CLINTON
INVESTMENT MANAGEMENT

The Time to Add to Municipal Bond Allocations Has Arrived

- **Municipal bonds are now two standard deviations cheap to historical fair value, when looking at the relationship of tax-free yields relative to Treasuries.**
- **Investors can now achieve tax-free yields that are higher than the nominal yields of taxable bonds.**
- **Municipal bond ratios are above 100% of Treasury yields.**
- **Investors at almost every tax bracket now benefit from owning municipal bonds, a rare condition that we do not believe will persist.**
- **Absolute yields now available on our municipal bonds strategies translate to 6.75% to 8.00% on a taxable equivalent basis.**

Winter is coming, both figuratively and literally, for global economies and corporations. Consistent with the outlook we shared in our most recent market commentary, the US economy is beginning to slow rapidly. The clearest illustration of this can be seen in the -1.4% Q1 GDP growth, however, we are now seeing multinational, bellwether companies, including Walmart, Amazon, Target, Ross Stores, Best Buy, and Snap, to name a few, reporting extremely disappointing earnings, guiding down their outlook for future profits, and experiencing breathtaking declines in their share prices. We believe the disappointing earnings announcements are highly correlated with the general health of the US consumer. Given that household consumption represents almost 70% of US GDP, this is a very concerning trend. The US economy is facing a perfect storm of elevated inflation, tightening financial conditions, and a materially weakened consumer. In the case of Walmart, when seeking to explain its disappointing earnings, the company referenced being "overemployed" as well. That is the condition that exists when companies have too many employees and insufficient sales to support them, negatively impacting corporate profitability. This often leads to significant layoffs and rising unemployment over time. Walmart is one of the largest employers in the world, with a total of 2.3 million associates, 1.6 million in the US alone. It's statement is an ominous sign for broader unemployment levels going forward. Declines in earnings and lowered profit guidance of this scale are causing a dramatic shift in investor sentiment. Given that we raised our concerns regarding the growth risks facing the US economy some time ago, we thought timing was appropriate to provide an update on our outlook as we are now meaningfully more constructive on the direction of interest rates and tax-free municipal bonds in particular.

A frightening decline in risk asset valuations is happening at time when tax-free yields for municipal bonds are the highest they have been since the depths of the pandemic and the Great Financial Crisis. Yet, underlying municipal credit quality is the strongest it has been in over three decades in our view. Twenty consecutive weeks of municipal bond fund outflows, from retail investors, has exerted temporary, upward pressure on municipal bond yields, causing the performance of municipal bonds to remain constrained, even as Treasury yields are falling. This has created a market condition whereby municipal bonds are now two standard deviations cheap to historical fair value, when looking at the relationship of tax-free yields relative to

Treasuries. Investors can now achieve tax-free yields that are higher than the nominal yields of taxable bonds. When municipal bond ratios are above 100% of Treasury yields, as they are now, this condition has historically represented an excellent entry point for investors as this relationship implies there is little to no value in the tax-exemption of municipal bonds. Yet, investors at almost every tax bracket now benefit from owning municipal bonds, a rare condition that we do not believe will persist. As our clients and advisors are aware, during the first four months of the year, we were cautious in committing new cash to the municipal bond market, given the unrelenting rise in rates. We have pivoted meaningfully, over the last few weeks, as recent economic data support our view that inflation and the US economy are beginning to slow meaningfully. As a result, we are much more constructive on the outlook for fixed income more broadly and municipal bonds in particular. Absolute yields now available on our municipal bonds strategies translate to 6.75% to 8.00% on a taxable equivalent basis, for those in the highest tax bracket. While these yields are dependent on market conditions and can change quickly, we believe the current level of yields are extremely compelling, offering investors substantial compensation for the very low default risk associated with municipal bonds. Considering the low expected returns for risk assets over the next five to ten years, we believe municipal bonds will continue to provide safety and compelling returns over that period.

As we look out over the remainder of the year and into 2023, economic uncertainty is clearly rising while economic growth is materially slowing. The Fed has only just begun raising rates and is set to begin reducing its balance sheet next month through quantitative tightening. Asia and Europe are slowing, and multinational corporations are feeling the pain of the weakened consumer, as evidenced by the recent alarming earnings announcements and corresponding share price declines. Wealth destruction of this nature is going to have significant impact on consumer demand and that is by the Fed's design. We see no reason why this trend will not continue until the economy is in recession or the Fed pauses whichever comes first. Given that CPI is a backward-looking indicator, we believe a recession will likely arrive first as the Fed has never reduced inflation by more than 2.9% without causing a recession. As such, we believe the time has come for investors to prepare for the eventuality of a US recession. With that in mind, investors should begin to materially add to their municipal bond allocations. Municipal bonds are an extremely safe store of value and perform quite well during periods of economic deceleration. Investors with high allocations to cash yielding close to 0%, or risk allocations which need to be modified for the new economic reality, will benefit from the attractive tax-free municipal bonds now offer.

Important Disclosure Information

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product, made reference to directly or indirectly in this newsletter (article), will be profitable, equal any corresponding indicated historical performance level(s), or be suitable for your portfolio. Due to various factors, including changing market conditions, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter (article) serves as the receipt of, or as a substitute for, personalized investment advice from Clinton Investment Management, LLC. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. The PSN universes were created using the information collected through the PSN investment manager questionnaire and use only gross-of-fee returns. The PSN/Informa content is intended for use by qualified investment professionals. Please consult with an investment professional before making any investment using content or implied content from any investment manager. A copy of our current written disclosure statement discussing our advisory services and fees is available for review upon request.