Municipal summer strength doesn’t disappoint

August update
• Rallying interest rates drove strong muni bond performance in July.
• Market dynamics remained seasonally favorable with demand for munis broadly outpacing supply.
• A more defensive posture may be warranted ahead of elevated risks in the fall.

Market overview
Municipals maintained their seasonal trend and posted strong performance throughout the month of July. The market benefited from a favorable supply-demand backdrop and rallying interest rates due to excess liquidity, short covering, and Delta variant fears. Tight credit spreads and rich valuations once again acted as a drag, spurring modest underperformance versus comparable Treasury bonds. The S&P Municipal Bond Index returned 0.70%, bringing the year-to-date total return to 1.95%. Longer-duration (greater interest-rate sensitivity) and lower-rated bonds outperformed the broader index.

Supply moderated from the robust levels experienced in June and trended more in line with historical expectations. Issuance of $35 billion was down -26% month-over-month but just 5% above the 5-year average, bringing the year-to-date total to $255 billion. Taxable issuance accounted for 27% of supply, the highest level since February, as lower interest rates made advance refunding tax-exempt debt in the taxable municipal market more economical. As a result, reinvestment income (from maturities, calls and coupons) significantly outpaced tax-exempt issuance and provided a strong technical tailwind.

Demand remained firm with the asset class garnering continued inflows. While fund flows slowed slightly into month end amid lower absolute yields, 2021 remains on pace to eclipse 2019 as the best fund flow year on record. We expect that the market will continue to benefit from a near-term supply-demand imbalance. However, given recent performance strength and current stretched valuations, we anticipate monetizing some of our gains in August, ahead of the less favorable seasonal trends and increased event risks in the fall.

Strategy insights
We maintain a neutral stance on duration (interest rate risk) 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.

Duration

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<th>Short</th>
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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

August 2021 | Municipal Market Update
Credit headlines

Local government fundamentals still in good health.
With the rise in COVID-19 cases, vaccination rates at the county level could provide insight on the impact on the U.S. economy. Counties with vaccination rates below the 39% national county average are concentrated in rural areas and account for a mere 15% of GDP. Counties with new cases above the U.S. county average represent only 36% of GDP. Although case density is rising in metro areas, three out of the top five metro areas have vaccination rates greater than the U.S. overall (>50%) and account for 17% of GDP, while the two that are below account for only 5%. As the virus continues to spread into metro areas, those with higher vaccination rates should see fewer hospitalizations and deaths. Nationally, sizable state revenue surpluses and unprecedented levels of stimulus funds could help any overloaded healthcare systems in areas with lower vaccination rates. These factors, along with state and local government actions thus far, indicate that the risk of new mandated lockdowns is significantly diminished and we expect limited impact on the high fundamental quality of municipalities.

Public utilities able to withstand the heat. Intense drought conditions combined with extreme heat have led to over 90 active wildfires across 12 states. These wildfires have been damaging to the regional economies and are affecting air quality nationwide. As in past instances, we anticipate state and federal aid as well as insurance will help mitigate financial impacts. Drought conditions are impacting California as well as most states west of Texas, leading to broad-based restrictions from water utilities. From a credit perspective we believe utilities have the necessary tools to effectively offset revenue declines that are associated with decreased demand. Unfortunately, a meaningful improvement to conditions in the affected areas is not expected through the fall months, so we anticipate that water usage limitations will become stricter and more widespread through year end.

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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