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Municipal Bond Market Insight | August 2021

Markets Enjoy Strong Performance Across the Board in July

Key takeaways

- » Municipal bonds, corporate bonds, and Treasuries all joined the equity market in enjoying strong returns in July.
- » If a proposed infrastructure bill is passed in the Senate, current modifications should result in no major changes related to municipal issuance.
- » Tax-loss harvesting opportunities for municipal bonds should be considered throughout the year rather than just at the year's end.
- » US economic activity, as measured by gross domestic product (GDP), was strong in the second quarter but is expected to be moderate in the second half of the year as concerns increase over the rapid spread of the COVID-19 Delta variant.

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General market update

This summer has marked a return to normalcy as Americans enjoy warm weather and vacations, although lingering pandemic concerns remain. Federal Reserve chairman Jerome Powell commented last week that the Fed is encouraged by an improving economy and will seek to start removing accommodation (the "tapering" process) toward the end of the year. GDP was measured at 6.4% for the second quarter of 2021, indicating strong economic growth, although the pace is expected to moderate in the second half of the year.

Inflation fears continued to subside in July as bond markets instead focused on other potential risks, sending interest rates lower. Those falling rates helped deliver positive returns across the fixed income market, with the Bloomberg Barclays US Corporate Bond Index returning 1.37% and the US Treasury Index returning 1.36% in July. The Bloomberg Barclays Municipal Bond Index took a breather and returned 0.83% in July, lagging other fixed income categories, although munis remain the standout fixed income performer year-to-date. Equities continued pushing higher at record levels, with the S&P 500® returning 2.27%, based on optimism that the federal government will continue its substantial support of the economy.

Supply

For the month of July, the muni market saw total issuance of $31 billion of supply, with a breakout of $22 billion and $8.7 billion for tax-exempt and taxable issuance, respectively. Total tax-exempt issuance now stands at $194 billion year to date, the highest since 2017. Notable tax-exempt deals include Illinois's Metropolitan Pier and Exposition Authority, the New York City Transitional Finance Authority, and the Los Angeles County Metropolitan Transportation Authority. Consistent heavy demand has easily met supply, which is typical of the summer period as reinvestment flows continue to enter the market. The Biden administration's proposed federal infrastructure bill doesn't include any modifications for the return of advanced refunding bonds or a new program that would have increased taxable muni issuance. If the bill is passed in its current form, we anticipate no major changes for muni issuance as a direct result.

Figure 1: Fixed income returns as of 7/31/2021

	MTD return	YTD return
Bloomberg Barclays Muni Index	0.83%	1.90%
Bloomberg Barclays US Treasury Index	1.36%	-1.25%
Bloomberg Barclays US Aggregate Index	1.12%	-0.50%
Bloomberg Barclays US Corporate Index	1.37%	0.08%

Source: Bloomberg, 7/31/2021. For illustrative purposes only. It is not possible to invest directly in an index.

Figure 2: AAA municipal yields as of 7/31/2021

Year	Current	MTD change	YTD change
2-year	0.16	-0.10	-0.08
5-year	0.49	-0.13	0.14
10-year	0.99	-0.17	0.11
30-year	1.50	-0.11	0.00

Source: Thomson Reuters Municipal Market Data, 7/31/2021. For illustrative purposes only. Not a recommendation to buy or sell any security.

Figure 3: US Treasury yields as of 7/31/2021

Year	Current	MTD change	YTD change
2-year	0.18	-0.06	0.06
5-year	0.69	-0.20	0.33
10-year	1.22	-0.25	0.31
30-year	1.69	-0.19	0.25

Source: Bloomberg, 7/31/2021. For illustrative purposes only. Not a recommendation to buy or sell any security.

It's always tax-loss harvesting season

Investors may often look to their municipal bond portfolio for loss-harvesting opportunities to reduce the impact of capital gains taxes on portfolio returns. All too often, this occurs only towards the year's end. With limited replacement options and typically wider bid-ask spreads, the tax alpha that may be generated at the end of the year is likely below potential. Often we see that the economic loss of selling out of the positions at the inopportune time eliminates any tax benefit at all. We believe more optimal results can be achieved by partnering with a professional manager with the capability to harvest losses throughout the year. Here are the key reasons:

More favorable liquidity. The last few weeks of the year historically experience lower trading volume. Market participants that operate on a calendar year generally reduce activity during this time, and overall liquidity suffers as a result. High liquidity costs can sometimes erode or outweigh the tax benefit of harvesting the loss. Minimizing transaction costs can help maximize tax alpha.

Access to attractive replacements. Issuance typically slows at the year's end as well. By trading throughout the full year, investors are likely to find more opportunities to access the new-issue market when replacing sales. Active new-issue supply helps reinvestment and increases the likelihood of finding compelling replacement bonds. Access to a wider variety of bonds may also prevent wash-sale violations and ensure that portfolio characteristics are maintained.

Optimal timing. We believe the best tax-loss harvesting strategy is one in which positions are monitored daily and no opportunities are wasted. If tax-loss selling takes place only at the year's end, yield fluctuations throughout the entire year will create lost opportunities. Only twice over the past 25 years has the annual peak in municipal yields occurred in December: in 2020 and 2016.

Efficiency and scale. Not only can year-round loss harvesting elevate after-tax total return potential, but it can also increase scale and efficiency for the advisor and client. By opting in to professional and continuous monitoring of individual securities, the advisor no longer needs to make year-end manual requests, which can be time consuming and labor intensive. Clients benefit from a manager who focuses their time and attention on identifying opportunities and providing superior execution.

To illustrate the value of tax-loss harvesting, the table below shows a scenario for an equal-weighted one-to-10-year laddered portfolio under various interest rate increases over a one-year time horizon.

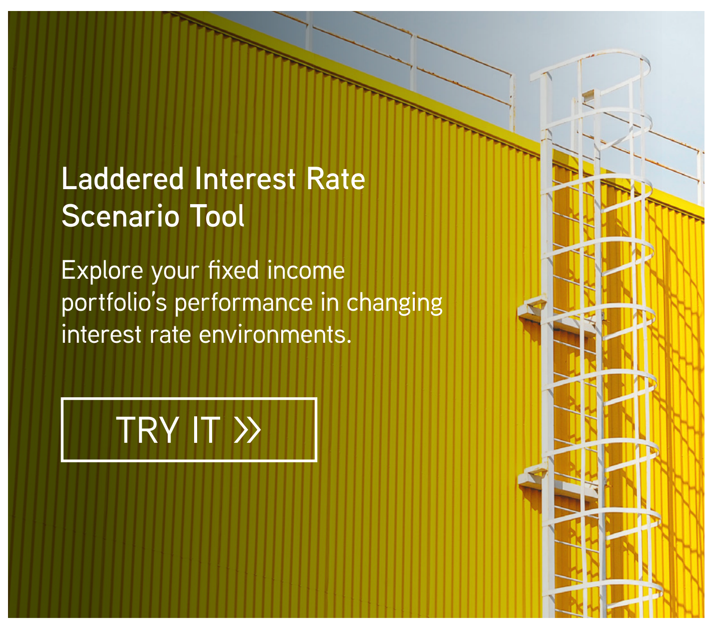
One-year total return of 1-to-10-year laddered portfolio

Interest rate rise	Pretax return	With loss harvesting	Value add
0.50%	-1.13%	-0.43%	0.70%
0.75%	-2.18%	-1.06%	1.12%
1.00%	-3.22%	-1.67%	1.55%
1.50%	-5.24%	-2.87%	2.37%
2.00%	-7.20%	-4.03%	3.17%

Source: Bloomberg, 8/3/2021. For illustrative purposes only. Not a recommendation to buy or sell any security.

For example, if yields increase by 1% (parallel shift) over the next 12-month period on a one-to-10-year ladder, pretax performance will be approximately -3.22%. However, by optimizing loss-harvesting opportunities, approximately 1.55% of tax alpha can be generated, resulting in higher after-tax performance of -1.67%.

The economy grew at a 6.5% annual pace in the second quarter, according to an advance reading of real GDP This growth was slower than the 8.4% median forecast in a July Bloomberg survey of economists. Supply-side constraints and struggles to build adequate inventories to meet record high levels of demand likely capped growth in the period. More recently, concerns over the rapid spread of the COVID-19 Delta variant has investors reevaluating economic growth in the second half of the year. At the time of this writing, the 10-year US Treasury yield sits below 1.20%, roughly 30 basis points lower since the start of Q3.



Key economic data

Change in nonfarm payrolls (June)	+850k
Unemployment rate (June)	5.9%
Core CPI–YoY change (June)	4.5%
Core PCE–YoY change (June)	3.5%
Average hourly earnings–YoY change (June)	3.6%
Real GDP Annualized QoQ (Q2 2021)	6.5%

Source: Bloomberg, 8/2/20211.

As we review minutes from the Fed's June meeting, we see little alarm over inflationary pressures. One area of particular concern, however, is slower-than-expected job growth in jobs and continued labor shortages. We see the Fed reiterating in its prepared remarks following its July meeting that the economy will take some time before fully recovering, particularly in terms of regaining the millions of jobs lost in 2020. This could mean a longer period of accommodation, delayed tapering of asset purchases, and lower rates for longer than currently priced into the market.

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27547 | 8.11.2021