA

Illustrative Example 1:

- A par bond with a 1% coupon and 10 years to maturity has a duration of 9.49 years.
- A premium bond with a 4% coupon and 10 years to maturity has a duration of 8.53 years.
- With a 1% rise in interest rates, the par bond will decrease by 9.49%, while the premium bond will decrease by only 8.53%, and decreases are magnified as changes in rates increase (graph, left).

Illustrative Example 2:

- If a bond with 10 years to maturity is purchased below \$97.50, the accretion from the purchase price to par would be subject to the ordinary income tax rate and not the typically lower capital gains tax rate.
- If a bond with 10 years to maturity is purchased between \$97.50 and par, the accretion from the purchase price to par would be *de minimis* and subject to the capital gains tax rate.
- If a bond with 10 years to maturity was purchased at a premium, no accretion and therefore no tax consequences exist.

While investors may be tempted to consider alternative coupon structures to increase yield, at WCA, we carefully evaluate and monitor each holding's liquidity and favor bonds priced at a premium in line with the market's convention. We believe that the in-depth monitoring offered by our active management is necessary to navigate the increasingly complex muni market while rates remain at historically low levels.

*Please see important tax and investing disclosures on page 6.



About Washington Crossing Advisors

Washington Crossing Advisors, LLC (“WCA”) is an SEC registered investment adviser and wholly owned subsidiary of Stifel Financial Corp. Registration with the SEC does not imply a certain level of skill or training. WCA helps supervise and manage over \$6 billion in assets under advisement for individuals and institutions as of June 30, 2021.

The team is managed by Kevin R. Caron, CFA, and Chad A. Morganlander, who were among the founding members of Washington Crossing Advisors.

Washington Crossing Advisors’ views on investing and markets are regularly sought by national media outlets, including *CNBC*, *Bloomberg*, *Fox Business News*, *The Wall Street Journal*, *Forbes*, and *Reuters*.

Philosophy and Process

We believe that investments should be selected only after clear and quantified measures of value, risk, and potential reward have been made. Our investment approach combines top-down analysis of the macro economy with fundamentally rooted, bottom-up security analysis.

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Description of Indices and Terms Description of Indices and Terms: All performance calculations of indices are calculated on a total return basis (reflecting reinvestment of dividends and other earnings). Indices are unmanaged, are not available for direct investment, and have no associated management fees.

Bloomberg Barclays Aggregate Bond Index: A composite of the Bloomberg Barclays Gov't/Corp Index, Mortgage-Backed Securities Index, and Asset-Backed Securities Index, including securities that are investment grade or better, have at least one year to maturity, and have an outstanding par value of at least \$100 million.

S&P 500 Index: Capitalization-weighted composite of 500 stocks traded on the NYSE, AMEX, and NASDAQ; not the largest 500 stocks in U.S., but rather a blend of leading companies in leading industries in the U.S. economy; index comprised of 10 broad industrial sectors.

Dow Jones U.S. Select REIT: The Dow Jones U.S. Select REIT Index intends to measure the performance of publicly traded REITs and REIT-like securities. The index is a subset of the Dow Jones U.S. Select Real Estate Securities Index (RESI), which represents equity real estate investment trusts (REITs) and real estate operating companies (REOCs) traded in the U.S.

The ICE U.S. Treasury 1-3 Year Bond Index is a market value weighted index designed to measure the performance of U.S. dollar-denominated, fixed rate U.S. Treasury securities with minimum term to maturity greater than one year and less than or equal to three years.

Markit iBoxx USD Liquid High Yield Index consists of liquid USD high yield bonds, selected to provide a balanced representation of the broad USD high yield corporate bond universe.

Moody's Baa Corporate Bond Index—An index comprised of industrial bonds rated Baa by Moody's with a minimum maturity of 20 years.

Consumer Price Index—A measure of the average change in prices over time for a basket of consumer goods.

Asset Allocation—Asset allocation does not ensure a profit or protect against loss.

The FTSE Developed All Cap ex U.S. Index is part of a range of indices designed to benchmark international investments. The index comprises large, mid and small cap stocks from developed markets excluding the U.S.

The FTSE Emerging Markets All Cap China A Inclusion Index is a market-capitalization weighted index representing the performance of large, mid and small cap stocks in Emerging markets. The index is comprised of approximately 3350 securities from 21 countries.

International and Emerging Markets Investing—There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries.

Bonds and High Yield Bonds—When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. High yield bonds have greater credit risk than higher quality bonds.

Commodities and Futures—The risk of loss in trading commodities and futures can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. The high degree of leverage that is often obtainable in commodity trading can work against you as well as for you. The use of leverage can lead to large losses as well as gains.

Real Estate—When investing in real estate companies, property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance.

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The S&P CoreLogic Case-Shiller 20-City Composite Home Price NSA Index is a value-weighted average that seeks to measure the value of residential real estate in 20 major U.S. metropolitan areas. The index is a composite of single-family home price indices for the nine U.S. Census divisions.

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