AB Municipal Portfolios

National Portfolio: Advisor Class: ALTVX
High Income Municipal Portfolio: Advisor Class: ABTYX
Intermediate Diversified Municipal Portfolio: Advisor Class: AIDYX
Municipal Bond Inflation Strategy: Advisor Class: AUNYX

Market Overview

The year 2023 was full of surprises, as some of the events forecasted at the beginning of the year—such as an economic recession followed by Fed cuts—did not come to fruition. The market performed well in the first half of the year, continuing the year-end rally of 2022. However, a difficult third quarter, in which robust economic indicators, particularly a strong jobs print in September, led to concerns of the Fed elongating its tightening cycle. This roiled markets, which gave back all the gains earned up to that point in the year. However, another impressive fourth-quarter rally brought returns mightily into the green. For the quarter, the Bloomberg Municipal Bond Index returned 7.89%, with 2023 returns of 6.40%.

The reasons for the outperformance were primarily attributed to a dip in inflation, as CPI measured 3.20% in October, down from 3.70% in September. This reduced interest rates notably, which when combined with supportive municipal technical factors, allowed for a very strong quarterly performance. The lower inflation (along with weaker job print numbers) at the close of the year has led investors to believe that the Fed is finally done raising rates and that interest-rate cuts will take place sometime in 2024. This view allows for the month of November to have been a record-setting month, with the performance of the Bloomberg Municipal Bond having its highest monthly performance since the early 1980s.

For the full year, fund flows were negative, continuing a trend seen in 2022, when there was a record $120.2 billion in total mutual fund and ETF outflows, according to Morningstar. However, through November, municipal mutual funds had outflows of $19.2 billion, while ETFs had inflows of $12.6 billion. The popularity of ETFs over mutual funds among municipal investors continues a trend that was highly visible in 2022, and we anticipate the adoption of ETFs to continue to grow. Important to note: the overwhelming majority of municipal ETF fund flows in 2023 came from the two largest municipal ETFs. In addition to the trend of mutual fund outflows, there were significant outflows in short-duration municipal funds, as investors sensed the end of the Fed's rate-hiking posture and looked to get in front by extending duration.

Municipal credit performed strongly in 2023, with the Bloomberg municipal BBB-rated and high-yield indices returning 8.93% and 9.21%, respectively, outpacing the 5.80% return of the AAA-rated index. This is a significant reversal from 2022, when the BBB-rated and high-yield municipal indices posted double-digit losses for the year. The performance divergence in 2022 and 2023 had less to do with underlying fundamentals and more with investor sentiment and a skittish retail base, which often flees performance setbacks while chasing opportunities. Ultimately, we continue to view credit as providing a strong long-term opportunity. Spreads are above long-term averages, which more than compensates investors for any implied defaults, which have remained low, both recently and historically.

Fund Performance

The Intermediate Diversified Municipal Portfolio delivered positive absolute returns for the fourth quarter but underperformed both its former benchmark, the Bloomberg Five-Year Government Obligation Municipal Bond Index, and new benchmark, the Bloomberg 1-10 Year Municipal Bond Blend Index, which returned 5.10% and 5.46%, respectively. Sector allocation and security selection detracted

from relative performance against both benchmarks, while yield-curve positioning was additive to relative performance against both benchmarks.

The National Municipal Portfolio delivered positive absolute returns in the fourth quarter but underperformed its benchmark, the Bloomberg Municipal Bond Index, which returned 7.89%. Security selection and sector allocation detracted from relative performance, while yield-curve positioning contributed. The largest detractors within sector allocation were not-for-profit healthcare and airports.

The High Income Municipal Portfolio delivered positive absolute returns for the fourth quarter, outperforming its benchmark, the Bloomberg Municipal Bond Index, which returned 7.89%. Relative outperformance was primarily driven by the Fund's yield-curve positioning and duration exposure. Security selection within senior living and multifamily housing sectors detracted from relative performance.

The Municipal Bond Inflation Strategy delivered positive absolute returns for the fourth quarter and outperformed its benchmark, the Bloomberg 1–10 Year US Treasury Inflation-Protected Securities (TIPS) Index, which returned 3.89%. Inflation protection detracted modestly from performance, and CPI swaps underperformed taxable inflation-hedging alternatives. Today, the Portfolio is targeting an overweight to duration and overweight on midgrade municipal credit while remaining fully hedged to inflation exposure at all times through CPI swaps.

Outlook

We expect the underlying strength of the municipal bond market to allow it to shine in 2024. While interest-rate volatility has enveloped the bond market over the past two years, the Fed's goal of eventually bringing inflation down to its 2% target should come closer to reality as a slowing economy and softening labor market conditions continue to become apparent. While it's possible to have some choppy waters in 2024, particularly as market expectations shift from tightening to easing, we expect lower yields by the end of 2024, which should generate added returns for municipals. Considering the recent yield compression over the last two months of 2023, much of the yearly returns could be generated from carry. Starting yields are north of 3%, which should provide investors ample compensation considering the solid fundamentals and supportive technicals that characterize the municipal market.

Our view of positive performance in 2024 is buttressed by our belief that inflows into municipal mutual funds will drive outperformance in municipal credit, which we define as issues rated single A and below. Performance in this area of the market was negatively impacted by the large outflows in 2022, which continued into 2023. Right now, spreads in municipal credit are above long-term averages and are providing exceptional value in light of the fundamentals. As the rally in rates continues as expected in 2024, this should have the effect of attracting inflows into municipal mutual funds which should cause further spread compression in these issues, their main area of support (in contrast to SMAs and ETFs, which primarily target the higher-quality part of the market). We believe mutual fund outflows should cease once rates stabilize and the yields of cash and money market instruments start to decline, thereby having less of a crowding out effect on municipals.

We view the credit fundamentals for the majority of the municipal market to be historically strong, although perhaps past the peak achieved a couple years ago. The balance sheets of municipalities remain supported by pandemic-era stimulus, as well as improved tax collection growth. However, the expectation of a slowing US economy should negatively impact revenue collections and employment, which could weigh on state and local issuers. Additionally, some revenue-backed sectors such as healthcare, senior living and transit are adjusting to inflation pressures and post-COVID lifestyle trends. Nevertheless, credit fundamentals remain resilient, a view supported by S&P and Moody's, which had a 4:1 upgrade-to-downgrade ratio of municipal issues through the first three quarters of 2023. While there can be some fiscal pressures in 2024, as well as headlines regarding budgetary shortfalls of high-profile issuers, we believe the market as a whole has the foundational strength to weather any short-term challenges. However, this provides the backdrop in which active management can provide exceptional value.

Going into 2024, we are confident in the flexibility of AB municipal portfolios and their ability to successfully navigate all market environments. Yields are above average over the past 10 years but are expected to move lower, and thus we feel confident in targeting a longer-duration position versus the benchmark. Additionally, we are finding greater value on the short and long end of the municipal yield curve, in contrast to the intermediate, which is less attractive due to the tendency of SMA buyers to target this area. Thus, we are implementing a barbell trade directed to these areas of value across our municipal funds, while keeping overall duration in line with targets. We are finding value in municipal credit, and we believe spreads will compress once flows come back into funds that favor these structures. We continue to be tactical in allocating to US Treasuries for eligible funds when municipals trade expensive, which occurred at the end of 2023. This is a trade that can provide superior after-tax yield while serving as a placeholder to eventually allocate back to municipals as valuations improve.

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A WORD ABOUT RISK

Below Investment Grade Securities Risk: Investments in fixed-income securities with lower ratings (commonly known as "junk bonds") tend to have a higher probability that an issuer will default or fail to meet its payment obligations. **Credit Risk:** A bond's credit rating reflects the issuer's ability to make timely payments of interest or principal—the lower the rating, the higher the risk of default. **Derivatives Risk:** Investing in derivative instruments such as options, futures, forwards or swaps can be riskier than traditional investments, and may be more volatile, especially in a down market. **Inflation Risk:** Prices for goods and services tend to rise over time, which may erode the purchasing power of investments. **Leverage Risk:** Trying to enhance investment returns by borrowing money or using other leverage tools—magnify both gains and losses, resulting in greater volatility. **Liquidity Risk:** The difficulty of purchasing or selling a security at an advantageous time or price. **Local Economy Risk:** This portfolio may contain municipal securities issued by the Commonwealth of Puerto Rico as well as other local governments whose current economic conditions could exacerbate the risks associated with investing in these securities. **Market Risk:** The market values of the portfolio's holdings rise and fall from day to day, so investments may lose value. **Municipal Market Risk:** Debt securities issued by state or local governments may be subject to special political, legal, economic and market factors that can have a significant effect on the portfolio's yield or value. **Interest Rate Risk:** As interest rates rise, bond prices fall and vice versa—long-term securities tend to rise and fall more than short-term securities.

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The Bloomberg Municipal Bond Index represents the performance of the long-term tax-exempt bond market consisting of investment-grade bonds. The Bloomberg 5-Year GO Municipal Bond Index represents the performance of long-term, investment-grade tax-exempt bonds with maturities ranging from four to six years. The Bloomberg 1-10 Year Blend Index is the 1-10 Year Blend (1-12) component of the Bloomberg Municipal Bond Index. The Bloomberg 1-10 Year TIPS Index measures the performance of intermediate (1-10 year) US Treasury inflation-protected securities.

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