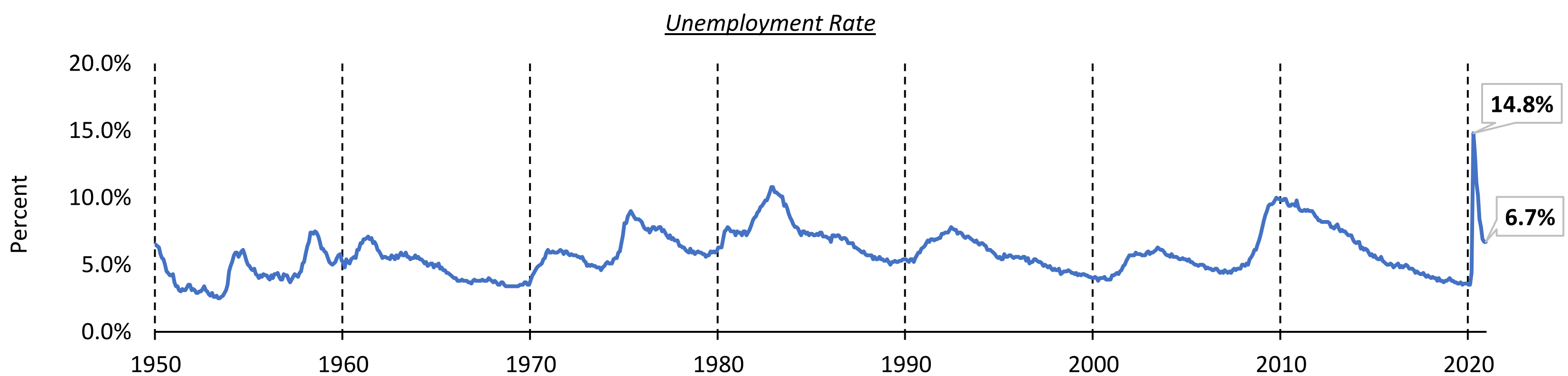
Review

Even though treasury yields moved higher during the final quarter of 2020, annual fixed income returns remained strong across a broad spectrum of sectors and credit quality. Markets appear primed for reflation as preliminary data points towards a gradual economic recovery and the potential for more monetary and fiscal stimulus.

Municipal Index	Effective Duration	4Q 2020 Return	YTD Return
ML Municipal 3-7 Year Index	3.87	0.868%	4.145%
ML Municipal 12-22 Year Index	7.52	2.591%	6.005%
Taxable Index	**Effective Duration**	**4Q 2020 Return**	**YTD Return**
ML US Corp & Gov 5-7 Year A Rated & Above	5.64	0.025%	8.696%
ML US Treasury/Agency 7-10 Year	7.94	-1.256%	9.969%
ML US High Yield BB Rated	4.46	5.736%	8.618%

Inflation

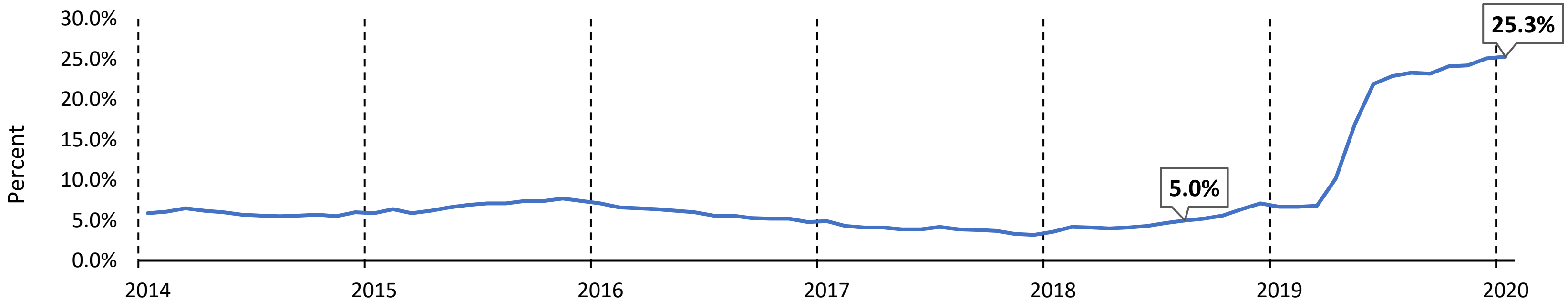
The chart below shows the unemployment rate for the last 70 years. The sharp spike up in 2020 to a level over 14.0% was due to layoffs during the pandemic. Fiscal stimulus by the government has helped to bring the rate down to 6.7%. While this rate is still relatively high it is about half of what it was in May. In addition to fiscal stimulus the Federal Reserve has been very accommodating. They decreased interest rates to the lower end of the zero bound, engaged in Quantitative Easing by expanding their balance sheet, increased the money supply, and instituted a variety of programs to provide liquidity to the markets which had frozen up in March.



Source: FRED

The combination of a coordinated fiscal and monetary response to this crisis has led to a stabilization of economic conditions and a reduction in the unemployment rate. The table below shows the increase in the money supply from about a 5.0% growth rate to an accelerating rate of over 25.0%. This is more than twice as much growth as we had during the Financial Crisis ten years ago. This has led to an increase in inflationary expectations as the Fed has been calling for inflation of over 2.0% with a tolerance for rates exceeding their target. Additionally, there has been an increase in the 10 year breakeven rates from a low of less than 1.0% to the current rate of over 2.0%.

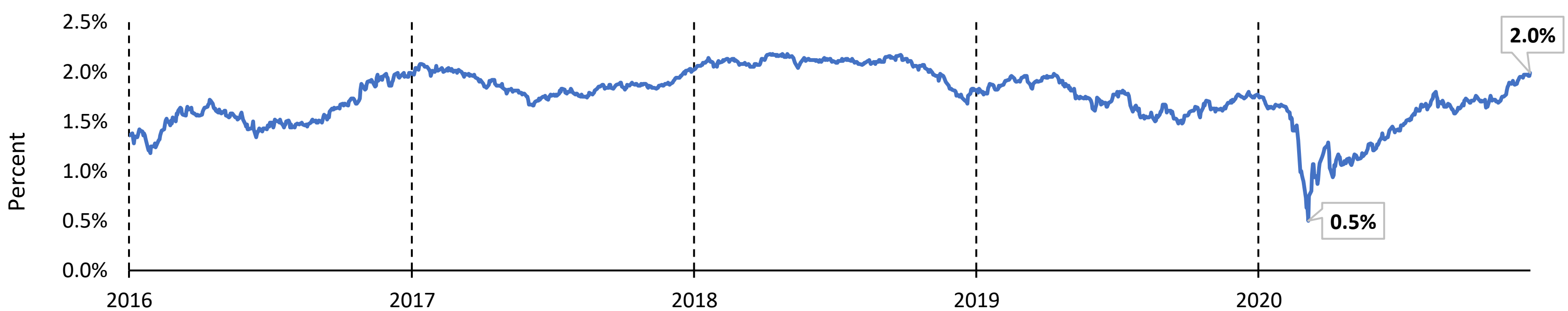
Federal Reserve Money Supply YoY % Change



Source: Bloomberg

The chart below shows the 10 year breakeven rates for inflation for the last 5 years. We are concerned another $1.9 trillion dollars of deficit spending in the current economic environment might cause inflation to rise faster than expected. This would have a negative impact on interest rates and could cause longer rates to rise. We still think we are in a low rate environment for a long period of time, but it is not difficult to imagine a 10 year UST yielding 1.5%-2.0%.

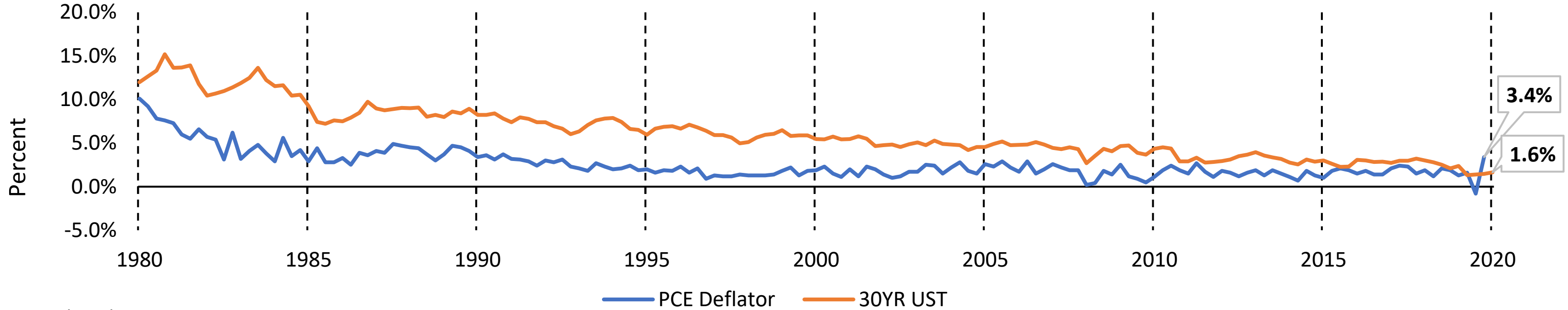
10YR Breakeven Inflation Rate



Source: FRED

The chart below shows the yield of the 30 yr UST compared to the PCE deflator. The deflator gain (3.4%) is now substantially higher than the yield on the 30 year UST (1.65% year-end / 1.83% currently.) This should put pressure on the long bond toward higher rates.

30YR UST vs. PCE Deflator



Source: Bloomberg

Biden's $1.9 Trillion COVID-19 Package: Muni Impact

Biden has proposed a $1.9 trillion stimulus package which may run into some difficulty in the Senate. This proposal is in addition to the $4.5 trillion which has already been allocated to fight COVID-19 under the Trump administration. This package includes aid to the States which has been met with stiff resistance in the past. We expect there will be significant resistance this year as well. There also may be resistance due to the size of the proposal and the impact it will have on deficit spending. It will be interesting to see if the new administration is able to generate the support it needs to pass this measure. We will be following this closely since Munis could be a beneficiary of direct Federal aid.

The stimulus package currently includes $420 billion of aid for state and local governments. $350 billion of this aid can be used at the discretion of the municipality, $50 billion is for small business grants and loans, and $20 billion is for mass transit. There is also $170 billion earmarked for education to help fund COVID containment. According to Route Fifty, a website about state and local government, there have been almost 1.4 million jobs lost in the state and local public sector since February 2020. This is a result of the budgetary pressures created by the pandemic last year. These pressures will continue into 2021. Many of these job losses have been in the education sector. These funds would help municipalities with their finances and help to save jobs in the public sector.

Conclusion

We are having a regime change in Washington this month. We are expecting the new administration to be friendlier and more supportive to state and local governments. This should be a positive for the Muni market. We expect the yield curve to continue to steepen as inflationary expectations move higher. However, it is important to remember we still have powerful headwinds for the economy. Negative demographic trends, high levels of debt to GDP, and technological changes will tend to dampen the increase in rates. We will be monitoring budgetary developments to see if Congress has the appetite for another $1.9 trillion of stimulus and deficit spending.