Editor’s Note: This commentary was contributed by Colleen Meehan, director of Municipal Money-Market Fund Strategies for BNY Mellon Cash Investment Strategies, a division of The Dreyfus Corporation. She manages the Dreyfus national and state-specific tax-free MMF portfolios and is a member of the iMoneyNet Advisory Board.

Tax-exempt money-market funds recently have shown renewed vigor after several years of lackluster yields in a persistently low interest-rate environment.

The Securities Industry and Financial Markets Association index, a weekly high-grade market index from Bloomberg LLP that is composed of seven-day tax-exempt variable-rate demand notes has increased steadily from 0.01 percent at the beginning the year to as high as 0.87 percent on Oct. 3. The year-to-date average for the SIMFA index is 0.39 percent, which compares very favorably to the 0.05 percent average for 2015.

Meanwhile, yields of one-year municipal notes have climbed more moderately from 0.62 percent at the start of 2016 to 0.78 percent on Oct. 24, according to the S&P Municipal Bond 1-Year High Grade Rate Index. As a result, the yield curve has flattened considerably for tax-exempt instruments in the overnight-to-one-year range, enabling VRDNs to provide attractive yields for high-quality, liquid assets.

At these levels, the SIMFA year-to-date average is providing 93 percent of the LIBOR year-to-date seven-day average. Although tax-equivalent yields vary across individual and corporate tax brackets, highly liquid, high-quality municipal money-market instruments currently provide even more robust real returns when their tax advantages are considered. Furthermore, we expect municipal money-market yields to remain attractive compared to taxable money-market securities with comparable maturities and similar credit ratings.

Clearly, in this constructive environment, municipal money-market funds have an important role to play in the portfolios of both institutional and individual investors. Now that the uncertainty surrounding money-market reform has passed, we fully expect assets to flow back into highly-liquid municipal money-market funds, especially in light of their currently attractive yields compared to taxable government money-market funds.

What is behind the impressive rise in tax-exempt money-market yields? In a few words: supply and demand.

The months leading up to the Oct. 14 money-market-reform compliance date saw substantial outflows of assets from municipal money-market funds. In the aggregate, assets in tax-exempt money-market funds have declined from $254.2 billion at the start of 2016 to $129.2 billion as of Nov. 8, a reduction of 49 percent.

With fewer assets to invest, demand for variable-rate demand notes has fallen significantly. Yet the supply of floating-rate tax-exempt instruments has remained relatively steady. In fact, the volume of outstanding VRDNs currently exceeds total assets under management by municipal money-market funds. This supply-and-demand imbalance has put upward pressure on current yields of floating-rate instruments.

Based on our analysis, municipal money-market funds have maintained historically short liquid portfolios in light of reform-related asset outflows and current uncertainty regarding the U.S. elections and the timing of expected short-term interest-rate hikes by the Federal Reserve’s Federal Open Market Committee. Even so, demand for one-year municipal notes has remained strong from separately-managed accounts, intermediate-term bond funds and long-term bond funds, which have experienced significant asset inflows. Robust demand from these crossover buyers has caused the yield curve to flatten between one year and five years, making one-year notes very attractive to this segment of the market. VRDNs also have been subject to greater demand from crossover buyers due to their attractive yields and

### VRDNs AND THE ATTRACTIVENESS OF MUNICIPAL MONEY-MARKET FUNDS

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strong liquidity features.

Furthermore, fiscal conditions for tax-exempt issuers generally remain favorable, as municipal credit quality appears to have stabilized after years of gradual improvement since depths of the 2008 recession. This is particularly evident at the state government level, where replenished rainy-day emergency funds provide a cushion against future economic downturns. In addition, tax receipts for most states have surpassed pre-recession levels, enabling them to balance their operating budgets or achieve budget surpluses.

For more information, please reach out to your BNY Mellon Fixed Income Sales representative or call our Institutional Servicing group at 1-800-346-3621.

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