Municipal Insights

I am the Walrus… goo goo ga joob

What? No doubt some of our younger readers may have to Google our opener to discover the source as John Lennon's lyrics from the B-side of "Hello Goodbye" and a track from the Beatles' 1967 album the *Magical Mystery Tour*. You should give it a listen.

John Lennon's confusing lyrics were meant to be just that, nonsensical and open to various interpretations. Some speculate that "goo goo ga joob" were Humpty Dumpty's last words before his great fall (yes, that is one correct way to spell it). The "walrus" was inspired by a verse from Lewis Carroll's poem *The Walrus and the Carpenter*. Keep clicking on the various theories inspired by the song's lyrics and you may find yourself going down the rabbit hole, which is exactly what I feel like I'm doing watching tweets and market movements of late. Well readers, roll up! Roll up for the magical mystery tour!

The magical mystery tour

How did we get to the 10-year Treasury yield closing in on 2.0%, well below the Federal Reserve (Fed) target of 2.25-2.50%? It's a fair question that has no clear answer. Let's face it; relatively speaking, it's all been a bit surrealistic and tough to digest. But our mystery tour set off late last year on equity weakness as the S&P 500® Index fell 13.5% over the fourth quarter. We can point to a number of cracks in the investor mindset, but the overarching theme, both then and now, was concern about slowing growth domestically and abroad. The cracks were many, including rising interest rates; China weakness; midterm election jitters; Brexit; worsening trade disputes; a growing deficit; and a slowing housing market. Equities posted a remarkable recovery over the first few months of 2019 on mostly positive earnings reports. In fact, over 76% of S&P 500® companies reported actual Earnings Per Share (EPS) above the consensus estimates. However, farsighted bond investors continued to push yields lower — a full percentage point lower since last October.

Municipal fixed income

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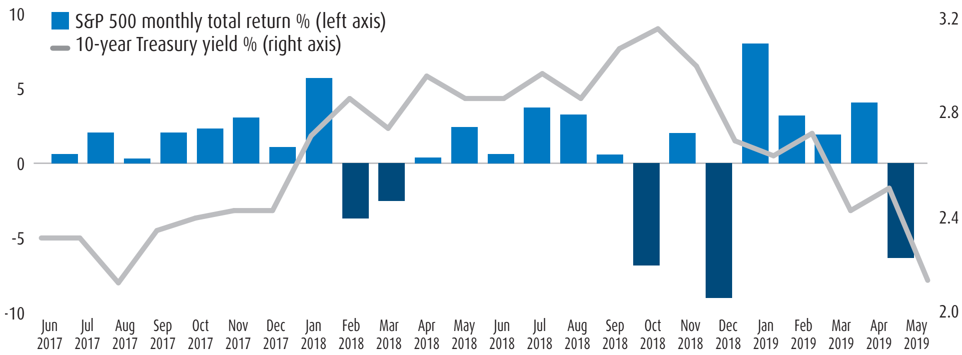
How did we get here?

Yields plummeted on equity weakness late last year



Source: Bloomberg

> So, what pushed bond yields lower over the past few months?

The descent in yields continued year-to-date despite a slew of positive economic reports, relatively robust U.S. GDP growth of 3.1% over the first quarter, and the unemployment rate hitting a five-decade low of 3.6% in April. So, what pushed bond yields lower over the past few months? We can't pinpoint any specific reason, but an overhanging cloud of market angst continues to concern the fixed income market. A number of obstacles from last year remain unresolved. For example, Brexit, and its unknown effects, has been pushed to October. After many false hopes, the tariff war with China has dragged on longer than we thought possible. The partisan gridlock in Washington has given us a dysfunctional federal government with no end in sight. Nationalism and protectionism are currently in fashion around the globe, and these practices are typically no champions of growth.

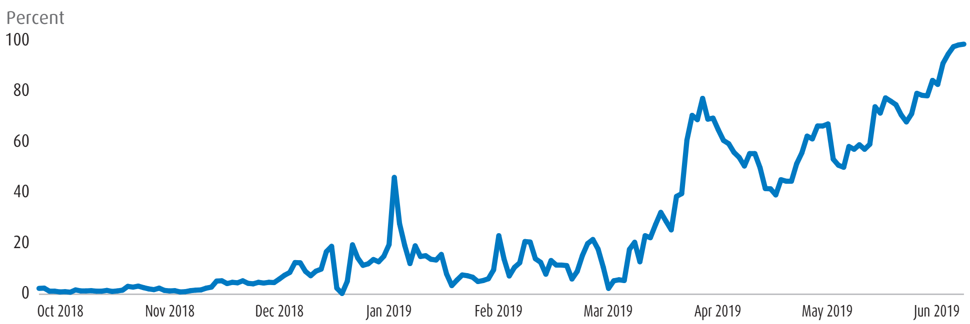
Additionally, the about-face by the Fed at their January meeting gave the fixed income market room to move lower. It wasn't long after this that we started hearing predictions of a Fed easing over the next two quarters. And, let's not forget, the lack of inflationary pressure gives the Fed room to pause and leads many market participants to believe there is room to cut.

A couple tour guides

Now, the question is, "Where are we headed?" Fortunately, we still have some respectable guides to give us some insight. Let's take a current look at a couple of key economic indicators we will be watching closely. But first, let's see what the market thinks about the potential for a Fed cut later this year. As you might expect from recent news, the probability of a Fed easing has climbed steeply over the past few months—from less than 20% chance in the first quarter to almost 100% currently. So, the market is showing good odds of a Fed cut on or before the December 2019 Fed meeting. Let's see what is driving that thought.

> Let's see what the market thinks about the potential for a Fed cut later this year.

Probability of cut by end of 2019



Source: Bloomberg

Inflation

Inflation is always a good guide for market prognosticators. In the second quarter of 2018, it appeared as if the Fed was making progress in attaining their 2% target for inflation as measured by their preferred core price gauge, the Personal Consumption Expenditure Index (PCE). Unlike the better known Consumer Price Index (CPI), the PCE is not the price change of a fixed basket of goods. It is a broader and more nuanced guide of price changes as well as changes in consumers' shopping habits. Hitting the 2% level last March gave the Fed confidence to hike interest rates four times through 2018—from 1.5% to 2.5% (upper bound). However, inflation has fallen quickly from this level over the first half of 2019. The Fed is attributing this decline to transitory factors. Unfortunately, it's not clear what they meant by transitory and how long this transition is expected to last. Why do they say it's transitory? They are looking at a "trimmed" PCE calculated by the Dallas Fed. This trimmed inflation measure throws out certain outliers. It is currently at 2.0% for the 12-month period and has not declined like the un-trimmed PCE.[1]

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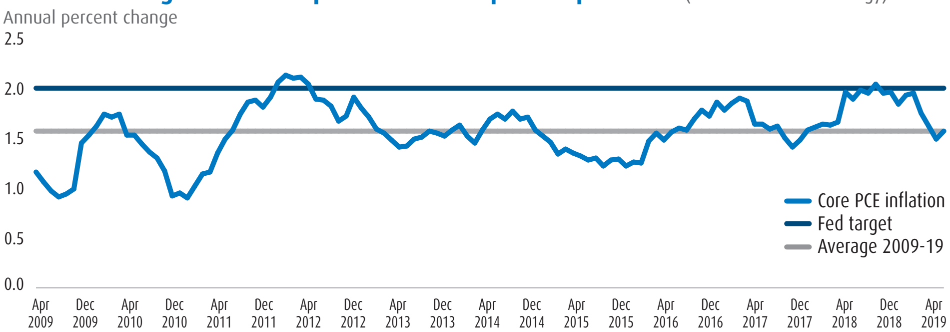
Annual % change in U.S. core personal consumption expenditure (excludes food and energy)



Source: Bloomberg

Perhaps a more important measure of inflation for investors to watch is wage inflation. The tight labor market is starting to push up wage inflation as measured by changes in average hourly earnings. Annual wage inflation has increased strongly, from 2.6% to 3.4% over the past year. This could feed into consumer prices directly from increased production costs or from stronger consumer buying power, i.e., increased demand. This has yet to occur, but the Fed continues to look for signs of wage-driven inflation.

Curve inversion

The bond market's historic recession indicator is an inverted curve where short-maturity bonds yield more than longer maturities. Many articles have highlighted this relationship after the first inversions earlier this year. Some have argued that a curve inversion, in this new world of global quantitative easing and extremely low and negative interest rates, is not a reliable predictor of a recession. That remains to be seen, but it does highlight investor angst over future economic growth. Last year, the 10-year yield was about 100 basis points (one percentage point) higher than the yield of a three-month bill. Now, it's about 22 basis points lower in yield, the first time since 2007. The longer the curve remains inverted, the more concerned we will be about a potential recession.

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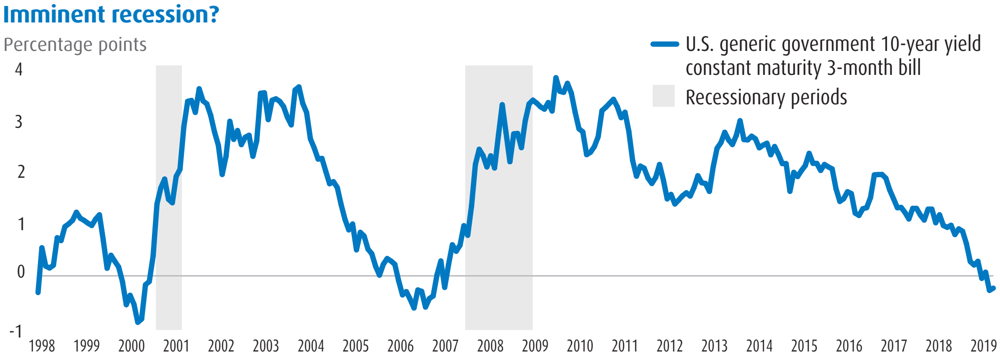
Imminent recession?



Source: Bloomberg

[1] For more reading on the Trimmed Mean PCE please see https://www.dallasfed.org/research/economics/2019/0528.aspx

Continued

One thing an inverted yield curve may help spur is a preemptive cut by the Fed, or what the media has been calling an insurance cut. Market expectations for a rate cut shot up in early June after Fed Chairman Powell stated the Fed is standing ready to cut rates if the economic outlook deteriorates on trade concerns. With low global rates and the expectation of a rate cut, it's hard to see a major correction higher in bond yields. We would need a number of economic surprises to the upside.

What we expect

There are many other indicators we could discuss to help guide us on the strength of the economy and the Fed's next move. If inflation continues to decline, we are more likely to see a rate cut in the next couple meetings. If it creeps higher and does prove to be transitory, we will likely see the Fed stop talking up rate cuts. As for the inversion in the Treasury curve, its indicative of the market's belief that the economy is slowing and that the Fed will have to cut rates. The curve has not been inverted long enough to predict a recession, but the clock is ticking. Other recent insights:

- Second quarter growth will be weak; the Atlanta Fed's GDPNow 2Q forecast is currently 1.5%.
- Wage inflation will continue to increase with the tight job market. This will feed into core price inflation measures, the question is at what speed this will occur.
  - The counter argument is that globalization and automation are containing prices.
- With inflation consistently below the Fed's 2% target, they are concerned that consumers and businesses don't believe the Fed will hit its target, i.e., inflation expectations will fall, which can become a self-fulfilling prophecy. This is also a motivation for the Fed to cut in the near future.
- Talk of further tariffs—like the President threatening Mexico due to immigration—will tend to keep bond yields suppressed.
  - Almost 5 million U.S. jobs are tied to trade with Mexico. Slowing that trade flow will impede growth.
  - Threats of tariffs are now being used for non-economic reasons; who's next?
- While housing price gains will continue to slow, we should see improvements in housing sales.
  - Mortgage applications are at multi-year highs due to falling rates, which are down almost 1% from last year.
- The U.S. economy added 75,000 jobs in May with the unemployment rate steady at 3.6%.
  - Still growth, but a miss from expectations of adding 175,000 jobs with March and April downward revisions as well.
  - The timing of this expectations miss is pushing bond yields lower and giving the Fed additional impetus to cut rates to help soften the U.S. slowdown.

Ultimately, we have to say that a rate cut over the next two months appears likely. Mostly from an "insurance" standpoint. The Fed wants to increase inflation expectations and is willing to let inflation move above their 2% target. A rate cut at this time would help that and support a nervous equity market. The Fed will have a tricky job messaging their intentions to a jittery stock market in the coming weeks and at their June meeting. We expect bond prices to remain firm and trade sideways as multiple cuts are already priced into the market.

Muni market performance

With quickly falling bond yields year-to-date, it's no surprise that municipal bonds are having a very strong year. The Bloomberg Municipal Bond Index returned 4.71% through the end of May. With yields dropping across the curve, the highest returns were on the long-end of the curve. Bloomberg's 1-15 year Muni Blend Index returned 3.97%, handily beating the shorter 1-5 year Muni Blend Index that returned 2.01%.

While much of the positive move in muni bonds is attributable to falling Treasury yields, munis also benefited from unusually strong demand, as high income investors saw the negative effect of State and Local Tax (SALT) deductibility limitations on their 2018 income tax payments. Investors, particularly in high tax states like California and New York, sought out munis as a tax haven. Municipal bond funds and ETFs have seen nearly $45 billion in inflows through May per ICI data. This historically strong demand combined with below average supply of new municipal issuance has pushed performance beyond that of U.S. Treasurys. The Bloomberg Municipal Bond Index return of 4.71% easily beat the U.S. Treasury Index return of 4.22% through May.

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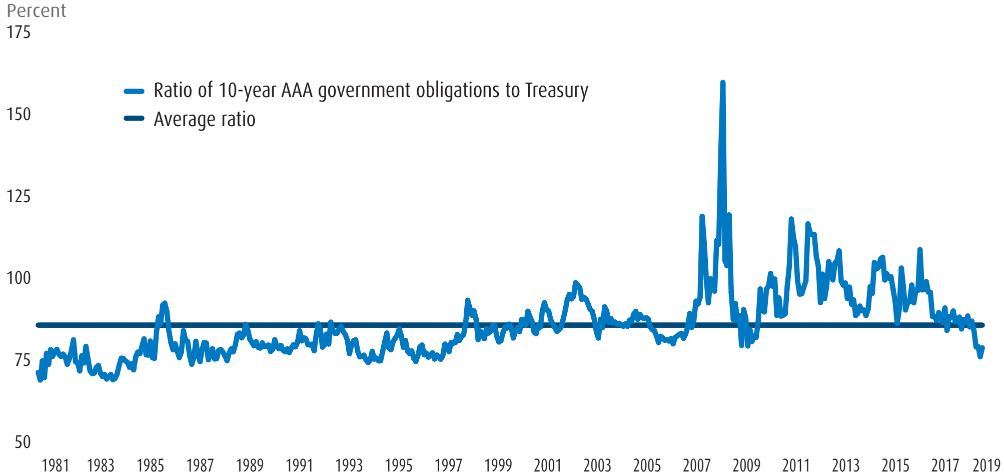
Continued

This demand for municipal bonds has driven the relative value for munis to rich levels versus other fixed income products. The 10-year AAA muni is currently yielding 77% of a 10-year Treasury bond. Last year, it yielded 85% of the Treasury yield. This richening of munis has occurred across the various maturities of the curve. While 77% is much richer than levels we've seen since the financial crisis a decade ago, it is in line with typical ratios in the 1980s and 90s. With the impact SALT had on muni demand and individual income tax rates still relatively high, we would not be surprised to see ratios settle in around recent rich levels.

> This richening of munis has occurred across the various maturities of the curve.

Muni yield as % of treasury yield



Source: The Municipal Market Monitor (TM3) from Thomson Reuters

Positioning

Duration

- Longer duration versus the benchmark.
- Tariffs and slowing global growth weighing heavily on U.S. markets.
- Fed Bank of Atlanta's running GDP estimate is currently tracking 1.5% for 2Q.
- Market implied probability of a Fed easing by the end of 2019 is basically 100%.
- Core PCE inflation remains less than the Fed's 2% target.
  – Wage inflation measured by average hourly earnings remains above 3% and may eventually feed into core price increases.

Yield curve

- Continue to reduce floating-rate note exposure and using proceeds to buy fixed-rate.
- We continue to favor intermediate maturity bonds with good roll returns projected over the next year.
- Bank holdings of long municipal bonds continue to decline on reduced corporate income tax rate but has not significantly impacted muni bond prices.
- The weekly municipal floating rate index (SIFMA) is 1.40% (6/5/2019) versus 1.33% last year. This has dropped significantly from an April tax-time spike of 2.30%. We expect the rate to drift lower in the coming weeks.

Credit and structure

- Growth in Q2 will likely mark a drop from 3.1% in Q1. Fed actions could determine the difference between a hard or soft landing.
- Paying for unfunded pension liabilities and other post employment benefits (OPEB) continues to weigh on municipalities.
- We continue to hold our credit over-weight, but remain selective in BBB purchases.

Geography and sector

- We currently favor airport bonds, transportation bonds and smaller general obligation deals that come to market as non-rated but we rate investment grade and AMT bonds.
- We are more selective in higher education and health care.
- Climate change impacts and environmental, social and governance (ESG) are becoming more important in fixed income analysis. We will discuss in more detail in credit comments in the near future.
- A recent ruling in the Puerto Rico "bankruptcy" may have a negative impact on the municipal revenue bond sector. An appeals court ruling upheld the thought that special revenues in a Chapter 9 bankruptcy filing are not required to flow to the bondholders at the option of the obligor. We will discuss this more in a special credit comment.

Continued

Performance

Fund performance as of May 31, 2019

Fund/Index	Share class	Inception date	Ticker	Returns as of May 31, 2019 (%) 1-month	YTD	1-year	3-year	5-year	10-year	Since inception	Returns as of March 31, 2018 (%) Q1	1-year	3-year	5-year	10-year	Since inception	Expense ratios (%)[1] Gross	Net
BMO Ultra Short Tax-Free Fund[2]	A NAV	05/27/14	BAUSX	0.12	0.71	1.45	1.05	0.76	—	0.99	0.46	1.40	0.99	0.75	—	0.98	0.62	0.55
BMO Ultra Short Tax-Free Fund[2]	A OFFER[3]			-1.92	-1.35	-0.62	0.36	0.35	—	0.78	-1.60	-0.67	0.30	0.33	—	0.77		
BMO Ultra Short Tax-Free Fund[2]	I	09/30/09	MUISX	0.14	0.81	1.71	1.27	1.01	—	1.23	0.52	1.65	1.25	1.00	—	1.22	0.37	0.30
Blended Benchmark[4]				0.24	0.88	1.74	0.95	0.70	—		0.55	1.62	0.87	0.65	—			
BMO Short Tax-Free Fund[2]	A NAV	05/27/14	BASFX	0.44	1.51	2.43	1.41	1.44	—	1.65	0.92	2.18	1.27	1.48	—	1.60	0.67	0.55
BMO Short Tax-Free Fund[2]	A OFFER[3]			-1.59	-0.55	0.35	0.72	1.02	—	1.34	-1.13	0.11	0.58	1.07	—	1.28		
BMO Short Tax-Free Fund[2]	I	11/29/12	MTFIX	0.45	1.58	2.68	1.56	1.59	—	1.82	0.95	2.34	1.42	1.65	—	1.77	0.48	0.40
Bloomberg Barclays Short (1-5 Year) Municipal Index				0.65	2.01	3.40	1.52	1.40	—		1.33	3.02	1.36	1.38	—			
BMO Intermediate Tax-Free Fund[5]	A NAV	05/27/14	BITAX	1.20	3.86	5.00	2.44	2.99	4.17	4.34	2.30	3.99	2.21	3.10	4.31	4.31	0.55	0.54
BMO Intermediate Tax-Free Fund[5]	A OFFER[3]			-2.35	0.24	1.36	1.23	2.25	3.80	4.19	-1.25	0.38	0.99	2.36	3.94	4.16		
BMO Intermediate Tax-Free Fund[5]	Y	02/01/94	MITFX	1.20	3.85	5.00	2.44	2.99	4.17	4.34	2.30	3.98	2.21	3.10	4.31	4.30	0.55	0.54
BMO Intermediate Tax-Free Fund[5]	I	12/27/10	MIITX	1.22	3.96	5.24	2.68	3.22	4.34	4.40	2.37	4.22	2.44	3.35	4.47	4.37	0.30	0.30
Bloomberg Barclays U.S. 1-15 Year Blend Municipal Bond Index				1.21	3.97	5.87	2.57	2.95	3.80		2.52	5.09	2.31	3.05	3.84			

Returns as of May 31, 2019	Returns as of May 31, 2019 (%) 1-month	YTD	1-year	3-year	5-year	10-year	Returns as of March 31, 2019 (%) Q1	1-year	3-year	5-year	10-year
Bloomberg Barclays U.S. 1-10 Year Blend Municipal Bond Index	1.09	3.44	5.29	2.25	2.47	3.27	2.21	4.63	1.99	2.54	3.28
Bloomberg Barclays U.S. Municipal Bond Index	1.38	4.71	6.40	2.97	3.58	4.58	2.90	5.38	2.71	3.74	4.72

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, 2019 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.

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Market data for the journey

Valuation data as of May 31, 2019

AAA yields (%)

Year	Current	Change 1-month	Change 3-month	Change 1-year
2	1.39	-0.18	-0.19	-0.36
5	1.42	-0.21	-0.25	-0.57
10	1.65	-0.21	-0.45	-0.76
30	2.32	-0.23	-0.66	-0.55

Source: InvestorTools® Perform

Cross-market values (%)[1]

Year	Current (1-year averages) Muni/treasury	Current (1-year averages) Muni/corporate
2	72 (66)	63 (65)
5	74 (72)	64 (68)
10	78 (82)	62 (72)
30	90 (97)	71 (81)

Sources: InvestorTools® Perform and Bloomberg

Yield curve data as of May 31, 2019

Slope changes (%)

	Current	Change 1-month	Change 3-month	Change 1-year
Wkly - 2s	0.50	0.88	0.32	-0.36
2 - 5s	-0.50	-0.21	-0.25	-0.57
2 - 10s	0.26	-0.03	-0.26	-0.40
2 - 30s	0.93	-0.05	-0.47	-0.19

Source: InvestorTools® Perform

Performance by maturity (%)

Year	1-month	3-month	1-year
3	0.65	1.10	3.40
5	1.08	1.82	4.93
10	1.50	3.29	7.28
22+	1.80	5.27	7.65

Source: Barclays Point

Credit data as of May 31, 2019

Current rating spreads (%)[2]

Year	Current (1-year averages) AAA–A	Current (1-year averages) AAA–BBB
2	0.12 (0.19)	0.42 (0.48)
5	0.29 (0.37)	0.61 (0.70)
10	0.33 (0.45)	0.67 (0.81)
30	0.40 (0.49)	0.70 (0.82)

Source: InvestorTools® Perform

Performance by quality (%)

Rating	1-month	3-month	1-year
AAA	1.20	2.88	5.88
AA	1.30	3.17	6.11
A	1.46	3.67	6.79
BBB	1.94	4.60	8.02

Source: Barclays Point

BMO Funds Tax-Free Suite

Fund name	Ticker Class A	Ticker Class Y	Ticker Class I	Ticker Premier Class
BMO Tax-Free Money Market Fund	—	MTFXX	—	MFIXX
BMO Ultra Short Tax-Free Fund	BAUSX	MUYSX	MUISX	—
BMO Short Tax-Free Fund	BASFX	MTFYX	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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All investments involve risk, including the possible loss of principal.

Fixed income securities are subject to increased loss of principal during periods of rising interest rates. Fixed-income investments are subject to various other risks including changes in credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications, and other factors. All of these factors can subject the funds to increased loss of principal.

Keep in mind that as interest rates rise, prices for bonds with fixed interest rates may fall. This may have an adverse effect on a Fund's portfolio.

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.

You could lose money by investing in the Fund. Although the Fund seeks to preserve the value of your investment at $1.00 per share, it cannot guarantee it will do so. The Fund may impose a fee upon sale of your shares or temporarily suspend your ability to sell shares if the Fund's liquidity falls below required minimums because of market conditions or other factors. An investment in the Fund is not a deposit of BMO Harris Bank N.A., or any of its affiliates, and is not insured or guaranteed by the FDIC or any other government agency. The Adviser has no legal obligation to provide financial support to the Fund, and you should not expect that the Adviser will provide financial support to the Fund at any time.

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 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.

The S&P 500® Index is an unmanaged index of large-cap common stocks.

Investments cannot be made in an index.

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