Market overview
Municipal bonds posted another month of strong performance in July. Supply-demand dynamics remained favorable and interest rates fell as COVID cases surged in many areas and Congress failed to pass additional fiscal support. The S&P Municipal Bond Index returned 1.41% for the month, bringing the year-to-date return to 3.41%. The strongest performers were BBB-rated credits, the more liquid sectors of the high yield market, and the long end of the yield curve (terms of 22 years+).

Supply hit a record high for the month of July at $45.9 billion. The net negative supply scenario that typically occurs at this time of year did not materialize as issuance continued to outpace the reinvestment of income from coupons, calls and maturities. It’s important to note that a significant 35% of supply was comprised of taxable issues, which are typically marketed to a different buyer base, allowing issuance to be more easily absorbed.

Demand remained firm throughout the month. Mutual funds, led by long-term funds, garnered substantial inflows, avoiding typical seasonal outflows around “tax day,” which was extended this year to July 15.

We hold a more cautious outlook for municipals in the near term given their recent strong performance, muni yields near all-time lows and muni-to-Treasury ratios having compressed materially across the curve, particularly in the long end. Additionally, seasonal trends typically turn less favorable in the fall, and we believe volatility is likely to be exacerbated alongside the upcoming U.S. election and ebbs and flows in the virus and vaccine progression.

Strategy insights
We have shifted to a shorter duration stance (i.e., reduced interest rate risk) in our municipal bond exposure given stretched valuations and the potential for increased volatility in the fall. We continue to hold a bias for higher quality assets overall and continue to advocate careful security selection as the impact of the pandemic can vary across market segments.

Duration

Yield curve
Barbell strategy, preferring 0–5 and 20+ years

Overweights
• Higher quality states and essential-service bonds
• School districts and local governments supported by property taxes
• Flagship universities and strong national and regional health systems
• Select issuers in the high yield space

Underweights
• Speculative projects with weak sponsorship, unproven technology or unsound feasibility studies
• Senior living and long-term care facilities
• Small colleges, student housing and single-site hospitals
• Credits highly correlated to hospitality, travel and leisure

August update
• Municipals delivered another month of strong performance in July.
• Robust supply has continued to be absorbed by strong demand.
• Volatility that is typical of the fall months may be exacerbated this year.
**Credit headlines**

**CARES II negotiations** continue in Congress. Market participants are expecting stimulus aid in the range of $250-400 billion. If additional federal assistance is not provided, we anticipate states will have to use their own fiscal tool kits to balance their budgets. This could lead to deep reductions in spending for health care and education, tax increases, furloughs and layoffs of public workers, and the cancelation of vendor contracts. The desire to avoid such a scenario is likely to compel Congress to pass another round of fiscal stimulus. Other components of a negotiated package, such as an extension of supplemental unemployment payments, would further support consumer spending and therefore, tax collections. If Congress delays on passing stimulus, state and local governments have the ability to tap into the $500 billion municipal liquidity facility to offset short-term disruptions in revenue collections.

**High yield muni bonds** continued the strong rebound from their March lows, gaining 2.18% in July. Puerto Rico and tobacco bonds continued to lead the rally as investors returned to these segments that were hit particularly hard in the March selloff given their higher liquidity. In the coming months, market watchers will be paying attention to First Energy and its former subsidiary, First Energy Solutions (now Energy Harbor Corp.), as these entities were recently charged with corruption and racketeering in relation to subsidies passed by the Ohio Legislature to bail out the company’s nuclear plants. Earlier this year, the former First Energy Solutions bonds were exchanged for equity shares of the new company, Energy Harbor Corp., as part of the company’s exit from bankruptcy. Investors who accepted the exchange later saw the shares fall more than 40% on news of the bribery charges; however, most municipal bond fund managers had sold the bonds prior to the restructure given that equity exposure is widely deemed an unsuitable risk for municipal bond mutual funds. We continue to monitor the situation as further poor performance could have a technical impact on the broader municipal market.

**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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