Municipal Fixed Income Commentary

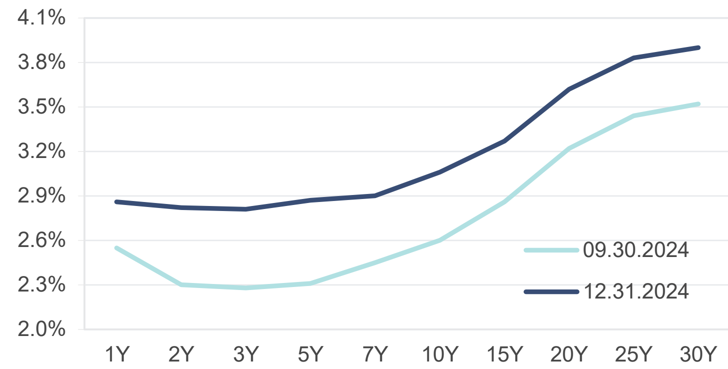
4th Quarter 2024

The municipal market resumed its circuitous path to higher yields in the fourth quarter, retracing to levels last reached in the spring, as the broad economy delivered stalwart growth and firm inflation while monetary policy eased. The resulting negative price change overwhelmed coupon returns during the quarter, and the ICE BofA 1-10 Year Municipal Securities Index delivered -0.80% in total return, detracting from the ultimate 1.53% total return result for the year. While excess return was minimal during the quarter relative to duration-matched treasuries, full-year excess return of -1.96% reflected costly municipal-to-treasury ratios to begin the year that reset to a more normal range as rate volatility persisted. Ratios ended the year at 65% for the five-year and 67% for the ten-year, approximately in line with three-year averages for each measure.

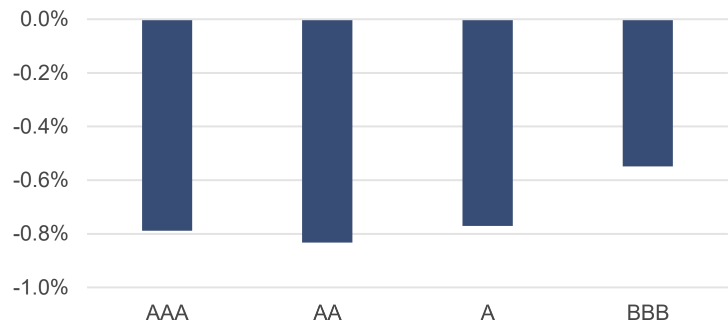
Primary market activity roared to close out the year, contributing to a record annual total and adding to the enduring momentum for higher tax-exempt rates. New issue supply of $121 billion during the quarter contributed to an annual supply total of $497 billion, sizable increases of 25% and 36% relative to the equivalent periods in the prior year, respectively. Supplementing new supply, bid wanted activity accelerated to a daily average par amount during the quarter of over $1.1 billion according to Bloomberg, a 24% increase relative to the prior quarter, in large part owed to increased selling driven by seasonal tax-loss harvesting strategies. Fund flows into municipal bond funds were persistent throughout the quarter and totaled nearly $7 billion, indicative of entrenched demand for tax-exempt income, even in a capricious market. As rates increased, the municipal curve slope further steepened though remained well below historical norms. Refinitiv's AAA-municipal curve 1-year to 10-year spread differential grew by 15 basis points (bps) during the quarter and ended at 20 bps, driven by a significant 46 bps increase in the 10-year rate. Even with the quarterly adjustment, the municipal curve slope remained relatively flat compared to historical levels with a ten-year median spread differential of 107 bps, according to Refinitiv.

Index returns narrowly favored lower quality credits with more spread compensation, a departure from the more pronounced risk-on environment from each of the prior three quarters. Total return for BBB-rated securities of -0.56% outpaced tight concentration in AAA-rated, AA-rated, and A-rated returns of -0.79%, -0.83%, and -0.77%, respectively. Lower-rated credits such as airports, various toll road and transportation exposures, and corporate obligors in the industrial development revenue (IDR) sector

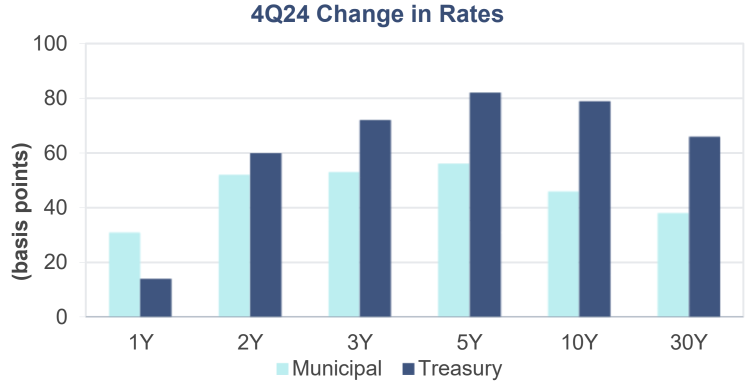
Refinitiv AAA Municipal Yields



4Q24 Total Return % by Rating Category



4Q24 Change in Rates



Data is as of 12.31.2024. Sources: Bloomberg L.P.; U.S. Treasury; Refinitiv. Yields are subject to market conditions and are therefore expected to fluctuate. Charts are for illustrative purposes only. The views expressed represent opinions of Sterling Capital Management. Any type of investing involves risk and there are no guarantees that these methods will be successful. Past performance does not guarantee future results.

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each delivered meaningful outperformance relative to the index. Higher profile names such as the New York Metropolitan Transportation Authority (MTA) and State of New Jersey each tightened by 3 bps, keeping with the broader trend across the index where the majority of the top fifty issuers experienced option-adjusted spread (OAS) tightening. Prepaid gas and electric index subclasses each underperformed the index despite 5 bps of OAS tightening for gas bonds and no change in spread for electric bonds, primarily a result of the longer effective duration of these subclasses relative to the index.

Sturdy credit fundamentals persisted during the quarter. Moody's upgraded the State of Pennsylvania to Aa2 from Aa3 and adjusted the outlook on the State of California from negative to stable, citing satisfactory budget management and favorable revenue performance in both cases. Moody's also reported stable outlooks in all public finance sectors except for public K-12 school districts, reflective of their slowing revenue growth and secularly declining enrollment trend. The National Association of State Budget Officers (NASBO) reported in their Fall 2024 Fiscal Survey of the States that the median rainy day fund balance (as a percent of spending) is projected to grow for the fourteenth consecutive year in the year according to state budgetary projections. Transportation Security Administration (TSA) data indicated broad consumer strength in the fourth quarter with an increase of quarterly throughput year-over-year of 3% and a new all-time high of 3.1 million daily checkpoint screenings in early December.

Our View

On the heels of a hawkish Federal Reserve (Fed) December cut, we maintain our expectation for above-trend economic growth, above-target inflation, and a resilient labor market in 2025. Fed officials believe that monetary policy is restrictive, despite lowering the federal funds rate by 100 bps in the final four months of the year while steadily increasing their assessment of the neutral interest rate. Accordingly, we view the Federal Open Market Committee (FOMC) as slowly letting off the monetary brakes rather than playing a more balanced role in the economy, a framework where higher inflation than expected would be first counterbalanced with less future easing (rather than tightening). In this context, we expect continued steepening of the municipal curve and a range-bound spread environment as our base case for the upcoming year.

During the quarter, we retained our prepaid energy overweight and continued to add to revenue bond exposure, positions that may pad portfolio yields in a supportive fundamental environment. We also maintained our bulleted position, matching our prospective view on curve shape change. In our opinion, abundant new municipal supply should continue as issuers further acclimate to the reality of higher rates, the reality of diminishing federal aid, and significant need for capital investments. We expect $520 billion of combined taxable and exempt supply in 2025, approximately 5% above 2024 levels. We also believe that the Trump administration brings with it uncertain policy outcomes, many of which are likely to buttress economic growth, while also posing a potential risk threatening the possibility of an upturn in inflation and geopolitical uncertainty. As markets price these various scenarios with no shortage of incoming municipal supply, we believe that any associated meaningful rise in tax-exempt rates would present a compelling risk-adjusted opportunity for investors with longer time horizons.

Disclosures

Past performance is not indicative of future results. Any type of investing involves risk and there are no guarantees that these methods will be successful. Economic charts are provided for illustrative purposes only. The information provided herein is subject to market conditions and is therefore expected to fluctuate.

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The volatility of an index varies greatly. All indices are unmanaged and investments cannot be made directly in an index.

The ICE BofA 1-10 Year Municipal Securities Index is a subset of the ICE BofA U.S. Municipal Securities Index including all securities with a remaining term to final maturity less than 10 years.

Refinitiv Municipal Market Monitor (MMD) AAA benchmark: The Municipal Market Monitor has been delivering the municipal market's MMD AAA benchmark for over 30 years, and is integrated into the most comprehensive source of critical municipal market information.

Bid Wanted: An announcement by an investor who holds a security, commodity, or currency. It indicates that they are looking to sell the product, and are ready to entertain price bids for it. Interested parties may thus respond with bids.

Build America Bonds (BABs) were taxable municipal bonds that featured federal tax credits or subsidies for bondholders or state and local government bond issuers.

General Obligation Bonds (GOs) are municipal bonds which provide a way for state and local governments to raise money for projects that may not generate a revenue stream directly.

Industrial Development Revenue Bonds (qualified small issue bonds or IDRBs) are securities issued by a local government agency for the purpose of acquiring or constructing capital facilities for use by private business and industry.

National Association of State Budget Officers Spring (NASBO) has been in existence for nearly 80 years and is a professional membership organization for budget and finance officers. The survey referenced is a semi-annual report gathered from all 50 state budget offices. Spring survey referenced: https://www.nasbo.org/reports-data/fiscal-survey-of-states

Option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is then adjusted to take into account an embedded option.

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