Munis display more noise than signal in August

BlackRock

September update

- Modestly negative performance in August capped a robust summer seasonal period.
- Issuance exceeded expectations, resulting in less of a supply/demand imbalance than is typical.
- We maintain a defensive posture into the historically less favorable month of September.



Peter Hayes, Head of the Municipal Bonds Group
James Schwartz, Head of Municipal Credit Research
Sean Carney, Head of Municipal Strategy

Market overview

Municipals deviated from the seasonal norm and posted modestly negative total returns in August. While rising interest rates acted as a drag, rich valuations and tight credit spreads drove further underperformance versus comparable U.S. Treasuries. The S&P Municipal Bond Index returned -0.27%, bringing the year-to-date total return to 1.67%. Shorter-duration and non-investment grade rated bonds outperformed. Notably, despite recent weakness, the seasonally favorable summer period (June- August) accounted for 43% of year-to-date performance.

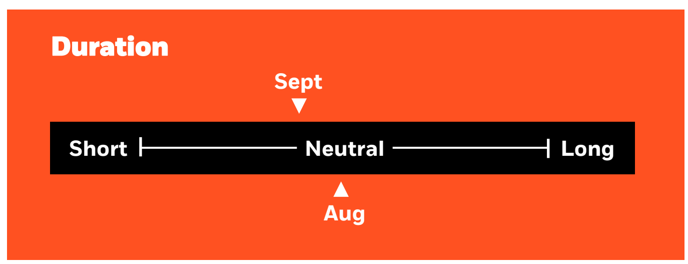
Supply exceeded expectations in August. Issuance totaled $41 billion, up 19% month-over-month and 13% above the 5-year average, bringing the year-to-date total to $296 billion. At the same time, taxable municipal issuance decreased -11% month-over-month to just 20% of supply, making tax-exempt issuance more burdensome. As a result, reinvestment income (from maturities, calls, and coupons) outpaced tax-exempt issuance to a lesser degree than expected and provided less of a seasonal tailwind.

Firm demand continued, and the asset class garnered $9 billion in mutual fund inflows in August. This brings year-to-date flows to $69 billion and keeps 2021 on pace to eclipse 2019 as the best fund flow year ever by November.

We maintain a defensive posture over the near term amid rich valuations, tight credit spreads, and less historically favorable supply/demand and interest rate dynamics in the fall. We acknowledge the potential for increased volatility stemming from elevated political, fiscal and monetary policy, and COVID-19-related uncertainties. However, we maintain a favorable view of the asset class over the medium term amid improved credit fundamentals and continued strong demand for tax shelter.

Strategy insights

We have shifted to a slightly short-of-neutral stance on duration within a barbell yield curve strategy. We continue to hold a preference for lower-rated credits and sectors that have been more impacted by the pandemic, such as transportation, education, travel-related (hotel tax, airport, etc.) and health care.



Yield curve

Barbell strategy, preferring 0-5 and 20+ years

Overweight

- Higher quality states and essential-service bonds
- School districts and local governments supported by property taxes
- Issuers that should benefit from the re-opening of the economy
- Select issuers in the high yield space

Underweight

- Speculative projects with weak sponsorship, unproven technology, or unsound feasibility studies
- Senior living and long-term care facilities in saturated markets

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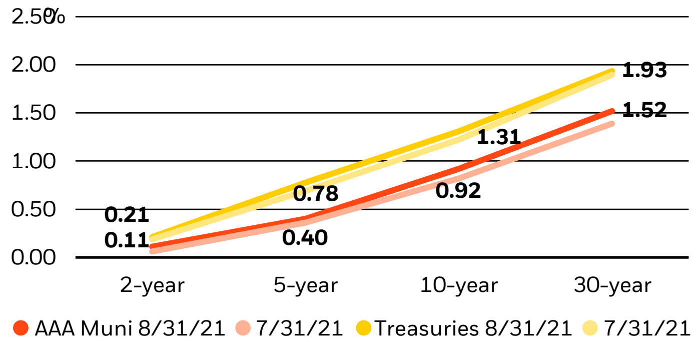
Credit headlines

On August 29, Hurricane Ida made landfall in southeastern Louisiana. The storm left an extensive trail of damage and flooding extending from New Orleans to New York City and beyond. The loss of human life and property is tragic and the process to rebuild some communities will take time, particularly in areas that remain without power. However, as with other similar natural disasters, we do not anticipate any long-lasting effect on municipal credit in the impacted areas. The flow of insurance proceeds and/or federal aid will spur the rebuilding effort. We also believe property taxes, the primary revenue source for most local governments, will be paid. We continue to monitor our municipal exposures with real-time mapping capabilities and other advanced analytic tools.

Municipal market participants continue to watch Congressional negotiations on infrastructure and budget reconciliation bills. The Senate's $1 trillion bipartisan infrastructure bill passed in August excluded certain municipal industry priorities such as tax-exempt advance refundings, a direct-pay bond program and broadening of the bank-qualified bond definition.

Municipal and Treasury yield movements



Sources: BlackRock: Bloomberg.

Municipal performance

	Aug 2021	YTD
S&P Municipal Bond Index	**-0.27%**	**1.67%**
Long maturities (20+ yrs.)	-0.53%	3.33%
Intermediate maturities (3-15 yrs.)	-0.20%	1.25%
Short maturities (6 mos.-4 yrs.)	-0.03%	0.56%
High yield	-0.16%	6.38%
High yield (ex-Puerto Rico)	-0.18%	6.42%
General obligation (GO) bonds	-0.28%	0.99%
California	-0.31%	1.25%
New Jersey	-0.25%	2.69%
New York	-0.37%	1.96%
Pennsylvania	-0.28%	1.96%
Puerto Rico	-0.03%	5.64%

Sources: S&P Indexes.

Investment involves risk. *The two main risks related to fixed income investing are interest rate risk and credit risk. Typically, when interest rates rise, there is a corresponding decline in the market value of bonds. Credit risk refers to the possibility that the issuer of the bond will not be able to make principal and interest payments. There may be less information available on the financial condition of issuers of municipal securities than for public corporations. The market for municipal bonds may be less liquid than for taxable bonds. A portion of the income from tax-exempt bonds may be taxable. Some investors may be subject to Alternative Minimum Tax (AMT). Capital gains distributions, if any, are taxable.* ***Index performance is shown for illustrative purposes only. You cannot invest directly in an index. Past performance is no guarantee of future results.***

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