June 30, 2021

Dear Shareholder:

Municipal bonds turned in a mixed performance during the first half of this year. While the first quarter witnessed an unexpected surge in Treasury yields that led to some volatility in municipal bond prices, municipal bonds then proceeded to post positive total returns each month during the second quarter. For the six-month period ended June 30, the Bloomberg Barclay Municipal Bond Index provided a total return of 1.06%.

Favorable supply and demand dynamics, a steady interest rate environment, and improving credit fundamentals all contributed to the steady performance of the municipal bond market. Summertime has historically been a period of strong performance for municipal bonds as reinvestment flows typically outpace new municipal bond issuance. This summer looks to be no different. Bloomberg estimates that $165 billion will be returned to bondholders (due to maturing bonds and interest payments) for reinvestment into the market, which is roughly $45 billion more than what is expected to come to market via new issuance. This "net negative supply" environment should keep bond prices firm in the near-term, especially with continued strong demand for tax-exempt investments.

The macroeconomic outlook continues to improve. Economic growth has strengthened considerably in recent months with real gross domestic product (GDP) increasing at an annual rate of 6.4% during the first quarter of 2021. This rapid growth reflects the continued bounce back in activity from depressed levels as large areas of the country emerge from the pandemic. Consumer spending for goods and services, which accounts for roughly two thirds of the U.S. economy, is increasing at a rapid pace, and the housing market is very strong. The labor market has also strengthened with the unemployment rate in May standing at 5.8%.

The vast majority of states and cities have emerged from Covid-19 with better than expected revenues. Against this backdrop and flush with federal stimulus dollars, governors and mayors across the country are pushing for large increases in spending. According to data compiled by the National Association of State Budget Officers, total general fund spending proposals rose approximately 5% to $963.6 billion for fiscal year 2022, with 39 states forecasting spending increases. At the federal level, Congress is currently debating passage of additional wide-ranging fiscal policy measures to shore up the economy and social welfare programs. All of this is occurring at a time when the Federal Reserve Board (the "Fed") continues to maintain an accommodative monetary policy.

Not surprisingly, this confluence of events has raised concerns about the potential for an outbreak of inflation. To be sure, inflation readings have increased notably in recent months. The Fed's preferred inflation measure, the core Personal Consumption Expenditures Index, increased at an annual rate of 3.4% in May (up from 3.1% in April). This rate exceeds the Federal Reserve's 2% longer-run inflation goal. However, there is an intense ongoing debate about whether the recent increase in prices will be "transitory" in nature as the Fed sees it, or "sticky" as others believe will be the case.

In testimony before Congress, Fed Chair Powell noted that the recent increase in inflation likely reflects four main factors: (1) base effects (i.e., comparisons with the low prices during the Covid-19 shutdown); (2) a rebound in spending as the economy reopens; (3) pass through of past increases in oil prices to energy prices; and, (4) supply bottlenecks which have limited how quickly production in some sectors can respond in the near term. Other Fed officials have also noted that large outliers such as skyrocketing used car and truck prices (+7.3% in May), car and truck rental prices (+12.1% in May), and airfares (+7.3% in May) have accounted for a significant portion of the price increases and are likely to revert to a level closer to the Fed's longer-run target as demand cools and these transitory supply effects abate.

The counterargument to the Federal Reserve's position is that some elements of consumer prices have exhibited signs of more sustained price increases. For example, housing prices have moved up sharply in recent months and have showed no signs of cooling. A shortage of semiconductors has also pushed up prices of consumer electronics and appliances. Some economists and investment professionals have also pointed out that the current administration's focus on reducing wealth inequality and promoting clean energy may support a structural lift to inflation.

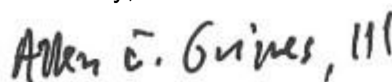
The market seems to be signaling that inflation will be transitory. The 5-year and 10-year breakeven inflation rates are currently at 2.51% and 2.35%, respectively. We tend to agree with those who believe that the parts of the economy that are contributing the most to inflation in recent months are merely "reflating" back to normal levels and will likely level off later this year or early next year. We certainly don't think the temporary spike in prices will lead to runaway inflation.

The Fed has been purchasing $80 billion of Treasuries and $40 billion of mortgage-backed securities on a monthly basis since March 2020 to support the economy. The inflation debate has renewed attention on the issue of when the Federal Reserve will begin to start winding down its asset purchases (also known as "tapering"). The Fed indicated after its most recent meeting which was held in mid-June that it would continue its purchases at the same pace until "substantial further progress" is made on employment and inflation.

The timing and duration of the Fed's tapering is important because it will likely dictate the timing of any future interest rate hikes. Most Fed watchers expect that the tapering process will be slow and gradual. After the 2008 financial crisis, tapering lasted approximately fourteen months. If history is any guide, and assuming that the Fed begins the process early next year, that would mean that the first interest rate hike could possibly come as early as the first quarter of 2023.

As always, thank you for investing with us. Enjoy your summer!

Sincerely,



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