

# Municipal Market Insight



Wealth  
Management

March 2024

Portfolio Advisory Group – U.S. Fixed Income Strategies

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## Municipals rebound to end February in positive territory

February was a difficult month for Treasuries. Government bond yields—which move inversely to price—rose between 22 and 40 basis points (bps), with shorter-maturity bonds seeing the greatest yield shifts. The primary driver of changing sentiment toward government debt, in our opinion, was investors' evolving view on monetary policy. Strong economic data, combined with hawkish sentiment from several Fed policymakers, led investors to trim expectations for 2024 rate cuts. At the beginning of February, interest rate futures' prices reflected a high probability of six rate cuts this year; by the end of the month, however, prices reflected only three likely cuts with a modest chance for a fourth.

The shift in policy sentiment came as economic data released during February showed a strong labor market and ongoing inflationary pressures. The nonfarm payroll report early in the month showed employment growing by 353,000, ahead of the consensus view of 185,000 in a Bloomberg survey. Similarly, the

### U.S. interest rate forecasts (%), February 2024

	2023	2024					2025			
	Q4	Q1E	Q2E	Q3E	Q4E	Q1E	Q2E	Q3E	Q4E	
FF	5.37	5.38	5.13	4.63	4.13	3.88	3.63	3.38	3.38	
2-yr	4.23	4.50	4.15	3.80	3.55	3.35	3.25	3.25	3.30	
5-yr	3.84	4.15	3.90	3.70	3.60	3.50	3.45	3.45	3.50	
10-yr	3.88	4.15	4.00	3.85	3.80	3.75	3.70	3.65	3.75	
30-yr	4.03	4.30	4.20	4.15	4.10	4.05	4.00	3.95	4.05	

Source - RBC Economics

### Treasuries vs. municipals (%)

	5-yr TSY	5-yr Muni	10-yr TSY	10-yr AAA Muni	30-yr TSY	30-yr AAA Muni
Beginning of month (2/1/24)	3.81%	2.26%	3.88%	2.28%	4.12%	3.42%
Mid-month (2/15/24)	4.22%	2.44%	4.23%	2.46%	4.41%	3.59%
End of month (2/29/24)	4.25%	2.44%	4.25%	2.46%	4.38%	3.59%

Source - Bloomberg (Treasuries), Thomson Reuters TM3 (Municipals)

For important disclosures and authors' contact information, see [page 9](#).

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Consumer Price Index showed inflation above survey expectations, with so-called core prices that strip out volatile food and energy showing an accelerated pace of monthly change. In addition to the data, multiple Fed officials in public speeches and commentary emphasized the “higher for longer” theme and discounted the possibility of rate cuts at the March policy meeting.

One continuing bright spot in the bond landscape has been corporate bonds, which have outperformed their government counterparts for multiple months now. The additional yield offered by corporate bonds over Treasuries, often referred to as a credit spread, has been declining consistently since October 2023. The North American High Yield CDX Index, which is based on credit derivatives linked to 100 of the largest sub-investment-grade issuers, has seen spreads decline nearly 200 bps in the last four months.

## Market investment strategy & market commentary

### Municipals erase February losses during last two trading days

After hovering in negative return territory throughout February, municipal yields firmed up the last two trading days of the month. As a result, municipals ended February returning 0.13% for the month. Municipals outperformed both Treasury bonds (-1.31%) and corporate bonds (-1.50%) for the month. Following February’s strong performance, municipals are returning -0.38% year to date.

date, outperforming Treasuries (-1.59%) and corporate bonds (-1.67%), according to Bloomberg data.

### Issuance exceeding last year

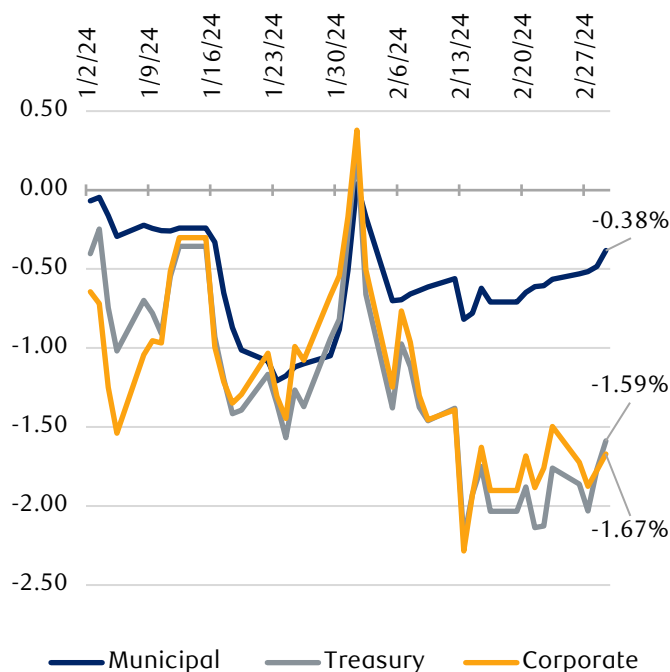
Municipal borrowers have issued \$58.6 billion in bonds through Feb. 29, marking a 28% increase over the \$45.7 billion issued last year through the end of February. The \$58.6 billion of issuance marks an 11% jump from our original projections that called for \$53 billion of primary market deals through Feb. 29, a trend we expect will continue over the next few months. The sizable bump in issuance drove 5-, 10-, and 30-year benchmark municipal yields 0.19%, 0.18%, and 0.16% higher, respectively. The benchmark 5-, 10-, and 30-year municipals ended February yielding 2.44%, 2.46%, and 3.59%, respectively.

Municipal bond fund flows have been mixed year to date through the end of February. Investors have added an aggregate \$1.8 billion through Feb. 29, with cash added to municipal bond funds in five of the first nine weeks of the year. During this period, investors began allocating a large pool of cash to high-yield funds as they seek to lock in higher yields, adding around \$2.6 billion to high-yield bond funds year to date.

### Looking ahead – A cautionary tale, patience should persevere

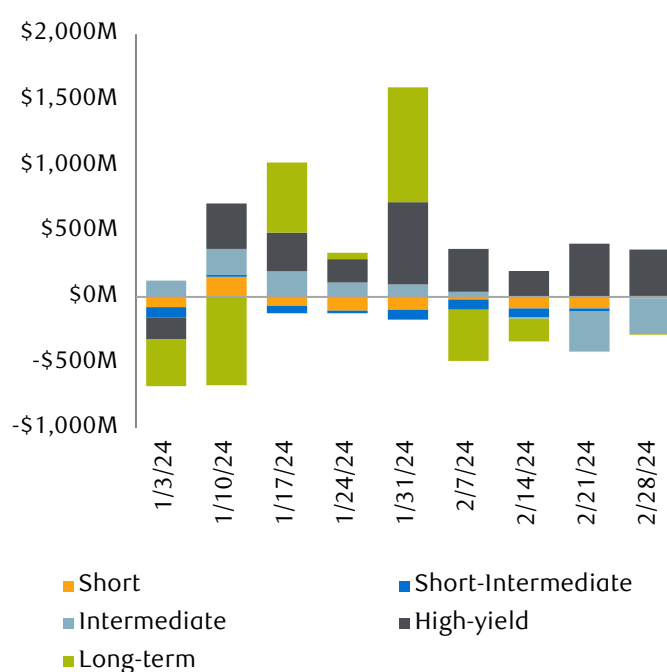
We are expecting yield volatility to continue through June, with RBC Capital Markets anticipating supply to outpace redemptions by around \$27 billion over that period. In addition, supply is on track to come in ahead of our

### Bloomberg indexes February 2024 returns



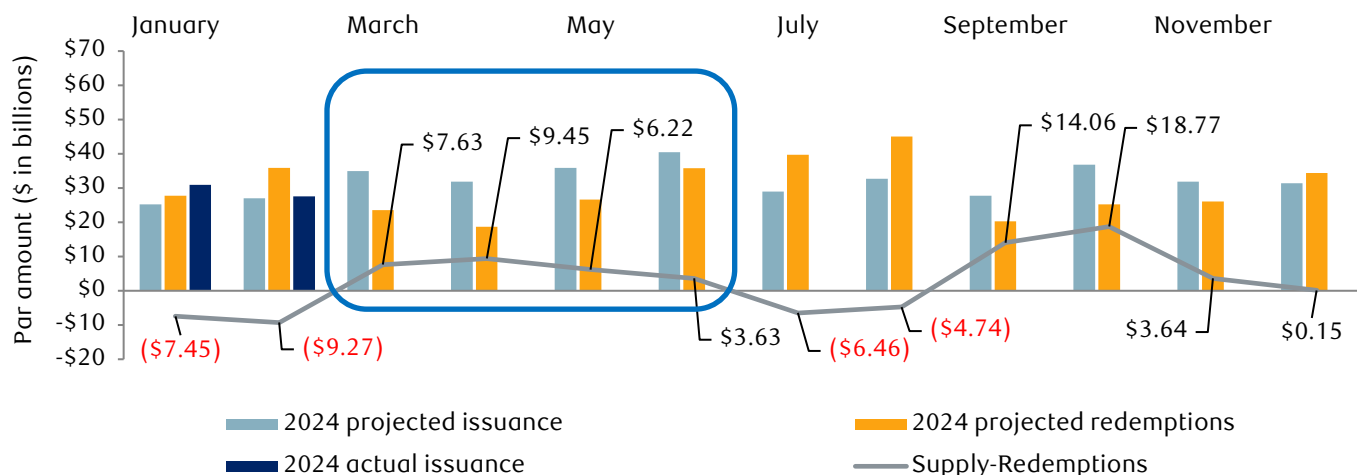
Source - RBC Wealth Management, Bloomberg; data through 2/29/24

### February 2024 municipal fund flows



Source - Refinitiv Lipper U.S. Fund Flows, RBC Wealth Management; weekly data 2/1/24–2/29/24

## Actual and projected 2024 municipal supply and redemptions



Source - CreditSights, RBC Capital Markets, RBC Wealth Management

original projection, as evidenced by the 28% y/y surge in issuance through Feb. 29.

We believe investors with “dry powder” should remain selective and patient over the next few months based on the potential for oversupply. Our expectations of higher yields could present investors with more attractive opportunities to maximize returns during periods when yields swing to the upside.

We see the potential for yield contraction during the summer months when net redemptions appear set to outpace supply. We urge investors to remain cautious considering the Fed could initiate an interest rate easing cycle during the second half of the year.

### Taxable municipal update

#### *Refinancing gains momentum for Build America Bonds in the taxable muni space*

Build America Bonds (BABs) were introduced to the taxable municipal market under the Obama administration in 2009 as part of the American Recovery and Reinvestment Act to create jobs and stimulate economic growth. Coupon payments on these bonds were subsidized by the U.S. government to help keep borrowing costs low for states and local municipalities. However, nearly all the \$100 billion in BABs that remain outstanding include extraordinary redemption options.

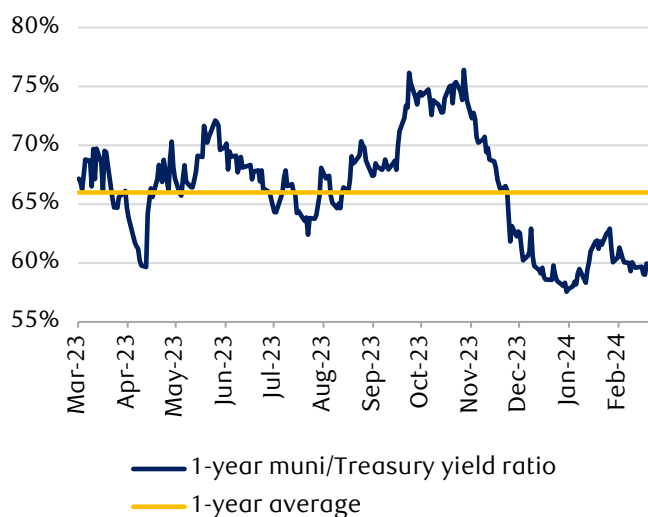
An extraordinary redemption gives issuers the ability to call their debt under unusual circumstances, such as catastrophic events or when bond proceeds are not spent on schedule. While most BAB issuers have yet to trigger this option, this trend has been gaining momentum of late. Last month, the Maryland Transportation Authority used the extraordinary redemption provision by issuing \$623 million of tax-exempt debt to replace previously issued taxable municipal BABs, saving the issuer just over

\$20 million in net interest costs. Even though rules state that extraordinary redemptions can only be triggered by unusual circumstances, it appears to us that the justification behind some of these outcomes has been somewhat nebulous. Be that as it may, with tax-exempt municipals currently trading at historically rich valuations versus Treasuries on a yield percentage basis, we think it’s likely that more BAB issuers will exercise this option in the coming months.

### Muni/Treasury yield ratios

Limited new issue volume and persistent demand for tax-exempt bonds caused municipal/Treasury yield ratios to trade at tighter spreads throughout February. As illustrated by the chart below, the benchmark for municipals maturing in 10 years yielded just under 60% of Treasuries on Feb. 29, compared to the one-year average of about 67%. However, given we expect municipal supply

### 10-year muni/Treasury yield ratios remain expensive



Source - Bloomberg, RBC Wealth Management; data as of 2/29/24

to easily outpace redemptions over the next four months, we think municipal/Treasury yield ratios are positioned to widen from current levels, while likely presenting investors with opportunities for more attractive entry points in the market. Considering historically tight municipal/Treasury yield ratios in maturities 10 years and shorter currently, we continue to find the most value with municipals in the 20-year and over range, where ratios appear significantly more attractive on a relative basis.

While municipal investors lately have been primarily focused on larger 5% coupons to avoid overextending duration amid historically rich valuations, we think investors should consider targeting 4% coupons in order to generate more yield and total-return potential when municipal/Treasury yield ratios improve, as we expect in the coming months.

## **This month's focus**

### **California's projected budget deficit**

California is facing a projected budget shortfall of up to \$68 billion that must be closed by this June as part of next fiscal year's budget process. However, part of the challenge is there is no single, definitive estimate of the budget deficit because it involves making numerous assumptions. The governor's office and the Legislative Analyst's Office (LAO) independently produce estimates of the state's fiscal condition for a three-year budget window, and their assumptions often differ. Case in point, the governor's office estimates the current shortfall at \$38 billion whereas the LAO estimates it at \$68 billion, with much of the difference based on the resiliency of the economy.

The governor's office and the LAO both agree revenue collections are coming in much lower than they previously projected, and future revenues have also been adjusted downward. But the magnitude of the projected declines differs between the two parties. Projecting accurate figures was further muddled by the extension of the 2022 tax filing deadline, which forced officials to finalize the fiscal 2023 budget with incomplete revenue information, causing a \$25 billion overstatement of fiscal 2023 revenues that was carried over and compounded into the current year's budget.

The revenue overstatement was primarily caused by the unforeseen Federal Reserve interest rate hikes, which chilled economic activity and the stock market. In turn, personal income tax collections from capital gains and stock-based compensation dropped, and these revenues account for a disproportionately large percentage of the state's total revenues.

## **Budget whipsaw**

California has a volatile tax revenue system because it relies heavily on its top 1% earners, who pay almost half of all the state's income tax revenue. Consequently, income tax and capital gains tax collections ebb and flow with economic cycles and the state's budget tends to whipsaw as a result. To illustrate, at the height of the pandemic California had to cut spending by \$54 billion. Then in 2021 and 2022, the state experienced a combined \$178 billion surplus, which was used to boost spending on education, homelessness, and health care, and to provide taxpayer relief for middle- and low-income earners.

## **Nothing new**

California's current budget challenge is nothing new. In fact, primarily because of periodic budgetary imbalance and reduced liquidity, the state's debt rating has twice cycled between an AA-category rating and a BBB-category rating within the past 25 years. Positively, the state enacted a law in 2016 that strengthened the mechanism funding the state's rainy-day reserves and increased the maximum authorized reserve balance. The law was two-fold positive in that excess revenues were squirreled away for lean times and expenditure growth was curtailed because the associated revenues were unavailable. As a result, California currently has a sizable rainy-day fund to help bridge the state's latest budgetary challenges without potentially incurring a negative rating action.

## **Solution**

Rebalancing the budget is always a political juggling act between revenue-raising measures, spending cuts, and use of rainy-day funds. To address the state's current projected deficit, the governor has identified \$8.5 billion in cuts, and the LAO has highlighted an additional \$16 billion of one-time or temporary spending decreases in its latest report. In addition, there are options to reduce spending on schools and community colleges that could address nearly \$17 billion of the budget problem. Further adjustments to one-time spending could address at least an additional \$10 billion. The state also has \$25 billion in four budget reserves that can be drawn up—with restrictions—to help balance the budget.

The governor's office is incentivized to assume a reasonable outcome, thereby requiring the least amount of politically unpalatable budget fixes. The LAO typically assumes the most reasonably bad scenario. As required by law, fiscal equilibrium ultimately will be found—but achieving it likely will be a rough road depending on how the economy and the stock market flesh out, in our view. The stock market hitting an all-time high suggests the road may be smoother than we initially thought, but only time will tell, and state officials will need to adjust accordingly.

## Municipal news

### Airport sector – A federal grant windfall

The White House announced it has awarded \$970 million in federal grants for passenger terminal upgrades. Around 114 airports in 44 states and three U.S. territories will receive federal grants. The funding marks the third round of federal grants for the airport sector. A total of \$5 billion, which was part of the Infrastructure Investment and Jobs Act, is being allocated in \$1 billion increments annually from 2022 through 2026. The airport sector, in most cases, has recovered to or surpassed pre-pandemic 2019 passenger levels.

### Chicago, IL – Proposed mansion tax struck down

Chicago Mayor Brandon Johnson's attempt to increase the city's real estate transfer tax was ruled against by a Cook County judge. The mayor was planning to use the additional tax receipts to help the city fight a growing homeless and migrant crisis in the city's boundaries. The proposed higher tax would have impacted sales of homes worth more than \$1 million.

### Gateway Tunnel Project, NY-NJ – Secures additional funding

New York and New Jersey's share of the \$16 billion Gateway Tunnel rail project dropped to a combined \$1.6 billion after the project secured another \$4 billion of federal funds. The additional funds were made available from the passage of the Infrastructure Investment and Jobs Act. New York's and New Jersey's share of funding stands at \$1.3 billion and \$308 million, respectively, based on the \$16 billion price tag.

### Green bonds – A certain degree of risk?

Industrial development bonds (IDB) sold for social or environmental projects, including energy and recycling plants, are increasingly becoming a less attractive option for those seeking higher yields, according to Municipal Market Analytics (an independent municipal research firm). IDB bonds that have been designated as green bonds accounted for 45% of first-time monetary default since 2021.

### New York City – Surplus exceeds mayor's projections

Mayor Eric Adams received some good budget news that helps reduce pressure on the mayor and city council to cut services. New York City budget officials revised the city's budget surplus by an additional \$2.8 billion thanks to a \$900 million increase in anticipated tax revenue and governmental spending that is more than \$1.9 billion lower than projected. The increased surplus provides the city with some additional flexibility to address the costs of the ongoing migrant crisis.

## Illinois updates

### State facing budget deficit

The state is facing its first deficit in three years amid rising costs, including education funding, other operating expenditures, and more funds for the state's growing migrant crisis. The state's budget office is projecting a \$721 million FY2025 deficit as revenue growth has begun slowing.

### Governor proposes to fully fund pensions

Governor J.B. Pritzker floated a plan to fully fund the five state pension funds, which are currently 45% funded. While the state has made significant strides in improving its contributions, it still lags most states whose pension systems are currently averaging a 70% funding level. The governor's plan, which is part of his FY2025 budget, would increase state contributions to the pension funds as other state debt is paid off. The state's five pension systems currently have an aggregate liability of \$142 billion.

### New Jersey – Governor proposes an increase in business taxes

Governor Phil Murphy is proposing to raise corporate taxes on the state's largest businesses. New Jersey's current 7.5% corporate tax rate would be bumped to 11.5% for the state's largest businesses, making the new rate the highest in the country, if passed. The "Corporate Transit Fee," as it is called, would increase taxes on all corporations with net income more than \$10 million. The governor is proposing to use the excess revenue generated by the tax increase to provide additional funding for the state's public transportation system, which is generating operating deficits.

### Congestion pricing implementation in question?

A lawyer representing New York City's Metropolitan Transportation Authority (MTA) said the implementation of congestion pricing in New York City may occur as early as mid-June. That development emerged during a court hearing challenging the mobility tax by the State of New Jersey. An MTA spokesman said the authority expects to finalize the plan by the end of March.

### State sales tax collections – Post increases in December

States collected \$30.3 billion in sales tax revenue during the month of December, a 2% y/y increase, according to data from the U.S. Census Bureau from 35 reporting states. General and sales tax and gross tax receipts jumped 2.3% during the month, accounting for 85% of sales tax receipts. Motor fuel taxes rose 4%, while tobacco, alcoholic beverage, and lodging tax collections all dropped year over year during the month.

## Transportation – States and cities receiving \$10 billion

The Biden administration funneled \$10 billion to public transit agencies as part of its FY2025 first half appropriations. The funds allow public transit agencies to put forth their 2024 applications for capital funds.

## Ratings corner

### Notable state and local issuer rating updates

#### Allegheny College, PA – Rating downgraded

On Feb. 14, Moody's downgraded the liberal arts college's rating one notch to Baa3 from Baa2; the outlook remains negative. Moody's attributed the downgrade to the college's weak financial operations. Declining enrollment trends are driving double-digit operating deficits and reducing the college's reserve position, which Moody's expects to continue in 2024. The college's \$289 million cash and investments position provides the college with additional flexibility to navigate its current challenges, according to Moody's. The rating agency went on to say that continued deterioration of cash and reserves could result in another downgrade, which would put the college's rating below investment grade.

#### Jefferson County, AL – Upgraded by Fitch

On Feb. 14, Fitch Ratings upgraded the county's limited obligation and general obligation warrants to AA from AA-; the rating outlook is stable. Fitch's upgrade "reflects the removal of the asymmetric risk relating to potential general fund exposure to the county's enterprise sewer system." In addition, the upgrade was also driven by the county's solid revenue growth and maintenance of strong reserves.

#### New York City, NY – Rating affirmed

On Feb. 20, Moody's affirmed New York City's Aa2 rating; the outlook is stable. The rating affirmation "reflects New York City's post-pandemic economic recovery, including record-high private employment, positive trends in assessed property values despite commercial real-estate challenges, steady tax revenue growth, and strong tourism metrics," according to Moody's report.

## Oklahoma – Rating affirmed, outlook revised

On Feb. 9, Fitch Ratings affirmed the state's AA rating and revised the rating outlook to positive from stable. The outlook revision "reflects the state's sustained improvements in expenditure flexibility and overall fiscal management, particularly its adherence to conservative budgeting practices through economic cycles including the recent period of volatility caused by the coronavirus pandemic."

## Palomar Health District – Under review for downgrade

On Feb. 23, Moody's placed the rating of Palomar Health under review for possible downgrade. Moody's cited a material and unexpected decline in Palomar's unrestricted cash and reserves through the interim six-month period ending Dec. 31, 2023.

## Territorial update

### Puerto Rico Electric Power Authority (PREPA) – Debtholders seeking to delay restructuring

A group of investors, including Goldentree Asset Management LP and Assured Guaranty, is pressing the U.S. bankruptcy court to delay a scheduled March hearing to restructure \$9 billion of outstanding debt. Investors are asking the court for a delay until the U.S. Court of Appeals for the First Circuit rules on bondholder security with respect to their lien on PREPA revenues.

## RBC Wealth Management retail trading (2/1/24 – 2/29/24)

Top 10 CUSIPs selling volume to retail customers

CUSIP	Description	Maturity	Coupon	Volume
014393ZS4	ALDINE ISD	02/15/2049	4.00	7,677
896035DN9	TRIB BRIDGE-A-1-BAM	05/15/2054	4.00	5,135
896035DM1	TRIBOROUGH BRIDGE-BAM	05/15/2064	4.13	4,528
187145SU2	CLIFTON HGR EDU-A-REF	08/15/2049	4.13	3,378
187145ST5	CLIFTON HGR EDU-A-REF	08/15/2044	4.00	3,061
896035DG4	TRIBOROUGH BRIDGE-A-1	05/15/2064	4.13	2,865
64972GSH8	NEW YORK CITY MUNI-DD	06/15/2049	5.00	2,846
64972JGX0	NYC TRANSIT FIN-F-1	02/01/2054	4.25	2,717
2837346Y2	EL PASO TX-C-BAM-TCRS	08/15/2047	4.00	2,665
64986DFT7	NY ENVRNMNTL FACS-E	06/15/2047	5.00	2,656

Source - RBC Wealth Management

Top 10 CUSIPs buying volume from retail customers

CUSIP	Description	Maturity	Coupon	Volume
19648FTP9	CO HLTH FACS AUTH-A	12/01/2047	5.00	1,859
54466HFC5	LOS ANGELES CO MTA-A	07/01/2042	5.00	1,184
13077DEY4	CA UNIV REV-A-REF	11/01/2048	5.00	1,063
246388TN2	DELAWARE ST HLTH FACS	06/01/2048	4.38	943
92812UE20	VA HSG DEV-C	07/01/2034	3.00	918
61371MCY8	MONTGOMERY MUD #108	09/01/2045	5.00	814
246388TP7	DELAWARE ST HLTH FACS	06/01/2050	5.00	733
54466HHF6	LOS ANGELES CNTY CA M	07/01/2044	5.00	718
921626PS0	VANCOUVER HSG-UNREFD	08/01/2034	3.75	705
54466HKY1	LOS ANGELES CO METRO	07/01/2044	5.00	695

## RBC Capital Markets institutional trading (2/1/24 – 2/29/24)

Top 10 CUSIPs selling volume to institutional customers

CUSIP	Description	Maturity	Coupon	Volume
646039ZH3	NEW JERSEY ST	06/01/2036	2.00	1,844
37970PLW0	GLOUCESTER CO IMPT	07/01/2054	5.00	1,759
89602RHS7	TRIBOROUGH BRIDGE-A	11/15/2052	4.00	884
46360WAY2	IRVINE FACS FING-A	09/01/2058	4.00	743
646140ER0	NEW JERSEY TPK AUTH-B	01/01/2043	4.25	632
04780MJ75	ATLANTA-B-1	07/01/2053	5.00	547
65830RDA4	N CAROLINA TPK AUTH-A	01/01/2058	5.00	505
20772KVS5	CONNECTICUT ST-B	01/15/2042	4.00	500
419792XU5	HAWAII ST	01/01/2032	5.00	499
723002NS6	PINE TREE ISD	02/15/2049	4.00	476

Source - RBC Capital Markets

Top 10 CUSIPs buying volume from institutional customers

CUSIP	Description	Maturity	Coupon	Volume
896035DG4	TRIBOROUGH BRIDGE-A-1	05/15/2064	4.13	7,197
896035DD1	TRIBOROUGH BRIDGE-A-1	05/15/2054	4.00	4,562
661309LS1	N OLMSTED CITY SD -B	10/15/2059	5.50	3,787
64972GSH8	NEW YORK CITY MUNI-DD	06/15/2049	5.00	3,473
64972EFH7	NYC HSG DEV MFH-B1A	05/01/2058	3.85	3,337
64972JGX0	NYC TRANSIT FIN-F-1	02/01/2054	4.25	2,453
544532JT2	LOS ANG DEPT OF WTR-E	07/01/2053	5.00	2,235
896035DJ8	TRIBOROUGH BRIDGE-A-2	05/15/2059	5.25	2,158
702845LV8	PASSAIC VLY WTR -REV	12/01/2048	4.00	2,000
20773CAB2	CONNECTICUT ST ARPT A	07/01/2049	4.00	1,736

## Bond Buyer indexes

Weekly	Current 2/29/24	Previous 2/22/24	2024 high	Date	2024 low	Date
Bond Buyer Revenue Bond Index	3.82%	3.82%	3.82%	(2/15)	3.59%	(1/4)
Bond Buyer 20-Bond Index	3.54%	3.54%	3.54%	(2/15)	3.31%	(1/4)
Bond Buyer 11-Bond Index	3.44%	3.44%	3.44%	(2/15)	3.21%	(1/4)

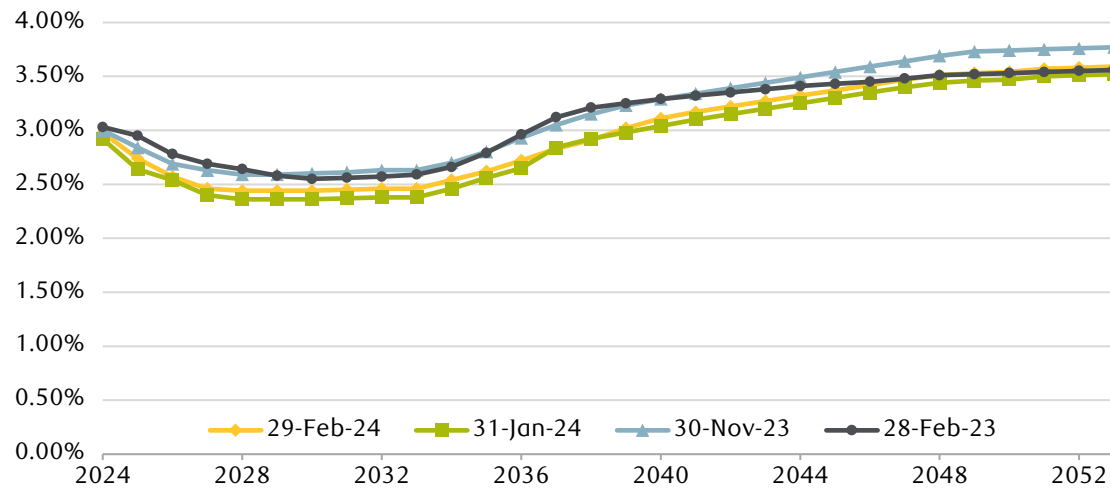
Source - The Bond Buyer

## Bloomberg Municipal Index returns

	Index								
	1-month	5-year (4–6)	10-year (8–12)	15-year (12–17)	Long bond (22+)	AAA	AA	A	BAA
Month-to-date total return	0.13%	0.06%	0.05%	0.18%	0.15%	-0.03%	0.09%	0.37%	0.37%
Year-to-date total return	-0.38%	-0.25%	-0.45%	-0.37%	-0.74%	-0.68%	-0.42%	-0.14%	-0.14%

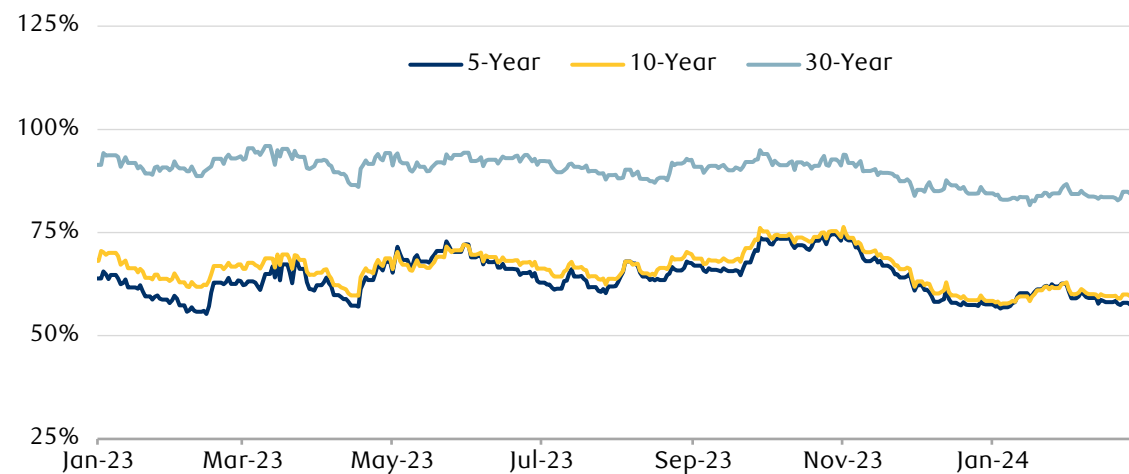
Source - Bloomberg; data through 2/29/24

## Muni market data AAA yield curve



Source - RBC Wealth Management, Thomson One Refinitiv; data through 2/29/24

## Muni/Treasury ratio comparison



Source - RBC Wealth Management, Bloomberg; data through 2/29/24

## Municipal bond insurers

Insurer	Moody's	Kroll Ratings
ACA	Not rated	Not rated
AMBAC	Not rated	Not rated
Assured Guaranty (AGC)	A2 (stable outlook)	AA+ (stable outlook)
Assured Guaranty Municipal Corp. (AGM)	A1 (stable outlook)	AA+ (stable outlook)
Berkshire Hathaway (BHAC)	Aa1 (stable outlook)	Not rated
Build America Mutual (BAM)	Not rated	Not rated
FGIC	Not rated	Not rated
National Public Finance (MBIA)	Baa2 (negative outlook)	Not rated
Syncora	Not rated	Not rated

Source - RBC Wealth Management; as of 2/29/24

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