STRONG DEMAND FOR MUNICIPAL BOND ETFs AND MUTUAL FUNDS IN 2019

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Demand for municipal bond exchange-traded funds (ETFs) and mutual funds reached record levels during the first four months of 2019. In fact, all four months individually ranked in the top 10 for monthly net inflows over the past 25 years (see Table 1 below). At first glance, strong demand for tax-free funds may seem counterintuitive following President Trump's tax reform legislation enacted in December 2017. However, we believe the specifics of tax reform, especially for high-tax states, combined with municipal bond supply dynamics and relatively strong fundamentals may continue to drive demand—and returns—for municipal bond ETFs and mutual funds.

Table 1: Municipal Bond ETFs and Mutual Funds: Monthly Estimated Net Inflows[1]

Rank	Month	Estimated Net Inflows
1	2/28/2019	$11,223,496,670
2	1/31/2018	$11,049,197,441
3	9/30/2009	$10,713,981,940
4	8/31/2009	$9,831,175,928
5	3/31/2019	$9,364,472,262
6	5/31/2016	$8,576,187,785
7	1/31/2019	$7,572,725,990
8	8/31/2016	$7,401,361,262
9	1/31/2013	$7,316,112,723
10	4/30/2019	$7,240,797,649

How is Tax Reform Linked to Increased Demand for Municipal Bond ETFs and Mutual Funds?

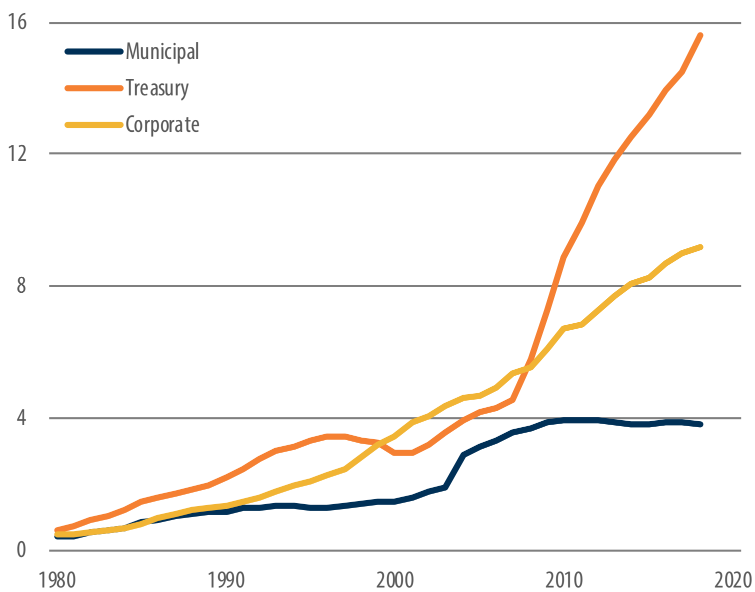
While the Tax Cuts and Jobs Act of 2017 lowered federal marginal income tax rates across the board, its net effects were unevenly distributed among taxpayers. This is largely due to a provision that limited the amount of state and local taxes that may be deducted from federal taxable income, which was reduced to $10,000. We suspect this may have had a larger-than-expected impact on the federal tax liability of many residents of populous, high-tax states, such as New York, California, and Illinois. If correct, this may help explain the surge of inflows into municipal bond ETFs and mutual funds this year, as taxpayers—upon filing their annual taxes—found themselves owing instead of receiving a refund. This, in turn, may have fueled investor appetite for tax-free income. Absent any changes to the tax code, we believe this may provide a continued source of marginal demand for municipal bond ETFs and mutual funds.

Tight Supply Relative to Other Fixed Income Categories

While demand for municipal bond ETFs and mutual funds has been relatively strong, municipal bond supply has been relatively tight compared to other fixed income categories. Over the last decade, total outstanding municipal bond debt grew by just 4% to $3.8 trillion, while total outstanding US Treasury debt grew by 170% to $15.6 trillion, and total outstanding corporate bond debt grew by 67% to $9.2 trillion (see Chart 1 below). In 2018, while US Treasury issuance was a record $2.7 trillion, and corporate debt issuance was $1.3 trillion, new municipal bond issuance totaled just $338 billion—the slowest pace since 2013—resulting in a $58 billion contraction of total outstanding municipal bond debt.

There are signs that the divergent supply of municipal bonds relative to US Treasuries may continue. The Congressional Budget Office projects annual federal government deficits in excess of $1 trillion beginning in 2022, and over the next decade, federal deficit financing (through treasury issuance) is expected to top $11 trillion.[2] While forecasting future municipal issuance is more difficult, analysts estimate a 4% decline in overall issuance in 2019.[3]

Chart 1: Outstanding Debt by Type | USD, trillions[3]



[1]Source: Morningstar. Data from 4/30/94 - 4/30/19). There is no assurance these trends will continue.
[2]Source: Congress of the United States Congressional Budget Office, *The Budget and Economic Outlook: 2019 to 2029*.
[3]Source: Sifma, *2019 Municipal Issuance Survey*.
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Robust Performance for Municipal Bonds in 2019

Consistent with these favorable supply/demand dynamics, municipal bonds have recently produced relatively strong returns. Over the 12 months ended 4/30/2019, the Bloomberg Barclays Municipal Bond Index had a total return of 6.2%, compared to the 5.3% total return of the Bloomberg Barclays US Aggregate Bond Index, a broad benchmark of the fixed income market. Municipal high yield bonds also fared favorably compared to corporate high yield bonds. The Bloomberg Barclays Muni High Yield Index had a total return of 8.3% compared to the Bloomberg Barclays US Corporate High Yield Index return of 6.7% over the same period. Depending on an investor's tax bracket, taxable equivalent returns were even better for most municipal bond investors.

Investing in Municipal Bonds

In our opinion, active management is of critical importance for tax-free investing, given the dynamic and evolving risks that impact municipal bonds. Accordingly, First Trust offers a robust lineup of six actively-managed municipal bond ETFs. As part of the rigorous investment process underlying each of these ETFs, macroeconomic trends such as demographics, default rates, and the regulatory environment are considered, as are issuer-specific factors such as cash flow analysis, bond covenants, and collateral provisions. In addition, interest rate risk is addressed by managing duration. We believe this approach, coupled with favorable supply and demand trends, contribute to a favorable outlook and a compelling opportunity for municipal bond investors.