March 31, 2023

Dear Shareholder:

The municipal bond market turned in a seesaw like performance during the first quarter. Following a very strong start to the year in January, municipal bonds posted negative returns in February as strong economic data and persistently high inflation led investors to reassess the likelihood of further interest rate hikes. The February pullback erased most of the early year gains. Returns then turned positive again in March. For the 3-month period ended March 31, 2023, the Bloomberg Municipal Bond Index provided a total return of 2.78%.

Municipal bond issuance continued to trend lower with tax-exempt issuance down approximately 20% on a year-to-date basis from last year and taxable issuance down over 40%. Strong demand during the first quarter generated primarily by reinvestment income from maturities, calls, and coupons led to a supply-and-demand imbalance which helped support municipal bond prices, even as interest rates continued to rise.

Federal Reserve Update:

The Federal Reserve (the "Fed") raised the target rate for the federal funds rate an additional 25 basis points to 4.75 – 5.00% at its meeting on March 22. Notably, the language in the Fed's statement was modified to indicate that some additional policy firming "may be appropriate," as opposed to the "will be appropriate" language that appeared in previous communications. The Fed also acknowledged that recent banking sector stress will likely result in tighter credit conditions and weigh on economic activity, hiring, and inflation.

The Fed must carry out a delicate balancing act. On the one hand, it must manage inflation expectations by emphasizing its continued resolve to fight stubbornly high levels of inflation. On the other hand, it must acknowledge that recession risks have increased significantly as tight financial conditions and banking sector stress hinder the economy. According to the latest Bloomberg monthly survey of economists, the probability of an economic downturn in the next 12 months stands at 65%, up from 60% in February.

There is a growing disconnect between how financial markets and the Fed view the economic outlook. This disconnect is particularly evident in the bond market where traders are now pricing in interest rate cuts later this year. A sharp decline in yields on the short end of the yield curve signals that bond traders anticipate an imminent recession, which will likely force the FOMC to cut interest rates sooner than anticipated. However, the Fed has made it clear that its campaign to get inflation back down to its desired level is still on track.

We think there is a good chance that the Fed will raise the fed funds target rate by an additional 25 basis points in May and then pause for a period to assess how the economy is responding to higher rates and tighter credit conditions. We remain confident that we are approaching the end of this tightening cycle. This historically creates a strong tailwind for municipal bond performance. High quality municipal bonds should also continue to benefit from a flight to safety bid as investors continue to seek out haven assets during a period of heightened volatility.

Thank you for the trust that you have placed in us.

Sincerely,

Allen E. Grimes, III

Allen E. Grimes, III
President

800-866-0614 ● 859-254-7741
P.O. Box 1149 ● Lexington, KY 40588
dupree-funds.com