

Quarterly Market Commentary

Municipal Fixed Income

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Stimulus Boosts Municipal Bond Market Views

The first half of 2021 continued to produce strong cash flows and positive returns for the municipal market. Fund flows for the year are proving to be the strongest on record, currently at \$58 billion, making them the third highest among full-year calendar flows.

As of June month end, the municipal bond market delivered a year-to-date return of 1.24% while the high-yield municipal bond market returned 5.50%. Thanks to a combination of federal stimulus dedicated to municipal issuers and sectors, and increased vaccination rates, we have seen stronger views of the municipal market as credit spreads tightened in all credit and rating sectors. The largest credit spread compression has been in the high-yield and BBB parts of the market as positive fund flows are causing investors to look lower in the credit spectrum in an effort to find attractive yield. As of the end of the first half of 2021, credit spreads for all ratings sectors are at or approaching their historical tight levels, with high yield still offering the widest spread differential to their tights.

Municipal-to-Treasury yield ratios remain very low, after reaching historical highs in 2020. The 10-year moved from 64% to 66% during the second quarter, versus a long-term average of 85%. The 30-year ratio dipped into the 60% range during the quarter, but ultimately ended the quarter steady at 70% compared to a long-term average of 93%. These low ratios indicate municipal outperformance, driven by both technical and fundamental factors.

The summer brings a cyclical lack of new issue supply in the market with July and August maturity and coupon payments providing a supply/demand imbalance. Should fund flows remain strong during this time, furthering the imbalance, we would expect to see credit spreads continue to tighten as maturities and fund

flows compete to find attractive yield in the primary and secondary markets. New municipal supply is up 8% as of June 30, with taxable municipal issuance currently accounting for approximately 30% of all new issuance, adding to the imbalance of supply in the tax-exempt municipal market. Changes to tax laws in 2017 reduced the flexibility of municipal issuers to refund tax-exempt debt with another tax-exempt issue forcing issuers to use taxable municipal debt. Combined, these market dynamics could help the overall market continue its trend of credit spread compression and positive returns, in our view.

It is hard to overstate the importance of the American Rescue Plan for municipal credit quality. Federal funds will continue to flow to municipalities, schools, and transportation facilities (to name a few) over the next 18 months to 2 years. These funds, along with the reopening of the economy and the subsequent increase in tax revenues for state and local governments, have created a strong catalyst for credit upgrades.

Lower-rated general obligation (GO) debt is already reaping the benefits. Illinois, the state with lowest-rated GO credit, was recently upgraded by Moody's, moving the state a notch further away from high yield. Illinois State GOs are one of the best-performing bonds to date this year. The upgrade in Illinois GOs also contributed to substantial credit spread narrowing for the city of Chicago, the Met Pier & Exposition Center, the Chicago Board of Education, and other lower-rated names in the state.

The federal infrastructure plan continues to dominate the headlines for the municipal market. The plan is currently bogged down in Congress as both sides negotiate the ultimate size and whether to raise taxes to pay for the increase in spending. A rise in tax rates is good for munis—although Senate Republicans prefer to leave the 2017 tax changes untouched. A Senate bipartisan group continues to negotiate a compromise, but the end package is likely to take the rest of the summer and fall to be reconciled. President Biden announced his roughly \$3 trillion plan earlier this year and proposed to pay for it with an increase in the corporate tax rate to 28% from 21% and an increase in the top income tax rate to 39.6% from 37%. In addition, he is proposing an elimination of the step-up basis for the estate tax. The plan

would likely increase demand for tax-exempt bonds from banks and property & casualty insurers. Also under discussion is a return of advanced refundings for municipal issuers, and potentially BABs (Build America Bonds)-like taxable bond structures—increasing the supply of municipals.

By Gerard Durr

Infrastructure, Infrastructure, Infrastructure

For decades, Americans have read and heard stories about the crumbling and outdated state of much of America's infrastructure. In recent years many even witnessed this first hand—think Flint, Michigan, the frozen Texas power grid, and our interstate highway system, vast portions of which are over capacity and near the end of their useful lives. The reality is that the United States now finds itself lagging further behind much of the developed world in terms of infrastructure quality.¹

Infrastructure—the essential component supporting all economic activity of a nation—has an outsized impact on the health and well-being of its citizens and is broadly defined as transportation systems, communication networks, sewage, water, and electric systems. Most recently, it has come to include schools, public parks, and recreation facilities. During the past two presidential elections, candidates from both parties presented ambitious spending plans to address “inadequacies” in America's infrastructure. It is a perennial favorite issue of politicians that impacts national security, and most economists agree that investments in infrastructure have a significant economic multiplier effect. A 2014 study found that infrastructure added as much as \$3 to GDP growth for every \$1 spent.² The question that begs to be asked is: Why is it so hard for America to deliver on infrastructure and will this Congress be any different?

Current state of affairs

In March 2021, the Biden administration put forth The American Jobs Plan, which has been billed as a plan to “invest in America in a way we have not seen since we built the interstate highway system and won the Space Race.”

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The administration's infrastructure plan came with a \$2 trillion-plus price tag and included items not normally considered conventional components by many. While the price tag matched several plans of the prior administration, its wide-ranging scope and level and type of tax increases has made it unrealistic to think it can get passed in its entirety.

In mid-June a sizable group of bipartisan senators came to an agreement on a framework to spend \$579 billion above current levels for infrastructure and a plan to invest \$973 billion over the next five years and \$1.2 trillion over the next

eight years in baseline and new spending.³ Although it cut heavily into the administration's original \$2.3 trillion spending figure it was endorsed by the president. After releasing the framework, the senators issued a statement stating: **"We support this bipartisan framework that provides a historic investment in our nation's core infrastructure needs without raising taxes. We look forward to working with our Republican and Democratic colleagues to develop legislation based on this framework to address America's critical infrastructure challenges."** The plan as proposed was broken

Figure 1
American Jobs Plan vs. bipartisan Senate framework

	Original Biden AJP	Bipartisan Senate Framework		Difference
Transportation infrastructure				
Roads (includes HSIP), bridges, major projects*	167	110	-57	-34%
Passenger and freight rail	80	66	-14	-18%
Public transit	85	48.5	-36.5	-43%
Airports	25	25	0	0%
Ports and waterways	17	16.3	-0.7	-4%
EV charging and buses/transit**	60	15	-45	-75%
Safety (excluding HSIP)*	12	11	-1	-8%
Reconnecting communities	25	1	-24	-96%
Infrastructure financing authority	0	20	20	inf.
Subtotal, transportation	471	312.8	-158.2	-34%
Other infrastructure				
Power infrastructure	100	73	-27	-27%
Broadband infrastructure	100	65	-35	-35%
Water Infrastructure	111	55	-56	-50%
Other proposed AJP spending not in bipartisan framework				
EV rebates	100	0	-100	-100%
Build/renovate affordable housing	213	0	-213	-100%
Build new public schools	100	0	-100	-100%
Research and development investment	180	0	-180	-100%
Invest in manufacturing and small businesses	300	0	-300	-100%
Workforce development	100	0	-100	-100%
Expand community caregiving	400	0	-400	-100%

Source: <https://www.enotrans.org/article/21-senators-sign-on-to-579b-infrastructure-plan/>

*The roads-bridges-major projects category for the AJP includes \$115 billion originally listed as roads and bridges, \$44 billion originally listed as major projects, and \$8 billion in Highway Safety Improvement Program funding that was originally listed as Safety but which is part of the Federal-aid Highways budget account and cannot easily be separated out of that budget.

**This total for the AJP includes the \$15 billion for a network of charging stations, the \$25 billion for transitioning diesel mass transit buses to electric buses, and the \$20 billion for transitioning diesel yellow school buses to electric buses.

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down into two components: transportation infrastructure and other infrastructure.

On July 7, a bipartisan group of Congressional representatives comprising 58 members known as the Problem Solvers Caucus endorsed the bipartisan Senate framework. While encouraging, there is much work to be done and many players who still need to weigh in. With the most important element—how will the plan be paid for?—unaddressed.

Dimensioning the problem

For years, academics and think tanks have studied and dimensioned America’s infrastructure needs. While the process remains both an art and a science, the overwhelming consensus is that America’s infrastructure is deficient, and the nation is falling further behind.⁴ The American Society of Civil Engineers (ASCE)—most often cited by politicians and infrastructure policy wonks when discussing America’s infrastructure deficit—has reported on the condition of the nation’s infrastructure since 2001 and uses a school report card format with grades ranging from “A” through “F.” The Report Card Committee studies current infrastructure conditions and needs, assigns letter grades, and makes recommendations using the following criteria:⁵

- **Capacity**—Does the infrastructure’s capacity meet current and future needs?
- **Condition**—What is the infrastructure’s existing, and near-future, physical condition?
- **Funding**—What is the current level of funding from all levels of government for the infrastructure category compared to its estimated funding need?
- **Future need**—What is the cost to improve the infrastructure? Will future funding prospects address the need?
- **Operation and maintenance**—What is the owners’ ability to operate and maintain the infrastructure properly? Is the infrastructure in compliance with government regulations?
- **Public safety**—To what extent is the public’s safety jeopardized by the condition of the infrastructure and what could be the consequence of failure?

- **Resilience**—What is the infrastructure system’s ability to prevent or protect against significant multi-hazard threats and incidents? Can the infrastructure quickly recover and reconstitute critical services with minimum consequences for public safety and health, the economy, and national security?
- **Innovation**—What new and innovative techniques, materials technologies, and delivery methods are being implemented to improve the infrastructure?

Making the grade

When ASCE first issued its 2001 Report Card for America’s Infrastructure the overall grade was “D+” and ASCE estimated that America would need \$1.3 trillion over the following five years in order to “remedy America’s current and looming” infrastructure problem. At the same time, ASCE called for

Figure 2
2021 report card for America’s infrastructure



D-	Aviation	D+	Public parks
C	Bridges	B-	Rail
D	Dams	D	Roads
C-	Drinking water	D+	Schools
C-	Energy	C+	Solid waste
D-	Hazardous waste	D	Stormwater
D-	Inland waterways	D-	Transit
B-	Ports	D+	Wastewater

Source: American Society of Civil Engineers, 2021 Report Card for America’s Infrastructure.

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a “renewed partnership between citizens, local, state, and federal governments, and the private sector.” Fast forward to 2021, and the current overall grade has improved to “C-” from “D+” (the first time in 20 years that the grade was not in the “D” range). The highest area-specific grade was (a “B”) for railways with the lowest grade (a “D-”) for aviation, hazardous waste, inland waterways, schools, transit, and wastewater. While most grades remained the same, aviation, drinking water, energy inland waterways, and ports improved. Bridges was the only category to receive a lower grade this year than in 2017.

The price tag

While some incremental progress has been made, with an estimated \$5.9 trillion in total needs over 10 years and a \$2.59 trillion funding gap, there is still a long way to go toward restoring and modernizing America’s infrastructure.⁶ According to ASCE, this is what it will cost to maintain a state of good repair and earn a “B” grade. This year the ASCE’s *Failure to Act Report* stated that America’s “failing to close the infrastructure investment gap will bring serious economic consequences... by 2039, a continued under-investment in our infrastructure at current rates will cost \$10 trillion in GDP, more

than three million jobs in 2039 and \$2.4 trillion in exports over the next 20 years. By 2029, America’s under-investment will cost the average American household \$3,300 a year.”⁷

Infrastructure spending has steadily declined both as a share of GDP (the peak of 3.0% was in 1959 during the height of the Interstate Highway System creation dropping to less than 2.3%⁸) and as a percentage of total federal spending. The fall in federal infrastructure spending as percentage of total federal spending is even more dramatic. Federal spending peaked in 1965 at 5.8% of total spending, by 2017 the level was 2.5%.⁹ ASCE’s \$2.6 trillion funding gap through 2029 would require an increased investment to an estimated 3.5% of GDP by 2025. By contrast Statista reports that in 2018, China spent nearly 5.57% of its GDP on total infrastructure spending—nearly 10x the amount of GDP that the U.S spent.¹⁰

Conclusion

The problem with infrastructure has never been a lack of projects or a way to finance construction. It has always been, and continues to be, finding ways to pay for, and maintain these assets once they are built as well as the politics they are tied to. Today, the need has never been greater. And it

Figure 3

Cumulative investment needs by system based on current trends, 2020 to 2029 (all values in billions)

Infrastructure system	Total needs	Funded	Funding gap
Surface transportation ¹¹	\$2,834	\$1,619	\$1,215
Drinking water/Wastewater/Stormwater ¹²	\$1,045	\$611	\$434
Electricity ¹²	\$637	\$440	\$197
Airports ¹²	\$237	\$126	\$111
Inland waterways and marine ports ¹²	\$42	\$17	\$25
Dams ¹³	\$94	\$13	\$81
Hazardous and solid waste ¹⁴	\$21	\$14	\$7
Levees ¹⁵	\$80	\$10	\$70
Public parks and recreation ¹⁶	\$78	\$10	\$68
Schools ¹⁷	\$870	\$490	\$380
Totals	\$5,937	\$3,350	\$2,588

Source: American Society of Civil Engineers, *2021 Report Card for America’s Infrastructure*.

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seems there may be a way to pay for the current bipartisan level of funding within the agreed-upon framework. That said, it is hard to tell if this time will be different. While there appear to be glimmers of bipartisanship and a willingness to make concessions in order to move forward, the road will be long and bumpy. Is it possible that politicians will see that continued half measures or inaction will only put the nation in a race it can no longer win? Maybe if we get the right mix of Washington politicians who get almost everything they want, but not everything, we will finally have a real infrastructure program. I am hopeful, but not entirely optimistic.

ENDNOTES

- ¹ Council on Foreign Relations, April 2021, *The State of U.S. Infrastructure*.
- ² Werling and Horst, *Catching Up: Greater Focus Needed to Achieve a More Competitive Infrastructure*.
- ³ www.masstransitmag.com June 25, 2021.
- ⁴ World Economic Forum. America is ranked 13 for transportation and utility infrastructure.
- ⁵ American Society of Civil Engineers, *2021 Report Card for America's Infrastructure*.
- ⁶ American Society of Civil Engineers, *2021 Study; Failure to Act: Economic Impacts of the Status Quo Investment Across Infrastructure Systems*.
- ⁷ American Society of Civil Engineers, *2021 Study; Failure to Act: Economic Impacts of the Status Quo Investment Across Infrastructure Systems*.
- ⁸ Congressional Budget Office.
- ⁹ Congressional Budget Office.
- ¹⁰ Statista website (Global investment on construction and maintenance of infrastructure).
- ¹¹ Data taken from ASCE Failure to Act 2021 study + rail funding gap from ASLRRA
- ¹² Data taken from ASCE Failure to Act 2021 study. www.asce.org/failuretoact
- ¹³ Includes estimates from ASDSO, USACE, U.S. Bureau of Reclamation, and FEMA
- ¹⁴ Data based on conversations with ASTSWAMO: RCRA Part C; Brownfield analysis; the Superfund funding information does not include DOE's Environmental Management program
- ¹⁵ Total needs numbers is based on discussions with the National Committee on Levee Safety

¹⁶ Estimates from National Parks Service; National Association of State Park Directors; City Parks, and National Association of State Park Directors

¹⁷ Data from State of our Schools: America's K-12 Facilities (2016). 21st Century School Fund, Inc., U.S. Green Building Council, Inc.

DISCLOSURES

The S&P Municipal Bond Index is a broad, market-value-weighted index that seeks to measure the performance of the U.S. municipal bond market. It tracks fixed-rate bonds exempt from federal income tax, though they may be subject to the alternative minimum tax (AMT), with par outstanding of at least \$2 million. The index includes bonds of all quality ratings—from AAA to non-rated, including defaulted bonds—and from all sectors of the bond market. The S&P Municipal Bond Index constituents undergo a monthly review and rebalancing.

The S&P Municipal Bond Investment Grade Index consists of bonds in the S&P Municipal Bond Index that are rated at least BBB- by Standard & Poor's, Baa3 by Moody's, or BBB- by Fitch Ratings. For the avoidance of doubt, the lowest rating is used in determining if a bond is eligible for the Index. S&P Dow Jones Indices looks at the long-term rating, either insured or uninsured, and the underlying rating for index inclusion. All bonds must also have a minimum maturity of three years and a maximum maturity of up to, but not including, 15 years, as measured from the rebalancing date.

The S&P Municipal Bond Intermediate Index consists of bonds in the S&P Municipal Bond Index with a minimum maturity of three years and a maximum maturity of up to, but not including, 15 years, as measured from the rebalancing date.

The S&P Municipal Bond Investment Grade Intermediate Index consists of bonds in the S&P Municipal Bond Index that are rated at least BBB- by Standard & Poor's, Baa3 by Moody's or BBB- by Fitch Ratings. All bonds must also have a minimum maturity of three years and a maximum maturity of up to, but not including, fifteen years as measured from the rebalancing date.

The S&P Municipal Bond Short Intermediate Index consists of bonds in the S&P Municipal Bond Index with a minimum maturity of one year and a maximum maturity of up to, but not including, eight years, as measured from the rebalancing date.

The S&P Municipal Bond Investment Grade Short Intermediate Index consists of bonds in the S&P Municipal Bond Index that are rated at least BBB- by Standard & Poor's, Baa3 by Moody's or BBB- by Fitch Ratings. All bonds must also have a minimum maturity of one year and a maximum maturity of up to, but not including, eight years as measured from the rebalancing date.

The S&P Municipal Bond Short Index consists of bonds in the S&P Municipal Bond Index with a minimum maturity of six months and a maximum maturity of up to, but not including, four years, as measured from the rebalancing date.

The S&P Municipal Bond Investment Grade Short Index consists of bonds in the S&P Municipal Bond Index that are rated at least BBB- by Standard & Poor's, Baa3 by Moody's or BBB- by Fitch Ratings. All bonds must also have a minimum maturity of six months and a maximum maturity of up to, but not including, four years as measured from the rebalancing date.

The S&P Municipal Bond High-Yield Index consists of bonds in the S&P Municipal Bond Index that are not rated or whose ratings are less than or equal to BB+ by Standard & Poor's, Ba1 by Moody's, or BB+ by Fitch Ratings. Bonds that are prerefunded or escrowed to maturity are not included in this index. The lowest

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Selected S&P Municipal Bond Index totals and averages

	AS OF JUNE 30, 2021								
	Number of holdings	Market value (in \$ billions)	Coupon	Yield-to-worst	Maturity	Maturity (in yrs.)	Priced-to-date	Priced-to-date (in yrs.)	Effective duration
Municipal Bond	212,173	2,648	4.25	1.05	07/25/2033	12.09	08/31/2026	5.18	5.23
Investment Grade (IG)	201,837	2,457	4.35	0.91	12/07/2032	11.46	07/22/2026	5.07	5.11
Intermediate	116,527	1,232	4.42	0.89	10/31/2029	8.34	08/02/2026	5.09	4.68
IG Intermediate	112,365	1,176	4.43	0.83	10/25/2029	8.33	08/04/2026	5.10	4.69
Short Intermediate	87,683	906	4.51	0.51	06/16/2025	3.97	10/29/2024	3.33	3.05
IG Short Intermediate	84,508	866	4.51	0.46	06/21/2025	3.98	11/06/2024	3.36	3.08
Short	52,563	529	4.48	0.29	07/04/2023	2.01	06/15/2023	1.96	1.80
IG Short	50,356	501	4.48	0.26	07/09/2023	2.02	06/18/2023	1.97	1.82
High Yield	10,336	190	3.35	2.83	09/28/2041	20.27	02/06/2028	6.61	6.81
High Yield ex-Puerto Rico	10,168	166	3.63	2.88	06/15/2041	19.98	11/02/2027	6.34	6.57
California	29,460	420	4.02	0.98	04/02/2034	12.77	10/15/2026	5.30	5.38
New York	13,140	323	4.39	1.03	01/23/2035	13.59	10/04/2026	5.27	5.44
Puerto Rico	216	26	2.16	2.39	08/14/2042	21.17	11/03/2029	8.39	8.23

Sources: Wilmington Trust Investment Advisors, Investortools, Inc., S&P Dow Jones Indices LLC, ICE Securities Evaluations, Inc. Index calculations by Investortools, Inc. Custom Index Manager, the Federal Reserve System.

long-term underlying rating, either insured or uninsured, is used in determining if a bond is eligible for the Index.

The S&P Municipal Bond High Yield Index Ex-Puerto Rico is designed to measure bonds in the S&P Municipal Bond Index that are not rated or are rated below investment grade, excluding Puerto Rico.

The state level municipal bond sub-indices consists of bonds in the S&P Municipal Bond Index that have been issued by municipalities or municipal authorities within the respective states, the District of Columbia, Puerto Rico, Guam, and the U.S. Virgin Islands. States and municipalities may have issues across the duration and quality spectrums or may be more concentrated to certain sub-indices, such as in the S&P Investment Grade or High Yield bond indices.

The S&P Municipal Bond Puerto Rico Index consists of bonds in the S&P Municipal Bond Index issued by the Commonwealth of Puerto Rico, and municipalities and municipal authorities within the Commonwealth. Individually these entities may have issues across the duration and quality spectra; however, as a general matter they have been increasingly concentrated in the S&P High Yield Bond Index.

Quality ratings are used to evaluate the likelihood of default by a bond issuer. Independent rating agencies, such as Standard & Poor's and Moody's Investors Service, analyze the financial strength of each bond's issuer. Moody's ratings range from Aaa (highest quality) to C (lowest quality). Bonds rated Baa3 and better are considered "Investment Grade." Bonds rated Ba1 and below are "Below Investment Grade" (also "High Yield" or "Speculative"). Similarly, Standard & Poor's ratings range from AAA to D. Bonds rated BBB- and better are considered "Investment Grade" and bonds rated BB+ and below are "Below Investment Grade."

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Selected S&P Municipal Bond Index total returns

	AS OF JUNE 30, 2021			CALENDAR
	MTD	QTD	YTD	2020
Municipal Bond	+0.29%	+1.50%	+1.24%	+4.95%
Investment Grade (IG)	+0.22%	+1.34%	+0.92%	+4.87%
Intermediate	+0.19%	+1.16%	+0.71%	+5.04%
IG Intermediate	+0.15%	+1.09%	+0.55%	+5.05%
Short Intermediate	+0.06%	+0.53%	+0.36%	+3.59%
IG Short Intermediate	+0.04%	+0.49%	+0.27%	+3.59%
Short	-0.00%	+0.23%	+0.36%	+2.32%
IG Short	-0.01%	+0.21%	+0.32%	+2.32%
High Yield	+1.18%	+3.66%	+5.50%	+6.00%
High Yield ex-Puerto Rico	+1.16%	+3.59%	+5.56%	+5.50%
California	+0.22%	+1.36%	+0.83%	+4.91%
New York	+0.35%	+1.82%	+1.63%	+4.35%
Puerto Rico	+1.24%	+3.51%	+4.58%	+8.86%

Sources: Wilmington Trust Investment Advisors, Investortools, Inc., S&P Dow Jones Indices LLC, ICE Securities Evaluations, Inc. Index calculations by Investortools, Inc. Custom Index Manager.

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Coupon: The annual interest payment that the bondholder receives from the bond's issue date until it matures. Coupons are normally described in terms of the coupon rate, which is calculated by adding the sum of coupons paid per year and dividing it by the bond's face value.

Yield-to-worst: A measure of the lowest possible yield that can be received on a bond that fully operates within the terms of its contract without defaulting. It is a type of yield that is referenced when a bond has provisions that would allow the issuer to close it out before it matures.

Effective duration: A duration calculation for bonds that have embedded options and can be estimated using modified duration if a bond with embedded options behaves like an option-free bond.