BlackRock

Munis off to a running start

February update

- Strong performance has continued to stretch rich muni bond valuations.
- We expect strong demand to continue outpacing elevated supply.
- Additional fiscal aid and vaccine distribution could support fundamentals.



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

Market overview

Favorable supply-and-demand dynamics drove strong municipal bond performance in January despite a material move higher in interest rates driven by vaccine optimism and expectations for additional fiscal stimulus. The S&P Municipal Bond Index returned 0.56% for the month. High yield munis posted the strongest gains, led by the more liquid tobacco and Puerto Rico bonds. The outperformance of munis versus Treasury bonds further stretched their rich valuations, pushing muni-to-Treasury ratios to all-time tightest levels in the intermediate and long end of the yield curve.

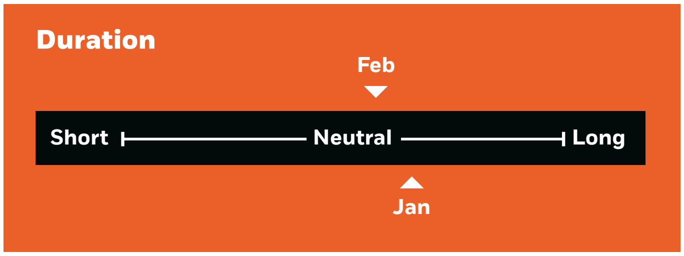
New supply underwhelmed lofty expectations in January as issuers took a wait-and-see approach on the new administration. Taxable issuance remained proportionally elevated at 29% of total supply, depressing traditional tax-exempt issuance. In the tax-exempt market, reinvestment of income from maturities, calls and coupons outstripped issuance by nearly $16 billion, creating a powerful tailwind. New issues were oversubscribed by 11 times on average.

With mutual fund flows approaching all-time highs for three consecutive weeks, January was the best fund flow month on record. High yield munis, which had considerably lagged in the rebound from the pandemic market shock last March, saw their largest-ever weekly inflow in January.

The month of February has produced positive total returns in 8 of the past 10 years. While rich valuations will cause a drag, we expect strong demand to continue outpacing an elevated but manageable level of issuance. We believe fundamentals will likely benefit from additional fiscal aid, and vaccine distribution should support longer-term revenue normalization. As the new administration lays out its agenda and tax policy comes into focus, we anticipate heightened demand for tax-advantaged assets such as muni bonds.

Strategy insights

We maintain a neutral stance on duration (sensitivity to interest rate movements). We see opportunities in high yield muni bonds and sectors that were more impacted by COVID such as transportation, travel-related (hotel tax, airport, etc.) and healthcare.



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

USRRMH0221U/S-1518482-1/2

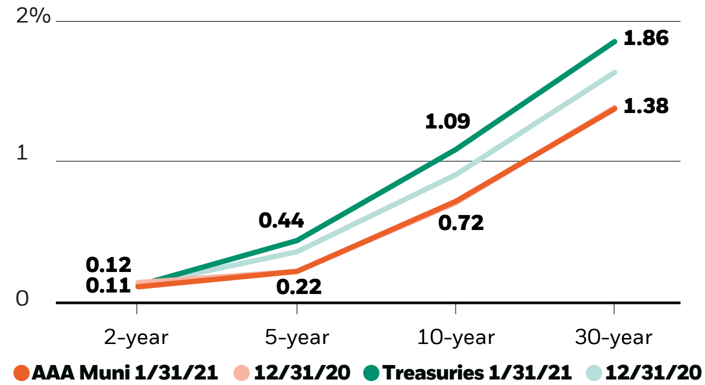
Credit headlines

New state budgets reflect revenue repair. Governors in California and New York submitted executive budgets for the 2022 fiscal year that reflect a better revenue picture than what was feared earlier in 2020.

In California, Gov. Newsom's proposed budget of $227 billion for the fiscal year beginning July 1 represents a $25 billion increase (+12.4%) over the current fiscal year, potentially triggering the Gann limit, a spending cap law that requires the state to send rebates to taxpayers if inflation-adjusted per capita spending exceeds 1978-79 levels. The proposal includes stimulus measures for the current fiscal year, including state payments to low-income individuals, aid to reopen public schools and small business relief funds. The budget also continues the trend of additional pension contributions to pay down unfunded liabilities. As of December, year-to-date revenues for the current fiscal year (ending June 30) were above estimates by $18.3 billion (+25.1%), driven by personal income taxes, sales taxes and corporate income taxes. In January, the state projected a $15 billion surplus for the current fiscal year, which is an extremely positive swing from the $54 billion deficit projected in April 2020.

New York's Gov. Cuomo proposed a $193 billion budget for the fiscal year beginning April 1, 2021 that closes a projected $10 billion gap. The budget entails hiking the top personal income tax rate from 8.82% to 10.86% through 2023 and delaying for one year the phase-in of income tax cuts for middle class residents. On a positive note, an improved tax receipt forecast reduced the projected gap by $6.5 billion. Reductions in local aid totaling $3.4 billion include a $1.5 billion cut to school districts. The plan assumes $6 billion of new federal stimulus aid, with $3 billion allocated in FY 2022, although there is great uncertainty on what amount of state and local aid will ultimately be passed. The state's current revenue shortfall resulting from the pandemic is similar to its predicament in 2011, when the new administration closed an inherited $10 billion projected gap, albeit on a smaller revenue base.

Municipal and Treasury yields



Sources: BlackRock; Bloomberg.

Municipal performance

	FY 2020	JAN 2021
S&P Municipal Bond Index	**4.95%**	**0.56%**
Long maturities (20+ yrs)	6.46%	1.00%
Intermediate maturities (3-15 yrs)	5.04%	0.49%
Short maturities (6 mos-4 yrs)	2.32%	0.20%
High yield	6.00%	1.87%
High yield (ex-Puerto Rico)	5.50%	1.85%
General obligation (GO) bonds	5.26%	0.40%
California	4.91%	0.44%
New Jersey	5.16%	1.20%
New York	4.35%	0.69%
Pennsylvania	5.04%	0.63%
Puerto Rico	8.86%	1.99%

Source: 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.***

OE42033T-0221

BlackRock.