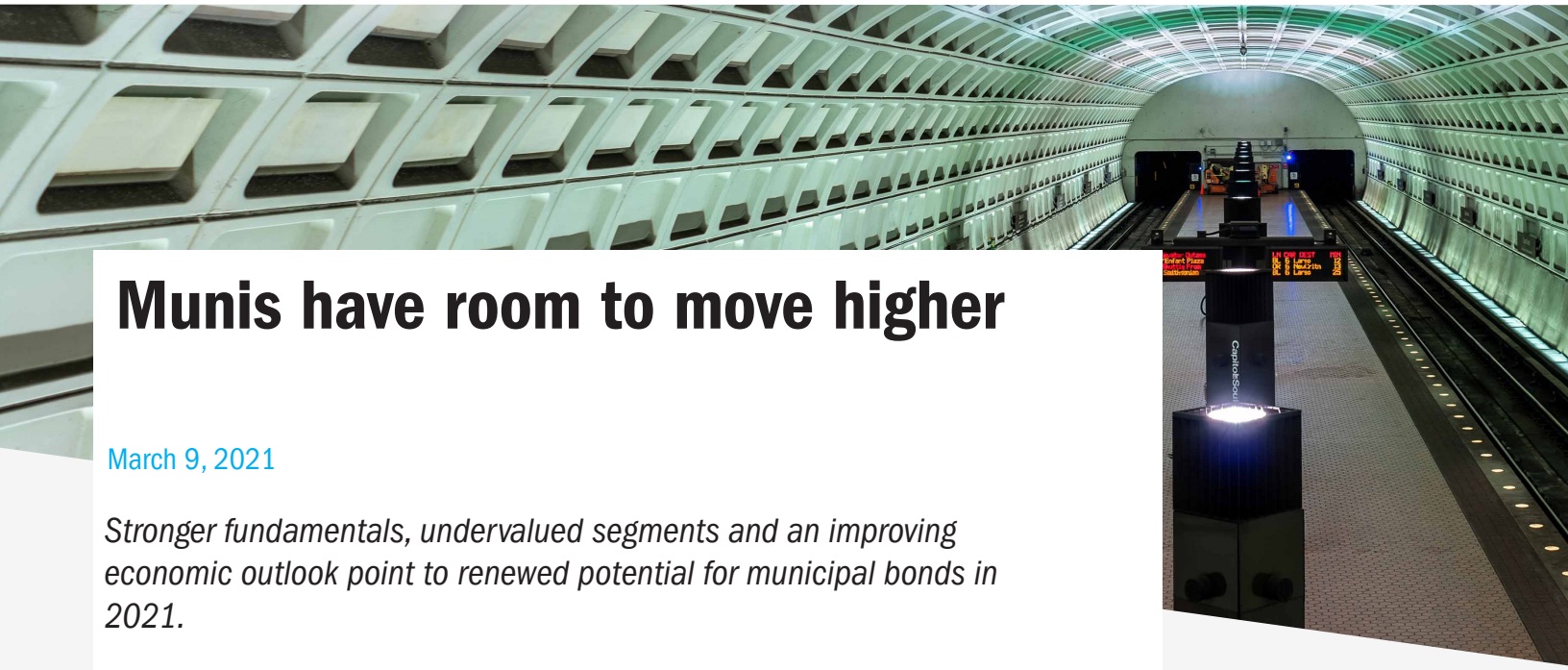
COLUMBIA THREADNEEDLE INVESTMENTS



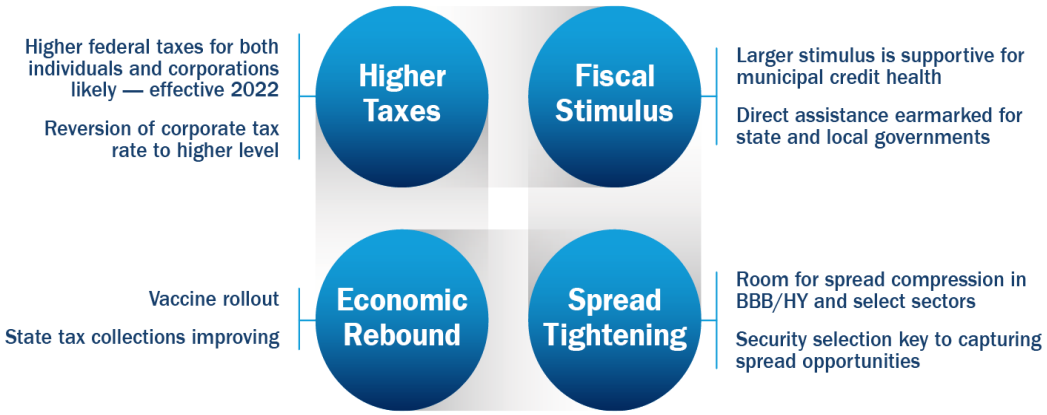
Munis have room to move higher

March 9, 2021

Stronger fundamentals, undervalued segments and an improving economic outlook point to renewed potential for municipal bonds in 2021.

After suffering the largest selloff in their history last March, municipal bonds have seen a strong recovery off lows, and we believe that there's room for munis to move even higher in 2021. Multiple catalysts fuel our optimism, including the probability of higher taxes, the likelihood of renewed fiscal stimulus and the potential for continued credit spread tightening as the recovery unfolds. We believe these significant demand drivers, alongside portions of the market remaining undervalued, are creating a positive backdrop for municipal investors.

Municipal bonds in 2021: a confluence of positive factors



Catherine Stienstra
Head of Municipal Bond Investments

Douglas Rangel, CFA
Vice President, Fixed Income Client Portfolio Manager

COLUMBIA THREADNEEDLE INVESTMENTS

A muni bond win-win

When we analyzed potential impacts of the 2020 elections last fall, all of the possible outcomes created at least some degree of benefit for tax-exempt investors. However, unified Democratic control of Congress and the White House was the most positive of those scenarios, and with that outcome now a reality, we will very likely see a push toward higher federal tax rates for both individuals and corporations.

When the Tax Cuts and Jobs Act (TCJA) reduced corporate rates from 35% to 21%, an important segment of investors — namely banks and insurance companies — effectively left the tax-exempt muni market. For this group, an increase in the corporate tax rate could provide enough of an incentive to make tax-free muni bonds attractive again. This increase in demand, coupled with higher taxes on high-net-worth individuals, should improve support for municipal bond prices overall and reinforce the positive technical environment.

Higher tax rates are not the only policy development likely to have implications for municipal bonds. Direct state and local government stimulus will also play an important role.

On-target aid

While higher tax rates may jumpstart demand and lift prices, more generous fiscal stimulus could provide the catalyst for underlying credit improvement. The initial rounds of stimulus provided much needed support to areas of the economy first battered by COVID. From hospitals to transportation, small businesses and consumers, much of the relief was a lifeline to essential portions of the economy. State and local governments, however, were excluded from the initial rounds of stimulus.

Despite this exclusion, most states haven't experienced the shortfalls they initially expected. The uniqueness of the COVID recession helped them avoid worse outcomes: job losses were centered in low-wage sectors, which left personal income tax collections from higher wage earners largely intact. Property tax collections also held steady on the strength of the residential housing market and the sharp rebound in equity market values created a capital gains windfall.

Targeted aid for municipalities is a core part of the Democratic relief plan, and with nearly complete control of the legislative and policy levers, there is a high likelihood that direct federal aid for municipalities will be part of the next stimulus package. Federal revenue support could help cover gaps in 2021 fiscal year budgets (ending June 30), allowing states to conserve funds and hold their ground as they wait for the economy to rebound to pre-COVID levels, mitigating broad concerns around municipal credit fundamentals.

COLUMBIA THREADNEEDLE INVESTMENTS

Finding the sweet spots

Investors looking for bargains might dismiss the opportunity in munis if they focus solely on the higher quality portions of the market. To date, the highest quality segment of the municipal market has rebounded more fully, leaving AAA-rated bonds rich by most valuation measures. While higher taxes and/or direct fiscal support to state governments has the potential to increase demand for high-quality paper, investors may be better served pursuing total return opportunities in lower rated bonds. We think uneven ratings across sectors and continuing borrower uncertainty will create opportunities for individual security selection to drive returns. Some uncertainty is likely to remain in a still uneven recovery, but gradual progress toward a post-COVID normal should continue to drive spread compression between higher and lower rated municipal bond segments. It is unlikely that recovery progression will be completely one-directional, so we view any temporary weakness as a buying opportunity underpinned by our solid long-term outlook for the sector.

The bottom line: Stay smart and flexible

Market dislocations like last year's historic muni selloff often create compelling investment opportunities. For munis in 2021, this means favoring the sharp pencil over the broad brush, staying flexible in your investment implementation and being selective and disciplined in choosing individual bonds.

Disclosures:

There are risks associated with **fixed-income** investments, including credit risk, interest rate risk, and prepayment and extension risk. In general, bond prices rise when interest rates fall and vice versa. This effect is usually more pronounced for longer term securities.

To find out more, call 800.426.3750
or visit columbiathreadneedle.com

Not Federally Insured	No Financial Institution Guarantee	May Lose Value

Securities products offered through Columbia Management Investment Distributors, Inc., member FINRA. Advisory services provided by Columbia Management Investment Advisers, LLC.

Columbia Threadneedle Investments (Columbia Threadneedle) is the global brand name of the Columbia and Threadneedle group of companies.

The views expressed are as of the date given, may change as market or other conditions change and may differ from views expressed by other Columbia Management Investment Advisers, LLC (CMIA) associates or affiliates. Actual investments or investment decisions made by CMIA and its affiliates, whether for its own account or on behalf of clients, may not necessarily reflect the views expressed. This information is not intended to provide investment advice and does not take into consideration individual investor circumstances. Investment decisions should always be made based on an investor's specific financial needs, objectives, goals, time horizon and risk tolerance. Asset classes described may not be appropriate for all investors. Past performance does not guarantee future results, and no forecast should be considered a guarantee either. Since economic and market conditions change frequently, there can be no assurance that the trends described here will continue or that any forecasts are accurate.

CTBPRVBY (03/21) 3464106