September 30, 2021

Dear Shareholder:

The third quarter was, for the most part, a quiet and uneventful one for the municipal bond market. It was "quiet" because trading volumes and measures of market volatility for the municipal bond market hit new lows. Investors are hanging on to the municipal bonds in their portfolios and also snapping up new issues at a record pace. It was "uneventful" because (with the exception of a small spike in yields at the end of the quarter) municipal bond yields and prices remained range-bound. The Bloomberg Barclays Municipal Bond Index has provided a year to date total return of 0.79%.

The Federal Reserve Open Market Committee ("FOMC") wrapped up its two-day meeting on September 22. The FOMC kept the fed funds target range unchanged at 0 to 0.25%. One of the main takeaways from the meeting was a signal that the FOMC is close to starting the "tapering" process of winding down its asset purchases. The FOMC will likely announce the start of the taper at its November meeting. Nobody really knows how long the taper will last. However, it is worth noting that the 2008 taper lasted approximately 14 months and the 2014 taper lasted approximately 10 months. Chair Powell has suggested that the taper could potentially be complete by mid-2022.

Regardless of how long it lasts, it's critical to understand that tapering is <u>not</u> the same thing as tightening. To the contrary, monetary policy will continue to be accommodative as the FOMC's balance sheet will continue to grow, albeit at a slightly slower pace. Economists estimate that the FOMC's balance sheet will exceed $8.5 trillion at the end of the taper process, which is roughly double the size that it was two years ago. Moreover, the FOMC's balance sheet is expected to stay at elevated levels for the foreseeable future.

After the official taper announcement, the focus will then shift to a discussion of the anticipated date of "liftoff" and the future path of the fed funds rate. The FOMC did update its "dot plot" at the September meeting, and several participants pulled forward their assessments of when the first interest rate hike would likely occur (9 of 18 participants now see a first interest rate hike in 2022 versus 7 in June). Nine FOMC participants also expect that the fed funds target rate will be above 1% by the end of 2023. The upward revisions were relatively minor and make sense given that recent elevated inflation readings have been more persistent than originally anticipated.

Discussing the nuances of the taper and trying to predict the date of liftoff are probably best left to economists and strategists. Instead, we think a couple of key points are worth considering as we move a bit closer to the start of a Fed tightening cycle. First, even though on the surface it may sound counterintuitive, interest rate increases are not a bad thing for fixed-income investors. Changes in interest rates matter when it's time to reinvest proceeds from coupon payments, called bonds, or bonds that have matured. Rising interest rates allow a fixed-income investor to reinvest at higher yields. This is the exact opposite of "financial repression" which is the term used to describe market conditions that have prevailed for the past decade or so where investors have been forced to accept lower yields that are available in the market at the time of reinvestment. As market yields normalize

over time, the yields of our funds will also start gradually increasing as we purchase new bonds issued at higher coupon rates.

Make no mistake, what can be bad for *short-term* fixed-income investors are *sudden and large increases in interest rates.* The FOMC has been talking about the taper since last December, and it has been very transparent about the criteria that must be met before a first interest rate hike occurs (i.e., maximum employment and inflation that runs above 2.0% for some time). To its credit, the FOMC has devoted a significant amount of time and resources in recent years to improving its transparency and communications. We don't think the FOMC will want to jeopardize its hard work and credibility by surprising markets with any sudden or larger than anticipated interest rate hikes.

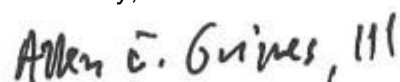
We continue to believe that the tightening cycle will be a gradual and shallow one. The economy continues to face numerous challenges and uncertainties, including significant supply-chain bottlenecks. This, combined with the fact that the starting point for the tightening cycle is near zero, strongly suggests that the fed funds terminal rate (the rate that exists at the end of the tightening cycle) will be substantially lower than it has been in previous tightening cycles.

Some nervous investors might be tempted to sell their bonds in anticipation of rising yields with the idea of buying them back once they cheapen up. We think it's worth briefly reminding folks that timing the market is almost always a losing proposition. Moving to cash instruments yielding near 0% carries with it a large opportunity cost, especially if yields don't rise as soon or as much as expected. Reallocating from bonds to stocks when stock market indices are near all-time highs is an even riskier proposition. The upshot is that if you are an investor with a multi-year investment time horizon, there's really no good reason to fear yield normalization--it's actually a positive long-term development.

It should be noted that Congress is still busy negotiating the passage of an infrastructure bill and much larger reconciliation bill. The details of the reconciliation bill are changing on a daily basis. Passage of an infrastructure bill will likely have a net positive impact on the municipal bond market. Among other things, higher individual and corporate income tax rates will make holding tax-exempt municipal bonds even more attractive for retail and institutional investors. Higher corporate tax rates should result in increased demand for tax-exempt municipal bonds by banks and property and casualty insurers, both of which significantly reduced their purchases after the 2017 tax reform. With higher tax rates on the horizon, we think it's more important than ever to have a portion of your overall investment portfolio invested in high quality tax-exempt bonds.

Thank you for your continued trust and support.

Sincerely,



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