

Municipal Insights

Midterm elections



November elections will be a great weathervane for the public's mood. We will be voting on 470 seats in the U.S. Congress; 35 Senate seats and all 435 House seats. Additionally, 36 states and three territories will vote for a Governor. Let's not forget the state legislature and mayoral elections.

The winners of the gubernatorial elections will have a significant impact over the next congressional redistricting drawn up after the 2020 census. The new congressional maps will play a large role in the course of U.S. politics for the next decade. More specifically for the municipal market, do voters have enough confidence in their current and future financial position to open the purse strings a bit wider for new schools, roads, water projects, etc.? It will be a busy year-end for analysts trying to discern the impact of the midterm elections. We currently see 271 bond elections totaling about \$44 billion on the November 6th ballots. On one database we queried, we saw 157 statewide ballot measures in 38 states. These included measures for higher educational funding, Medicaid expansion and healthcare, restrictions on taxes and minimum wage increases. All in, there could be a variety of impacts on municipal market issuers.

Before we get overwhelmed with the election results, we think it's important to remind our readers that municipal bonds have been a relative stable investment through many uncertain times. Generally, credit quality has improved over the past few years for municipal issuers as the economy has grown. Recent rating changes by S&P has left every U.S. state with a stable or positive rating outlook. At this time, 45 states are rated in the AA and AAA categories. More broadly, we have seen 21 defaults year-to-date through September this year versus 35 for the same period last year. In 2016, we had 53 over the same period; a nice decline for municipal issuers in that statistic. While defaults have increased in the wake of the Great Recession, they are rare compared to corporates. A Moody's Investors Service study in 2017 showed a default rate of all rated municipals at 0.17% versus 10.24% for global corporates.

We'll be back with results after the election. However, unlike market movements, credit changes in the municipal market typically develop slowly. This gives professional money managers with experienced municipal analysts the opportunity to avoid troubled waters.

Municipal fixed income

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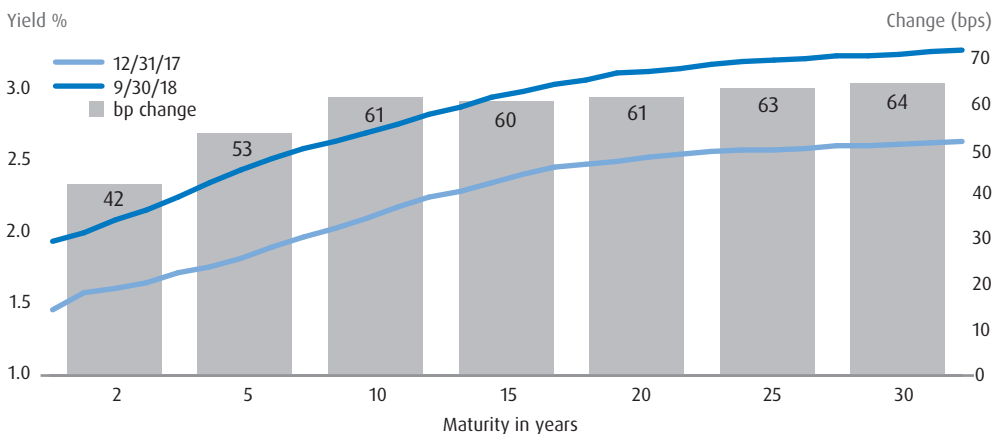
Market commentary

Interest rates barely moved over the first two months of the quarter, then came September and yields rose across the fixed income markets. For example, the 10-year AAA municipal yield rose from 2.45% to 2.60%, or 15 basis points higher in yield; Treasury yields moved higher by about the same amount. Not a complete rout, but enough to post a negative monthly return of -0.65% for the Bloomberg Municipal Bond Index. For the quarter and year-to-date periods, the Index returned -0.15% and -0.40%, respectively. Returns were mixed across the curve over the quarter, ranging from a positive 0.06% for the intermediate portion to -0.48% for the long end. Broadly, with higher interest rates, short maturity municipal funds outperformed longer funds. Ten-year Treasury yields now seem firmly set above the 3% hurdle that investors had been watching closely and perhaps anticipating. Over the past month, hedge funds have had a record net-short position on 10-year notes and appear to be looking for yields to continue to move higher.

The Fed is anticipating higher interest rates as well. The Federal Open Market Committee (FOMC) raised short-term rates for the third time this year at their September meeting, pushing the target Fed Funds rate higher by a quarter-percentage point to a range between 2% and 2.25%. The hike is notable in that it's the first time the target rate has been above 2% since 2008 and also the first time in many years it has been above the core inflation rate. Projections from the meeting show that Fed officials expect to raise rates by a percentage point through 2019; but the economy is a moving target with many drivers in play at this time. The Committee also removed the "accommodative" language from the description of their rate stance. Perhaps a nod that interest rates are closer to a neutral positioning, or maybe an acknowledgement that rate setting is an imprecise tool. The next meeting is around the corner in December and the market is currently implying about a 70% chance of another quarter-percent hike.

September municipal issuance totaled \$24 billion, bringing year-to-date issuance to \$249 billion, a 15% decline versus the same period last year. As has been the case this year, new money deals are significantly outpacing refunding deals. With early estimates, municipal flows reversed in September as investors pulled about \$240 million from municipal funds and ETFs, likely due to the back up in yields. However, year-to-date net inflows are still strong at about \$19 billion.

AAA government obligation yield curve 12/31/17 to 9/30/18



Source: Bloomberg



Broadly, with higher interest rates, short maturity municipal funds outperformed longer funds.



Fed officials expect to raise rates by a percentage point through 2019; but the economy is a moving target with many drivers in play at this time.

Strategy overview

Duration

- Maintaining shorter portfolio duration than our benchmark and peers.
- Federal Reserve Bank of Atlanta's running GDP estimate currently tracking 4%.
- Probability of additional rate hike in December is about 70%.
- Increased Treasury issuance continues to weigh on the bond market.
- Inflation in line with Fed expectations, but we are closely watching wage pressure.

Curve

- Municipal bonds across the curve cheapened to Treasury bonds over the past month, but longer bonds are more attractive than the short end.
- Maintain barbell positioning in intermediate portfolios.
- We like the longer end for intermediate portfolios. The municipal curve is much steeper than the treasury curve, providing relatively higher yields out long. Additionally, the callable municipal bonds have a much shorter duration than other long-dated taxable bonds.
- Overweight variable rate demand notes.
- The weekly municipal floating rate index (SIFMA) is 1.56% (9/26/2018) versus 0.94% last year.

Credit and structure

- As always, yield continues to be an important driver of total return, but attractive opportunities to add it are limited.
- High Yield Munis were down in September as the Bloomberg Muni HY Index returned -0.40%. We do not believe the decline is due to credit concerns; more likely that the price appreciation of sectors driving HY performance (e.g., tobacco bonds) has peaked.

Geography and sector

- We continue to favor revenue bonds and have been focusing on hospital bonds, higher education, and transportation bonds. We are watching for fallout from recent tariff actions, but have not noted any excessive stresses on credit quality at this time.

Performance

Fund performance as of September 30, 2018

| Fund/Index | Share class | Inception date | Ticker | Returns as of September 30, 2018 (%) | | | | | | | | Expense ratios (%) ¹ | | |
|--|----------------------|----------------|--------|--------------------------------------|-------|-------|--------|--------|--------|---------|-----------------|---------------------------------|------|--|
| | | | | 1-month | Q3 | YTD | 1-year | 3-year | 5-year | 10-year | Since inception | Gross | Net | |
| BMO Ultra Short Tax-Free Fund ² | A NAV | 05/27/14 | BAUSX | 0.01 | 0.19 | 0.82 | 0.89 | 0.74 | 0.69 | — | 0.93 | 0.64 | 0.55 | |
| BMO Ultra Short Tax-Free Fund ² | A OFFER ³ | | | -2.04 | -1.86 | -1.24 | -1.16 | 0.05 | 0.27 | — | 0.71 | | | |
| BMO Ultra Short Tax-Free Fund ² | I | 09/30/09 | MUISX | 0.13 | 0.25 | 1.01 | 1.15 | 1.00 | 0.96 | — | 1.19 | 0.39 | 0.30 | |
| Blended Benchmark ⁴ | | | | -0.05 | 0.10 | 0.80 | 0.68 | 0.55 | 0.48 | — | | | | |
| BMO Short Tax-Free Fund ² | A NAV | 05/27/14 | BASFX | -0.17 | 0.07 | 0.70 | 0.54 | 1.01 | 1.51 | — | 1.47 | 0.76 | 0.55 | |
| BMO Short Tax-Free Fund ² | A OFFER ³ | | | -2.19 | -1.96 | -1.34 | -1.49 | 0.33 | 1.11 | — | 1.13 | | | |
| BMO Short Tax-Free Fund ² | I | 11/29/12 | MTFIX | -0.06 | 0.21 | 0.82 | 0.69 | 1.19 | 1.68 | — | 1.64 | 0.51 | 0.40 | |
| Bloomberg Barclays Short (1-5 Year) Municipal Index | | | | -0.38 | -0.11 | 0.66 | 0.01 | 0.80 | 1.08 | — | | | | |
| BMO Intermediate Tax-Free Fund ⁵ | A NAV | 05/27/14 | BITAX | -0.50 | -0.16 | -0.25 | 0.25 | 1.88 | 2.99 | 4.50 | 4.25 | 0.58 | 0.56 | |
| BMO Intermediate Tax-Free Fund ⁵ | A OFFER ³ | | | -3.95 | -3.63 | -3.74 | -3.25 | 0.68 | 2.26 | 4.13 | 4.10 | | | |
| BMO Intermediate Tax-Free Fund ⁵ | Y | 02/01/94 | MITFX | -0.50 | -0.17 | -0.25 | 0.25 | 1.88 | 2.99 | 4.50 | 4.25 | 0.58 | 0.56 | |
| BMO Intermediate Tax-Free Fund ⁵ | I | 12/27/10 | MIITX | -0.39 | -0.10 | -0.07 | 0.58 | 2.15 | 3.22 | 4.65 | 4.31 | 0.33 | 0.33 | |
| Bloomberg Barclays U.S. 1-15 Year Blend Municipal Bond Index | | | | -0.56 | -0.06 | -0.13 | 0.02 | 1.76 | 2.72 | 4.00 | | | | |

| Other benchmarks as of September 30, 2018 | Returns as of September 30, 2018 (%) | | | | | | |
|--|--------------------------------------|-------|-------|--------|--------|--------|---------|
| | 1-month | Q3 | YTD | 1-year | 3-year | 5-year | 10-year |
| Bloomberg Barclays U.S. 1-10 Year Blend Municipal Bond Index | -0.50 | -0.07 | 0.03 | -0.19 | 1.39 | 2.15 | 3.44 |
| Bloomberg Barclays U.S. Municipal Bond Index | -0.65 | -0.15 | -0.40 | 0.35 | 2.24 | 3.54 | 4.91 |

Source: Bloomberg Barclays and BMO Global Asset Management

Performance data quoted represents past performance and past performance is not a guarantee of future results. Investment returns and principal value will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Mutual fund performance changes over time and current performance may be lower or higher than what is stated. To receive the most recent month-end performance, call 1-800-236-3863. Returns quoted are pre-tax. Investor should consider his or her current and anticipated investment horizon and income tax bracket when making an investment decision as the illustration above does not reflect these factors. For more information about performance, please contact your investment professional. Total returns for periods of less than one year are cumulative.

¹ Expenses for Class A shares are based on estimated amounts for the current fiscal year. Net expense ratios reflect contractual fee waivers and/or expense reimbursements if applicable, made by BMO Asset Management Corp., the investment adviser (Adviser). The Adviser may not terminate these fee waivers and/or expense reimbursements prior to December 31, 2018 without the consent of the Board of Directors, unless the investment advisory agreement is terminated. Without these contractual waivers, the Fund's returns would have been lower.

² Performance data quoted prior to the inception of the Class A shares is the performance of the Fund's Investor Class (Class Y). Class A Offer reflects a sales load charged at the time of initial investment. On June 2, 2017, the Fund's Class Y shares were converted to Class A shares. The Fund no longer offers Class Y shares.

³ Offering Price (MOP) returns for the BMO Ultra Short Tax-Free Fund and the BMO Short Tax-Free Fund include the maximum sales charge of 2.00%. Offering Price (MOP) returns for the BMO Intermediate Tax-Free Fund include the maximum sales charge of 3.75%. Net Asset Value (NAV) returns exclude this charge, which would have reduced returns.

⁴ The Blended Benchmark: 50% Bloomberg Barclays 1-Year Municipal Bond Index and 50% iMoneyNet Money Fund Tax Free National Retail Index.

⁵ Performance data quoted prior to the inception of the Class A shares is the performance of the Fund's Investor Class (Class Y). Class A Offer reflects a sales load charged at the time of initial investment. Performance data quoted prior to 12/27/10 (inception of Class I of the Fund) is the performance of the Fund's Investor Class (Class Y), not adjusted for any differences in the expenses of the classes.

Market data for the journey

Valuation data as of September 30, 2018

| AAA yields (%) | | | | |
|----------------|---------|---------|---------|--------|
| Year | Current | 1-month | Change | |
| | | | 3-month | 1-year |
| 2 | 1.97 | 0.27 | 0.33 | 0.97 |
| 5 | 2.20 | 0.18 | 0.21 | 0.85 |
| 10 | 2.58 | 0.14 | 0.12 | 0.58 |
| 30 | 3.19 | 0.17 | 0.25 | 0.35 |

Source: InvestorTools® Perform

| Cross-market values (%) ¹ | | |
|--------------------------------------|---------------------------|----------------|
| Year | Current (1-year averages) | |
| | Muni/treasury | Muni/corporate |
| 2 | 70 (70) | 70 (69) |
| 5 | 74 (74) | 73 (73) |
| 10 | 84 (85) | 77 (77) |
| 30 | 100 (97) | 85 (84) |

Sources: InvestorTools® Perform and Bloomberg

Yield curve data as of September 30, 2018

| Slope changes (%) | | | | |
|-------------------|---------|---------|---------|--------|
| | Current | 1-month | Change | |
| | | | 3-month | 1-year |
| Wkly—2s | 1.26 | 0.00 | -0.05 | -0.62 |
| 2—5s | -0.62 | 0.18 | 0.21 | 0.85 |
| 2—10s | 0.61 | -0.13 | -0.21 | -0.39 |
| 2—30s | 1.22 | -0.10 | -0.08 | -0.62 |

Source: InvestorTools® Perform

| Performance by maturity (%) | | | |
|-----------------------------|---------|---------|--------|
| Year | 1-month | 3-month | 1-year |
| 3 | -0.41 | -0.11 | -0.11 |
| 5 | -0.55 | -0.19 | -0.56 |
| 10 | -0.62 | 0.06 | -0.14 |
| 22+ | -0.91 | -0.48 | 1.08 |

Source: Barclays Point

Credit data as of September 30, 2018

| Current rating spreads (%) ² | | |
|---|---------------------------|-------------|
| Year | Current (1-year averages) | |
| | AAA-A | AAA-BBB |
| 2 | 0.19 (0.20) | 0.46 (0.47) |
| 5 | 0.38 (0.41) | 0.70 (0.72) |
| 10 | 0.47 (0.49) | 0.82 (0.84) |
| 30 | 0.49 (0.51) | 0.81 (0.83) |

Source: InvestorTools® Perform

| Performance by quality (%) | | | |
|----------------------------|---------|---------|--------|
| Rating | 1-month | 3-month | 1-year |
| AAA | -0.65 | -0.30 | -0.28 |
| AA | -0.65 | -0.19 | 0.13 |
| A | -0.64 | -0.09 | 0.65 |
| BBB | -0.66 | 0.20 | 2.03 |

Source: Barclays Point

BMO Funds Tax-Free Suite

| Fund name | Ticker | | | |
|--------------------------------|---------|---------|---------|---------------|
| | Class A | Class Y | Class I | Premier Class |
| BMO Tax-Free Money Market Fund | — | MTFXX | — | MFIXX |
| BMO Ultra Short Tax-Free Fund | BAUSX | — | MUISX | — |
| BMO Short Tax-Free Fund | BASFX | — | MTFIX | — |
| BMO Intermediate Tax-Free Fund | BITAX | MITFX | MIITX | — |

¹ Cross-market values represent the ratio of tax-free municipal yields to taxable Treasury yields. The percentage in the parentheses represents that average of this ratio over the prior twelve months.

² The current rating spread is the difference between the benchmark AAA municipal yield curve and the associated rating benchmark (either A or BBB) for the appropriate maturity time frame. The percentage in the parentheses represents the spread over the prior twelve months.

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Interest income from Tax-Free Fund investments may be subject to the federal alternative minimum tax (AMT) for individuals and corporations, and state and local taxes.

Credit risk is the possibility that an issuer will default on a security by failing to pay interest or principal when due. Lower credit ratings correspond to higher credit risk.

Municipal bonds are subject to risks including economic and regulatory developments in the federal and state tax structure, deregulation, court rulings, and other factors.

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Bloomberg Barclays 1-10 Year Blend Municipal Bond Index is an unmanaged index of municipal bonds rated BBB or better with 1 to 12 years to maturity.

Bloomberg Barclays Municipal High Yield Index measures the USD-denominated, high yield, fixed-rate corporate bond market.

Bloomberg Barclays U.S. Municipal Bond Index is an unmanaged index of a broad range of investment-grade municipal bonds that measures the performance of the general municipal bond market.

Blended Benchmark consists of 50% Bloomberg Barclays 1 Year Municipal Bond Index and 50% iMoneyNet Money Fund Tax Free National Retail Index. Money Fund Report Averages™ is an arithmetic average of performance for all money market mutual funds tracked within this category. Money Fund Report Averages™ is a service of iMoneyNet, Inc. (formerly IBC Financial Data). The Bloomberg Barclays 1-Yr Municipal Bond Index is the 1-year component of the Bloomberg Barclays Municipal Bond Index, which is an unmanaged index composed of long-term tax-exempt bonds with a minimum credit rating of Baa.

Bloomberg Barclays Short (1-5 Year) Municipal Index includes investment-grade tax-exempt bonds that are issued by state and local governments and have maturities of 1 to 5 years.

Bloomberg Barclays U.S. 1-15 Year Blend Municipal Bond Index is the 1-15 year Blend component of the Bloomberg Barclays Municipal Bond Index, which is an unmanaged index composed of long-term tax-exempt bonds with a minimum credit rating of Baa and a range of maturities between 1 and 17 years.

Investments cannot be made in an index.

Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

Personal Consumption Expenditures (PCE) Index measures the prices paid by consumers for goods and services without the volatility caused by movements in food and energy prices to reveal underlying inflation trends.

Basis point is equal to one one-hundredth of one percentage point (0.01%).

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