Tax-Exempt Money Market Commentary

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On June 14, the Federal Reserve (Fed), in a well-anticipated move, paused their tightening cycle for the first time since March 2022, having hiked interest rates by 500 basis points over 10 consecutive meetings. The Federal Open Market Committee (FOMC) decision was unanimous and aimed to allow the committee to "assess additional information and its implications for monetary policy."

While the federal funds target rate remained at 5.00% – 5.25%, the median rate forecast for 2023 rose by 50 basis points to 5.60%. Investors are now pricing in a 25-basis-point increase in the federal funds rate at the next scheduled meeting on July 26. In a hawkish statement, Fed Chair Jerome Powell indicated that any rate cuts would be a "couple of years out" as he continues to attempt to push back the market from pricing in rate cuts into late 2023 and early 2024.

Similar to the past several months, supply and demand dynamics continued to drive the volatility in the SIFMA Index (7-day high-grade market index reported to the Municipal Securities Rulemaking Board), which moved approximately 150 basis points during June. Yields on tax-exempt money market funds have increased the past several months as the Fed continues the path to higher interest rates but were kept muted because of a new-issue-starved market seeking to put cash to work in the front of the yield curve.

Municipal money market funds have seen assets rise in the past few months as investors enjoy increased yields and stability of the money market space. The front end of the yield curve—securities maturing within one year—have seen yields drift down as demand is robust across the yield curve.

The dearth of new issuance, combined with an increase in appetite for tax-exempt income, kept demand strong through the first half of the year. Issuers have been slow to enter the market with the increase in funding costs. As we come through our annual "note season," when states and municipalities issue their financing for the year, we have seen a noticeable decline in issuance. States and municipalities are still flush with Covid-19 relief money from the federal government and that has helped temper the

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demand. We expect this to change in 2024, as relief money wanes and issuance increases due to lower capital gains and personal income tax receipts. Demand continued to remain strong for shorter-dated paper, as investors stay in the shorter end of the market in anticipation of higher interest rates in the future. In this environment, we maintain high levels of liquidity with variable-rate-security indexes trending higher and strive to continue providing shareholders with competitive market returns.

The state of municipal credit remains strong, although we expect volatility in the days ahead as tax revenues soften in a tightening environment. State budget flexibility remains high due to strong rainy-day reserves and revenues exceeding projections—45 states reported fiscal year (FY) 2023 general fund revenues were exceeding enacted revenue forecasts per the Spring 2023 National Association of State Budget Officers (NASBO) Report. The current estimates are outperforming earlier forecasts by 6.5%. Thirty-nine states are on track to further increase the size of their rainy day fund balances in FY 2023. The median rainy day fund balance as a share of spending is expected to increase from 11.5% in FY 2022 to 12.0% in FY 2023 and 13.5% in recommended budgets for FY 2024.

We do expect a softening in general fund revenues for FY 2024 due to weaker economic growth, stock market volatility and tax cuts instituted by states. The level of revenue declines will be determined by whether we enter a recession and how deep it is. Revenue is projected to decline by 0.7% in FY 2024, based on forecasts used in governors' budgets, after an estimated 0.3% dip in FY 2023 per a recently released NASBO survey. In response to a weaker economic environment and slowing revenues (when adjusted for inflation) FY 2023 state spending is expected to grow at 12.6%, slower than 16.8% in FY 2022. Recommended budgets for FY 2024 call for general fund spending of $1.23 trillion, a 2.5% increase that is much slower than 12.6% for FY 2023.

Existing home sales recorded a minor gain of 0.2% in May and sales retreated 20.4% from one year ago per the National Association of Realtors. The inventory of unsold existing homes grew 3.8% from the previous month to 1.08 million at the end of May, or the equivalent of 3.0 months' supply at the current monthly sales pace. Sales were mixed among the four major US regions, with the South and West posting improvements and the Northeast and Midwest experiencing pullbacks. All four regions experienced year-over-year sales declines. As mortgage rates have stabilized, home sales have picked up and are expected to remain stable in the near term. We expect a stable housing market to continue to support local governments and their budgets.

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