DUPREE MUTUAL FUNDS

December 31, 2019

Dear Shareholder:

What a difference a year can make. In 2018 virtually every asset class (municipal bonds & U.S. Treasuries being notable exceptions) lost money for investors. This year has been the exact opposite—virtually every asset class has generated strong positive total returns for investors. While a number of geopolitical events created lots of uncertainty and some market volatility, financial markets nonetheless demonstrated remarkable resiliency in 2019.

Like most other asset classes, fixed-income investments delivered above average returns in 2019. The municipal bond market enjoyed its best year since 2014 with demand for safe-haven assets and tax-exempt income pushing bond yields lower and bond prices higher. The Bloomberg Barclays Municipal Bond Index provided a total return of 7.54% for the 12-month period ended December 31, 2019. Tax reform, favorable supply-and-demand technical factors, benign inflation, declining default rates, improving credit quality, and a favorable interest rate environment all contributed to the strong performance of the municipal bond market in 2019.

The $10,000 cap on the State and Local Tax (SALT) deduction that was enacted as part of the Tax Cuts and Jobs Act of 2017 (TCJA) increased the tax burden for individuals that itemize deductions and has led to a surge in demand for municipal bonds. The increased demand has been reflected in large municipal bond mutual fund inflows which have set a record this year. Even though the TCJA reduced the corporate tax rate from 35% to 21% (which resulted in banks and some insurance companies reducing their tax-exempt holdings), the decline in demand by these institutions has largely been offset by the surge in demand by retail investors.

At the same time that demand for municipal bonds has increased, the net supply of tax-exempt bonds has continued to decline from the peak levels seen in 2016 and 2017. Issuers have continued to be very efficient at calling higher coupon tax-exempt bonds. That, combined with the elimination of tax-exempt advance refundings under the TCJA, has significantly reduced the net supply of tax-exempt bonds. One of the most interesting developments in the municipal bond market this year is that low absolute interest rates and elimination of tax-exempt advance refundings have caused the supply of *taxable* municipal bonds to surge as states and municipalities have utilized more nontraditional bond deal structures. Taxable municipal issuance is expected to continue to grow with some analysts predicting that it could approach $100 billion in 2020 if interest rates remain stable.

Inflation is a fixed-income investor's worst enemy. Fortunately, key measures of inflation have continued to be subdued. The Fed's preferred inflation gauge, the core PCE, increased at an annual rate of only 1.6% in November which continues to run well below the Fed's 2% inflation target. Near-term and long-term inflation expectations have also continued to be well anchored.

Default rates of investment grade municipal bonds have continued to run at historically low levels as credit conditions have continued to improve. State and local government revenues have continued to show signs of improvement. According to data compiled by the Urban Institute, combined state and local revenues were up 11.1% in the second quarter of 2019 compared to the same period last year. Many states have been successful in strengthening their rainy day reserve

P.O. Box 1149
Lexington, KY 40588-1149
Tel: 859-254-7741
800-866-0614
Fax: 859-254-1399
www.dupree-funds.com

funds. According to rating agency data compiled by Moody's Investors Service, municipal bond upgrades exceeded downgrades by a wide margin in 2019.

At the end of July, the Federal Reserve Open Market Committee (FOMC) surprised the market and cut the fed funds rate for the first time in over a decade. The July interest rate cut was followed by two additional one-quarter point cuts to the fed funds rate in September and October. Chair Powell has made it clear that the FOMC intends to keep the fed funds rate on hold for the foreseeable future. The FOMC's pivot towards an easing stance acted as a tailwind for municipal bonds during the second half of this year.

I attended a municipal bond conference in New York City a couple of weeks ago that had lots of really smart and seasoned municipal bond market participants offering their views about where they think the municipal bond market is likely headed in 2020. The good news is there seemed to be a consensus that most of the themes that propelled the municipal bond market's performance in 2019 would remain largely intact next year leading to solid returns, albeit slightly lower than this year.

One of the other main items discussed at the conference was the fast growing trend in the investment industry towards additional Environmental, Social, and Governance (ESG) investment. ESG investing has been touted as the next "disruptive" change in investment strategy and combines environmental, social, and governance factors into traditional investment evaluations and decisions. Among other things, ESG investing is driven by the concept that investment objectives and goals and personal values aren't mutually exclusive.

One of the main takeaways was that, in many ways, investing in the municipal bond market represents the *original* ESG investment. After all, when states and municipalities issue bonds, the proceeds are frequently used to finance environmental or green projects such as wastewater treatment facilities or renewable energy projects (the "E") or other socially responsible public projects such as hospitals, schools, and affordable housing (the "S"). Municipal bond issuers are invariably subject to good governance practices (the "G") due to federal tax and disclosure requirements and other compliance obligations such as bond indenture requirements. Citigroup estimates that approximately $2.9 trillion, or 76% of the municipal market, is likely to screen well for ESG investors. We think that's a powerful and comforting thought.

Thank you for investing with us. All of us here at Dupree appreciate your investment in the Funds and wish you the best in 2020. Happy New Year!

Sincerely,

Allen E. Grimes, III

Allen E. Grimes, III
President