

Municipal Seasonality

Background

The short-term municipal market possesses distinct seasonal trends compared to the taxable liquidity market. Where appropriate, cash managers may seek to take advantage of these patterns in an effort to achieve preferable yields on an after-tax basis.¹ However, during certain periods throughout the year, the potential benefits of municipal instruments may be diluted, causing yields to move lower in the short-term municipal market. Despite this seasonal movement, we believe investments in the short-term municipal market over the course of the year may still provide investors with an overall benefit. The following is a view of the short-term municipal market, the factors that cause its seemingly independent traits and points of interest which may help explain seasonal yield variations.

The municipal market January effect

In the early weeks of a new calendar year, municipal money market funds often receive a triple dose of cash inflows from municipal bond maturities, coupon payments and a rush of corporate investments. As municipal funds look to fully invest these assets, they frequently do so in the form of purchasing short-term Variable Rate Demand Notes (VRDNs). Although this investment in VRDNs (or other alternatives) helps achieve the goal of investing extra cash on hand, it can also temporarily drive down the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index² because this excess investment causes a sharp decline in the supply of available VRDNs. The SIFMA Index, which represents the average yield on seven-day Variable Rate Demand Note (VRDN) securities, fluctuates based on the absolute available supply of VRDNs on dealer balance sheets. Greater dealer balances generally lead to higher SIFMA levels, and conversely, lower inventories of VRDNs on dealer balances sheets lead to lower SIFMA levels. Therefore, as new money enters the short-term market in early January, inventories of VRDNs fall, and dealers typically quickly reset the SIFMA Index lower. Historically, when the SIFMA Index drops below 65% of taxable securities, investors temporarily divest municipal

holdings, which helps offset these municipal money market funds' need for cash reinvestment. Overall, however, the increasing demand for VRDNs during this time may provide investors with less favorable yields than at other points in the year when VRDN demand has normalized.

Key points to know

Historically, short-term municipal securities have become favorable when pre-tax yield ratios are greater than 65% of taxable securities.

Demand for tax-free securities typically increases in early January due to year-end municipal coupon payments received and corporate balance sheet activities.

Similar to what is often seen from the January effect, demand spikes may occur mid-year as well due to factors associated with municipal fiscal year-ends.

Periodic high demand drives VRDN yields down and subsequently lowers this advantage.

Tax season may offer a period where investors can achieve favorable yields in the short-term municipal market given certain market factors affecting VRDN demand.

Municipal securities tend to react less quickly to Federal Open Market Committee (FOMC) interest rate changes than taxable securities.

Tax season rebound

In March, unlike January, a period of higher yields usually begins, due to two primary factors related to taxes. First, for corporations, tax payments are typically due on March 15, which often leads to a period of redemptions from municipal money market funds to meet these payments. Second, individuals who utilize money market funds as cash alternatives may redeem these holdings in advance of tax day, typically in April, given these funds' high levels of liquidity. These two factors generally contribute to a supply and demand imbalance featuring excess supply of VRDNs. Further, as tax season unfolds in subsequent weeks, VRDN inventories tend to remain elevated; this excess in inventory compels the dealer community to push the SIFMA Index consistently higher during this period to attract taxable crossover investors into the market.

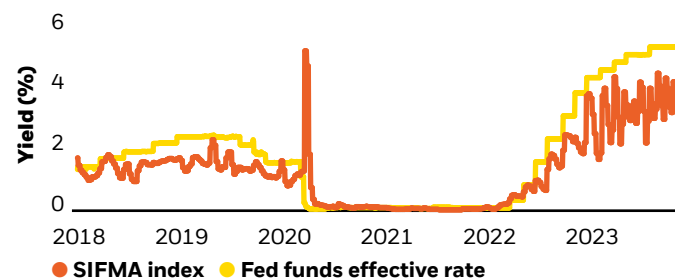
Mid-year municipal reinvestment demand

During June and July (and to a lesser extent, August), it can be expected that municipal money market funds again receive an increase in cash inflows. July 1 coupon payments and maturities saddle these funds with excess cash, and the funds (as well as individual investors) seek temporary investments until the coupon inflows can be reinvested in longer-term securities. This extra cash, similar to what occurs in January, is typically reinvested in VRDNs, which compels the dealer community once again to reset VRDN yields lower, usually below 65% of taxable yields. Again, similar to the January effect, a municipal money market fund's ability to outperform taxable money market funds may become temporarily compromised as a result of these lower yields.

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A look at VRDN yields vs. Fed rates



Bloomberg: As of October 31, 2023. Past performance is no guarantee of future results.

The wild card: Fed movements

Typically, taxable money market funds respond more quickly to changes in federal funds rates than do municipal securities, which exacerbates this cyclical phenomenon. The municipal markets' supply and demand characteristics depend more heavily on technical aspects of the market, whereas taxable funds typically trade on fundamentals, such as economic data; these technical aspects (i.e. the heavy reinvestments in January and July) temporarily push yields lower in the short-term municipal market. Then, over time, fundamentals compel the municipal market to move back into equilibrium with the taxable market, offering a period where municipal money market funds can outperform taxable money market funds on an after-tax basis.

In our view, appreciating these factors impacting the short-term municipal market can help investors better understand the seasonality of the market, and most effectively maximize their cash investments.

1 All tax-equivalent calculations are based on a 35% federal income tax rate. 2 The Securities Industry and Financial Markets Association Municipal Swap Index is a 7-day high-grade market Index comprised of tax-exempt Variable Rate Demand Notes (VRDNs) with certain characteristics. The Index is calculated and published by Bloomberg. The Index is overseen by SIFMA's Municipal Swap Index Committee.

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