Dupree
Mutual Funds

March 31, 2022

Dear Shareholder:

After experiencing record-setting inflows and posting solid returns in 2021, the municipal bond market is off to a rocky start this year. Flows into municipal bond funds turned negative, and Treasury and municipal bond yields surged (valuations have declined) as market expectations reset to reflect ongoing fears about persistently high inflation readings, the outbreak of war in Ukraine, and a pivot to a more aggressive monetary policy stance by the Federal Reserve Open Market Committee (FOMC).

The abrupt and unexpected change in market sentiment and the resulting sell-off in the municipal bond market surprised many, including us. In addition to the factors mentioned above, less favorable supply and demand dynamics (i.e., a higher supply of tax-exempt bonds coupled with less demand) also contributed to falling bond prices. This combination of factors and events led to a perfect storm: the municipal bond market suffered one of its worst quarterly losses on record during the first quarter. The Bloomberg Municipal Bond Index provided a -6.23% total return for the 3-month period ended March 31.

Federal Reserve Update

The FOMC raised the fed funds rate by a quarter percentage point to a target range of 0.25% to 0.50% after its mid-March meeting. It also strongly hinted that additional rate hikes will follow at each of its six remaining meetings this year. Elevated inflation, mainly reflecting supply and demand imbalances related to the pandemic and higher energy prices, was the main reason given for adopting a tighter monetary policy stance.

The FOMC released a new economic forecast and dot plot which provide information about the expected path of the fed funds rate. The FOMC anticipates weaker GDP growth this year, and it now expects to raise the fed funds rate a total of ten times (six hikes in 2022 and four hikes in 2023). That means that the terminal fed funds rate range will probably be somewhere between 2.75% and 3.00%. The FOMC also raised its near-term median forecasts for core PCE inflation to reflect the recent increase in prices.

In addition to raising the fed funds rate, the FOMC also indicated that it would start reducing its balance sheet holdings, which consist of Treasury securities, agency debt, and agency mortgage-backed securities. No precise timeline was announced for starting the balance sheet reduction process, but it could potentially start as early as May. Instead of purchasing more securities or replacing securities coming due, the FOMC will simply let securities roll off organically as the debt matures. With approximately 25% of the balance sheet maturing within two and a half years, the FOMC should effectively be able to reduce the size of its balance sheet without having to resort to any open market asset sales.

<u>The Income Component of Fixed-Income Returns</u>

Make no mistake, the volatility and downward price action in the municipal bond market have been gut wrenching. As human beings, our natural tendency is to react emotionally to market sell-offs which almost always leads to poor investment decisions. With bond yields still relatively low and the FOMC embarking on an interest rate hiking cycle, fixed-income investors are understandably a bit anxious and nervous.

Benjamin Graham, known as the father of value investing, believed the key to investment success—in both equity and bond markets—is having the temperament to keep emotions in check and remain focused on long-term results. In his book, *The Intelligent Investor,* Graham wrote, “For indeed, the investor’s chief problem—and even his worst enemy—is likely to be himself.”

In volatile markets with falling bond prices, investors sometimes forget that the ***income component*** of fixed-income investments typically accounts for over 90% of total returns for periods as short as five years. If you are an investor with a reasonably long investment time horizon, it isn’t rational to focus on bond prices alone when the vast majority of the total return of bonds is generated by the income component. While the share prices of all our single-state municipal bond funds have declined recently, each of these funds continues to generate a steady stream of tax-free income that can be counted on, regardless of share price.

Interest rates have remained at historically low levels for close to a decade which has caused the prices of bonds to remain artificially elevated. With yield normalization, bond prices will be returning to more historic levels, and investors will be earning higher yields as new bonds are issued at higher interest rates. In a rising interest rate environment, when it’s time to reinvest bond proceeds from coupon payments, calls, and/or maturities, changes in interest rates do matter. As rates rise an investor can reinvest at higher yields. If an investor has a multi-year investment time horizon, this reinvestment effect means that the investor should ultimately be better off. So, please keep in mind that with rising interest rates long-term bond investors have little to fear and even, potentially, something to gain.

The shift to a buyer’s market from a seller’s market happened quickly and without much warning. From our perspective as portfolio managers, sell-offs like we experienced during the first quarter of this year present great opportunities to find value and build higher and more durable income streams for investors. Rest assured, we are staying busy trying to do just that.

Thank you for the confidence you have placed in us.

Sincerely,

Allen E. Grimes, III

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