

AB Municipal High Quality Portfolio

Separately Managed Accounts

Market Overview

During the first quarter of 2024, the municipal market drifted sideways as the economy displayed surprising reliance to start the year. Returns for municipals were largely flat with the Bloomberg Municipal Bond Index returning -0.39% for the quarter. The 10-year US Treasury yield rose 32 basis points (bps) from 3.88% at the beginning of the year to 4.20% to end the quarter. Meanwhile, 10-year municipal yields rose 23 bps, rising from 2.28% to 2.51%. Coming off a massive rally in 4Q:23 of 7.89%, it isn't completely surprising that the market would give a bit back. While the market endured headwinds of higher rates, credit spread compression and increased demand from fund buyers proved to be constructive toward performance.

The reason for the sell-off in rates was attributed to higher inflation prints and employment numbers, which reset the market's expectations for when the Fed will begin cutting rates. The market went from pricing in seven rate cuts to start the year to three cuts to end the quarter. After-tax AAA-rated municipal-Treasury spreads started the year at extremely expensive levels, on the back of a sizable municipal bond rally to end 2023. Spreads stayed range bound through much of the quarter, although they ended at cheaper levels across maturity cohorts. After-tax spreads on the intermediate part of the curve remained particularly expensive, signaling favorable value for tactical Treasury crossover trades.

An interesting question in 2024 was whether the elusive mutual fund buyer would finally return. The market saw more than \$126 billion in combined fund outflows in 2022 and 2023, which weighed heavily on municipal returns during that time period. In the first quarter, we saw glimpses of the fund buyer returning, with approximately \$11.5 billion in inflows (with ETFs being nearly flat). Much of this was concentrated in long duration and high-yield funds, with fund buyers clearly favoring to add duration before possible Fed rate cuts. However, these inflows are still a far cry from negating the most recent outflow cycle. The positive flows are a good sign to begin 2024, although continued strength could depend on the Fed making a move toward finally easing rates.

Supply was robust in the first quarter, with an estimated \$100 billion coming to market. This was 25% greater than 1Q:23 and puts the market on pace for at least, if not above, \$400 billion in total municipal issuance for 2024. The increase in supply is from new financing activities for infrastructure improvement, which is needed now that Federal stimulus funds are starting to dwindle. However, there have also been increases in refunding activity, which could be attributed to relatively low municipal rates in the first quarter. Additionally, issuance tends to be front-loaded in the first half of election years. Whatever the cause, the increased supply has been easily digested with no meaningful market impact, given the increase in mutual fund inflows and the continued demand from SMA buyers. Of note, supply in high-yield municipals has decreased drastically, which combined with increased demand for spread products from mutual fund vehicles, provided a positive technical for lower-rated bonds thus far this year.

One of the bright spots this year has been municipal credit, with the municipal high yield and BBB indices returning 1.51% and 0.60% this quarter, respectively. Credit spreads narrowed meaningfully in the quarter with A, BBB and high-yield municipal spreads tightening 13, 20 and 49 bps, respectively. The tightening of spreads can be attributed to the return of the fund buyer as mentioned previously. But spreads are also above long-term averages, and the most recent narrowing can be due to the strong relative value compared to the underlying credit strength. Despite the elongation of the current credit cycle, municipal credit fundamentals continue to be strong, as evidenced by S&P upgrading 86 issuers in January and February, compared with 39 downgrades.

Portfolio Performance

For the quarter, the AB Municipal High Quality Portfolio outperformed its benchmark, the Bloomberg Managed Money Intermediate (1-17) Municipal Bond Index, both gross of fees and net of fees. Gross of fees, the Strategy's allocation to A-rated paper and security selection contributed to performance. Security selection within state and local G.O. sectors, as well as the water and sewer sector, contributed to performance.

Outlook

Despite this year's rise in rates, the municipal market's -0.39% quarterly return has held up better than other fixed-income asset classes, as represented by the -0.78% return in the Bloomberg US Aggregate Index and the -0.96% in the Bloomberg Treasury Index. An overweight to municipal credit has been a theme we've been positioned in many of our strategies for some time. While it is well understood that there's a higher initial yield by allocating to lower-quality credits, investors should also be mindful of the return benefits achieved through spread compression. This double-barreled approach to returns, carry plus capital appreciation, we believe will prove to be powerful in 2024. We have already seen spreads tighten this year, and in response, we have reduced our credit risk targets down slightly. However, we continue take a constructive view of municipal credit and remain overweight.

Underlying our conviction in credit is our view of the underlying fiscal strength of municipalities, which is thanks to the record amount of Federal stimulus the last few years that enabled states and cities to build up their reserves. However, the possibility of a slowing US economy, leading to a negative impact on revenue collections and employment, is something we are both mindful of and accounting for. However, it is important to separate reality from the noise. While headline-grabbing articles of massive budget deficits do well to sow seeds of despair, they often do not reflect the true actual position facing municipalities. A timely example of this is the action California governor Gavin Newsom took earlier this quarter to balance the state's \$38 billion fiscal 2024 budget deficit. This included among other measures drawing \$13.1 billion from the state's cash-funded reserve fund, budget cuts of \$8.5 billion and delaying \$5.1 billion worth of spending. This serves as a reminder that even if there are tax revenue declines, states are well equipped to solve potential budget shortfalls.

On March 20, the Federal Reserve decided to keep the benchmark federal funds rate unchanged at its current range of 5.25–5.50%, which marked the fifth consecutive meeting in which the Fed has chosen to maintain the same interest-rate range. We believe that a reduction in rates is dependent on a looser labor market to bring inflation down. The Fed's decision to begin rate cuts could also be affected by the 2024 election. The Fed, in its desire to appear impartial, could choose to refrain from beginning its cutting cycle in the months immediately before and right after the election. However, we believe the trajectory of interest rates is lower and therefore feel confident in maintaining our overweight duration positioning in all our municipal strategies to their respective benchmark. It's important for investors to be in the municipal market before the Fed starts to cut. Investors who entered the market two to three months before the first Fed cut earned more than double the 12-month return compared with those who waited until one month after, due to bond yields falling in anticipation of the Fed's actions.

A compelling opportunity to add value in portfolios continues to be exhibited in the inversion of the municipal yield curve. As of quarter-end, the curve was kinked with the two-year portion of the municipal curve inverted up to the 15-year part of the curve. Strategically allocating across the yield curve can add additional yield in portfolios today. We are maintaining our barbell trade of overweighting the short and long end of the municipal yield curve and underweighting the intermediate portion. This is a trade that has been beneficial to recent performance and one in which we still believe bears fruit as the municipal curve makes its eventual reversion to its traditional upward sloping curve.

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