State of the Municipal Bond Market

A Reversal of Fortune

Financial markets have suffered tremendous volatility in the wake of the COVID-19 pandemic, and the $3.9 trillion municipal market[1] is no exception. After a strong 2019 and healthy January and February 2020, the municipal market suffered investor panic in March with the dramatic impact of the coronavirus and widespread lockdowns. Credit spreads widened as investors sold off high quality assets to raise liquidity. The municipal market is much smaller and typically less liquid than taxable bond markets; as such, this lack of liquidity was exacerbated by volatile market conditions. Nevertheless, the Coronavirus Aid, Relief and Economic Security (CARES) Act and the Federal Reserve stimulus programs have helped the municipal market return to some semblance of normalcy. Municipalities are suffering significant revenue shortfalls as economic growth falters and the economy has come to a standstill during the stay at home order. The risk of downgrades has increased, but the sector has been historically safe and resilient, and defaults have been extremely rare. Most state statutes and public entity investment policies permit the purchase of municipal securities, and the asset class provides an opportunity to diversify portfolios. However, investors must proceed cautiously, and credit analysis is more critical than ever.

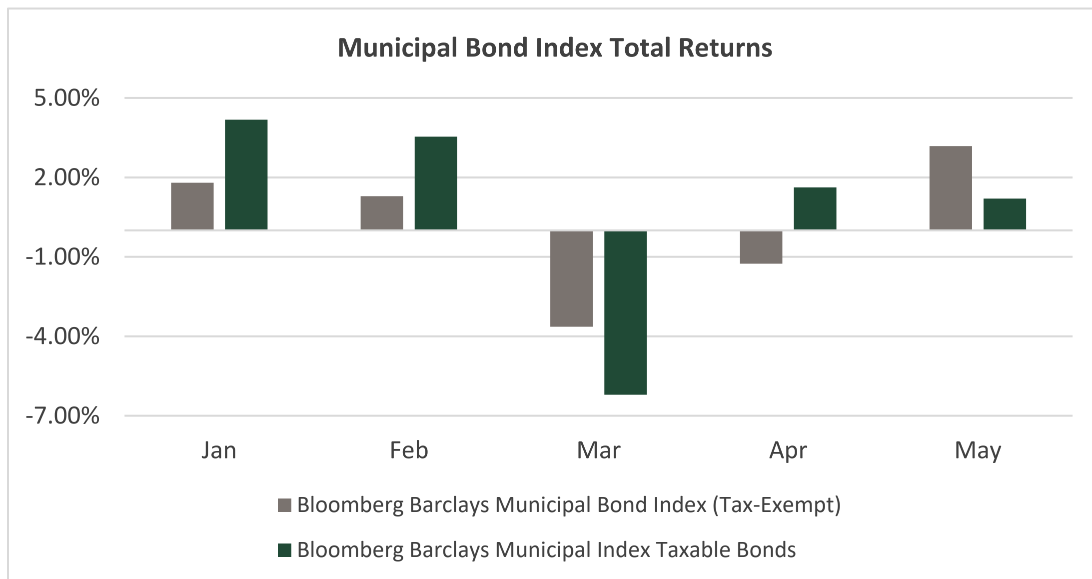
Municipal bonds delivered healthy returns in 2019 and early 2020 prior to the pandemic. Tax-exempt municipals had a strong year in 2019 with returns of 7.5%, and taxable municipal bonds returned 11% over the same period, according to the Bloomberg Barclays Municipal Bond Indices. Tax policy changes were the primary driver of tax-exempt municipal performance; slowing global growth, trade war concerns, FOMC rate cuts, and a flight to quality also contributed to the strength of the sector.

The Tax Cut and Jobs Act of 2017 caused dramatic changes affecting the municipal bond market. The 10% limitation on State and Local Tax (SALT) deductions fueled demand for tax-exempt securities, particularly from investors in high tax states such as California and New York. Additionally, tax-exempt advance refundings were eliminated as a vehicle for municipalities to realize debt service savings by refinancing higher cost debt. However, since taxable rates declined so dramatically, issuers could execute advance refundings with taxable debt, which is permitted under tax law. Historically, this structure has not provided savings since taxable debt typically carries higher rates than tax-exempt debt; however, in this environment, the rates are so low the savings can be substantial. This dynamic supplemented taxable supply before the market was disrupted by the pandemic, and still provides an opportunity for issuers in the current market.

As the extreme volatility of financial markets began to dominate the investment landscape in early 2020, the sector experienced more flight to quality and declining yields, resulting in a 3.1% return in the first

[1] Source: Bloomberg

two months of 2020, with an even stronger 7.9% return for taxable municipal bonds, according to Bloomberg. However, the trend reversed sharply in mid-March as shelter in place orders were implemented. Panic ensued with an astounding selloff in municipal bonds and other high-quality assets as investors attempted to raise liquidity. Municipal market depth and liquidity were severely impaired. However, the Federal Reserve stepped in with unprecedented speed and magnitude to bring immediate stabilization to the market. The Fed's Municipal Liquidity Facility provides up to $500 billion in lending to states and large municipalities via debt security purchases. The population threshold for the program was lowered from two million residents initially to 500,000 for counties and from one million residents to 250,000 for cities. The program was just expanded to include smaller borrowers and issuers with revenues resulting from activities such as public transportation and utilities. Pricing will be at a fixed rate based on swap rates plus a spread, ranging from 150 basis points for AAA/Aaa-rated notes to 590 basis points for credits below investment grade. Additionally, the Fed reinstated the Money Market Mutual Fund Liquidity Facility in order to provide liquidity to the commercial paper, money markets, and the short-term municipal bond markets. As previously stated, fiscal stimulus arrived with historic magnitude in the $2 trillion CARES Act, signed on March 27th, which directs $150 billion to state and local governments. Municipal market returns fell sharply in March and began to recover in April as the stimulus programs stabilized the market.



Source: Bloomberg

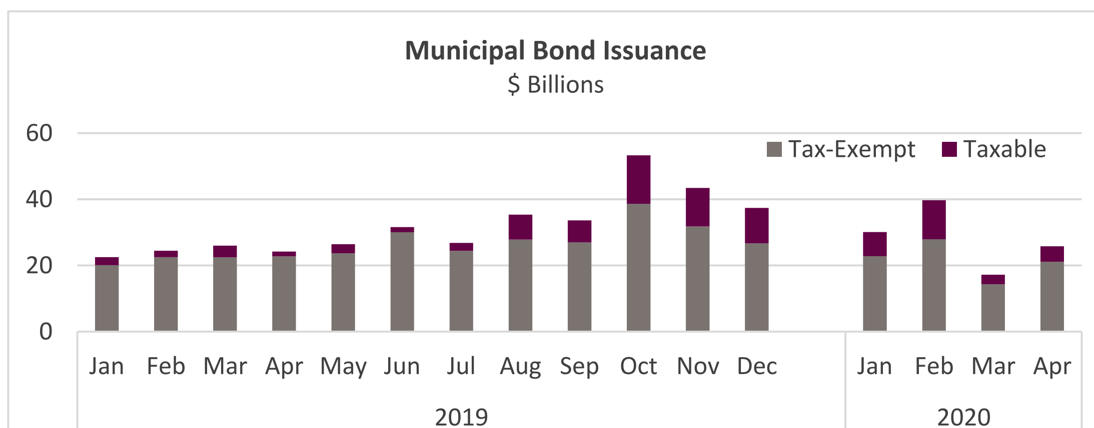
Discussions for additional stimulus are continuing in Washington, but the outcome is uncertain at this time. According to Moody's, state and local governments may need additional aid of approximately $500 billion to make it through the next two fiscal years without having to make substantial budget cuts or tax increases. U.S. states currently have no legal avenue to declare bankruptcy and the likelihood of that changing is minimal; however, another round of federal aid for states and local governments is potentially more realistic.

Supply

Although municipal securities are permitted by most state statutes and investment policies, short-term, high quality paper has been difficult to source due to limited supply. If you have tried to purchase taxable municipal bonds in the last few years, you probably experienced the "feeding frenzy" of heavily oversubscribed deals. However, ultra-low rates and taxable advance refundings caused supply to spike in 2019. In fact, according to SIFMA, $67.3 billion of taxable municipal bonds were issued in 2019, compared to an average of $36.5 billion annually over the last ten years, and $37 billion was issued in the fourth quarter of last year alone. Taxable munis accounted for 17% of the total market last year and 24% so far in 2020, by far the highest since the advent of Build America Bonds in 2010. Refunding issuance ramped up to $159 billion in 2019, an increase of over 50% from 2018, and refundings are up 57% year-over-year through April 2020. Issuance in 2020 reached around $70 billion by the end of February (up about 50% over 2019) but dropped off significantly in March as the coronavirus began to cripple the market and the economy. Issuance began to recover to historically normal levels in April; taxable issuance is still up 187% year-over-year through April even with the steep decline in March. The market has been poised for increased supply from taxable advance refundings, but many deals have been on hold due to Illiquidity, widening spreads, and budget cuts. Most large deals are still reflecting "day to day" status, dependent on market conditions. Scarcity still exists for investors but return of fund inflows and demand should allow more deals to come to market. Additionally, municipalities may utilize the capital markets to fund revenue shortfalls.

Demand

In 2019 and early 2020, municipal funds exhibited positive flows for over 60 weeks amounting to over $100 billion, according to ICI. Tax policy changes, slowing global growth and trade war concerns contributed to a flight to quality, including municipals. Additionally, the sector has experienced growing demand from international investors as negative yielding sovereign debt grew to approximately $17 trillion[2] at its peak and investors hunted for safe haven securities. However, this trend reversed abruptly in mid-March as the market realized the severity of COVID-19. Investors responded with significant outflows, adding liquidity pressure to the market. After six weeks of outflows, demand began to recover in mid-April after the Fed stepped in to facilitate market liquidity.

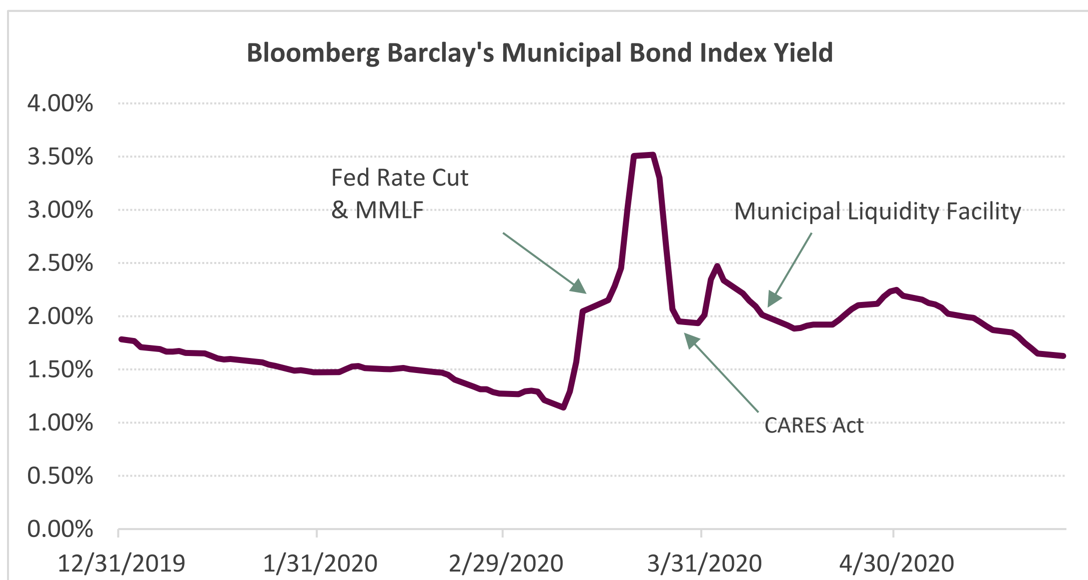


Source: SIFMA

[2] Source: Bloomberg

Relative Value

If investors allocate a portion of the investment portfolio to high grade taxable municipal bonds, relative value must be evaluated. Is the investor being compensated for assuming incremental credit risk? Spreads on taxable municipal bonds were historically narrow prior to the pandemic. This was due to both high demand and limited supply along with healthy credit metrics. As the COVID-19 crisis developed in March, spreads widened dramatically and yields surged, breaking records for the magnitude of change in such a short period of time. After the stimulus programs were announced, spreads and yields recovered with equal speed, but remain elevated relative to pre-pandemic levels. The Fed's Municipal Liquidity Facility and Money Market Liquidity Facility (MMLF) have made a meaningful impact to the liquidity and functioning of the municipal market.



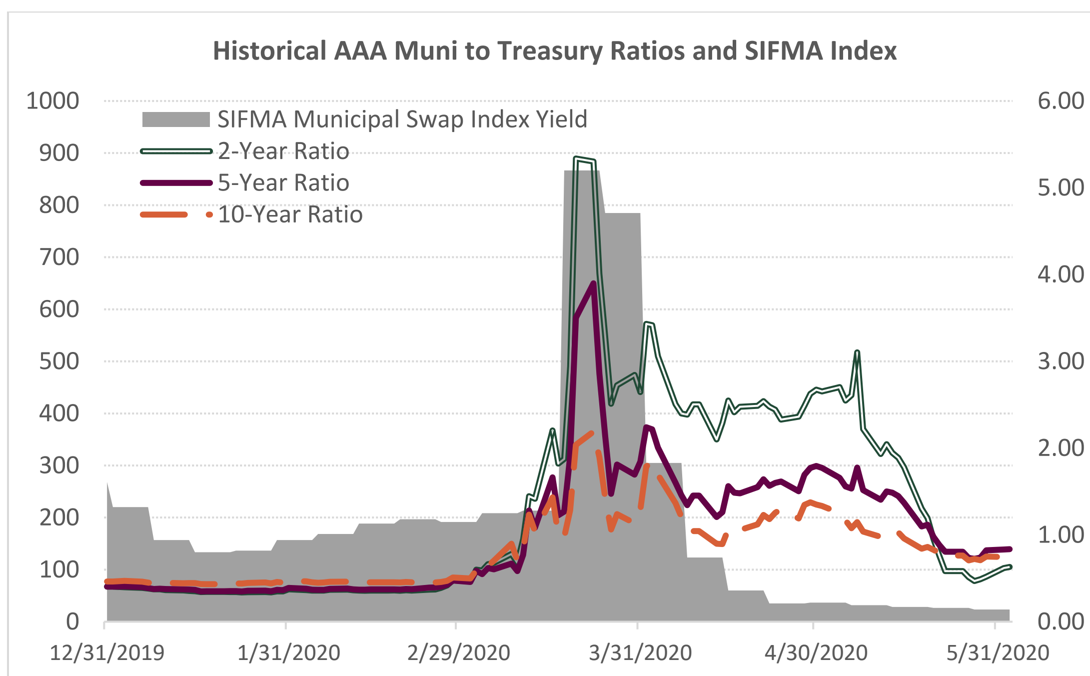
Source: Bloomberg

Higher rated bonds outperformed lower rated credits during the crisis. For example, according to Bloomberg, the State of Utah, rated AAA/Aaa/AAA by S&P/Moody's/Fitch issued approximately $450 million of general obligation debt, with 5-year bonds trading at 0.75%, which was slightly lower than the AAA benchmark. In contrast, Illinois, rated BBB-/Baa3/BBB- by S&P/Moody's/Fitch, issued $800 million general obligation debt in the same mid-May timeframe, with 5-year debt trading at a yield of 5.60%.

Additionally, weekly reset rates on variable rate demand notes (VRDNs) spiked to levels not seen since 2008. Some high-quality issues even reset at double-digit levels. After tracking at an average of 0.93% over the last 5 years, the SIFMA municipal bond index surged to 5.20% on March 18th before returning to normal levels after the Fed announced they would buy investment grade municipal debt including VRDNs. SIFMA reset at 0.14% on May 27th.

Municipal bond ratios also surged during this period and remain elevated relative to historical averages. The ratio of tax-exempt to taxable yields should theoretically equal (1 - highest marginal tax rate) or (1 –

37%) = 63%. However other factors affect the ratio, such as supply and demand and absolute rate levels. When rates fall, ratios tend to rise due to fixed fees on funds and absolute rate levels, resulting in yield compression. While tax-exemption is irrelevant for public entity investors, when ratios rise over 100%, valuations become attractive since municipal bonds provide a higher yield than treasuries. In fact, in this environment, some municipals have even exceeded yields on AA-rated corporate notes. According to Bloomberg, the 10-year AAA Municipal Bond Yield has averaged approximately 90% of the 10-Year US Treasury since 2005. The ratio jumped from 83% at the beginning of March to a peak of 365% on March 23rd. Current 2-year, 5-year, and 10-year ratios as of June 2nd, 2020 are 105%, 139%, and 123% respectively.



Source: Bloomberg Indices: BVAL AAA Muni Yield % Treasury 2 year, 5 year, 10 year

Credit Selectivity

From a credit perspective, the sector has been historically safe and defaults have been extremely rare. The municipal market has a long history of functioning through downturns. Thankfully, most sectors were relatively healthy prior to the pandemic. Municipalities are suffering revenue shortfalls as economic growth falters and many have started to implement layoffs and furloughs; however, many state and local governments have built substantial reserves and liquidity since the 2008 Financial Crisis. However, not all municipal credits are created equal; the financial impact of the pandemic and the resilience of the entity will vary within the sector. The ultimate damage to municipal finance depends on the duration of the crisis and the depth of the recession, along with the entity's revenue mix and the extent of federal aid.

On a state level, budgets are starting to feel the impact. States have begun to release projected tax revenue shortfalls, with many expecting double digit percent declines. According to Moody's, the average state will see about one fifth of its budget disappear by the end of fiscal year 2021, which is nearly twice

the level of fiscal shock seen by the average state during the entirety of the Great Recession. According to Bloomberg, California has estimated shortfall of $35 billion, New York expects a $10 billion deficit and Illinois is looking at a $2.7 billion revenue decline this year and a $4.6 billion budget gap in fiscal year 2021. Federal tax collections have been delayed three months, adding to budget gaps, and California has given businesses up to a year to gradually remit the sales taxes they collect from customers. Florida sales tax collections were down almost $600 million in April, according to the state Office of Economic & Demographic Research. Three states have been downgraded by the rating agencies so far: Alaska was downgraded by S&P to AA- and by Fitch to A+ due to reliance on oil and gas revenues. New Jersey was downgraded by Fitch to A-, and Illinois was downgraded by Fitch to BBB-, all with negative outlooks.

A thorough analysis of the credit metrics is required to select the credits with the highest financial strength, flexibility and resiliency to weather the storm.

Analyzing and carefully selecting municipal credits for your portfolio is always important, but more critical than ever in this market environment. On April 1, 2020, S&P placed all US public finance credits on negative outlook. Moody's and Fitch have been more specific relative to sectors. Ratings are only a starting point for determining compliance with your investment policy and state statute. A more thorough analysis of the credit metrics is required to select the credits with the highest financial strength, flexibility and resiliency to weather the storm.

- Strong general obligation credits with substantial reserves and diverse economies are most likely to perform the best in this environment.
  - Entities dependent upon sales and use tax, lodging and other similar taxes are experiencing steep revenue declines.
  - Municipalities more dependent on property taxes have more stability in the short run, but higher unemployment and recessionary pressures could dampen property tax collections in the longer term.
  - Underfunded pensions will suffer from weak returns and exacerbate the unfunded liability problem.
  - Geographic areas with a significant exposure to the energy industry or tourism may suffer higher levels of unemployment and economic distress.
- Essential service revenue bond credits may be well positioned to weather this storm.
  - Essential services such as water and sewer are natural monopolies with pricing power and the ability to adjust budgets to new economic dynamics. Many entities have agreed not to shut off service due to late payment but maintain ample liquidity to manage cash flow.
  - Risk is higher for transportation-related entities such as toll roads and airports with severely reduced travel.
  - Higher education is also suffering due to lost auxiliary revenues, cuts in state funding, declines in fall 2020 enrollments, and weaker endowment investment performance.
  - Healthcare and nursing homes present higher risk with the increased costs of providing care for COVID-19 patients, lost revenues, and weaker investment income.

Overall, high yield and entities with weaker credit metrics before the crisis are more vulnerable than high grade credits. Staying up in quality should help mitigate risk and position the municipal allocation for better performance.

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Conclusion

Municipal bonds continue to offer an opportunity to diversify portfolios utilizing a historically safe asset class. Careful analysis and caution are paramount in selecting specific issuers that can withstand short-term stress. Look for issuers with strong credit fundamentals prior to the crisis, including healthy liquidity and reserves, diverse revenue sources, and strong management. Additionally, seek credits with lower debt burdens and higher debt service coverage ratios, along with protective covenants. We believe defaults will be rare among high quality issuers. More probable risks include downgrades, covenant violations, and reserve fund draws, although fiscal support and substantial reserves and liquidity are mitigating factors. Careful selection should position the allocation to weather the storm and deliver the benefits of diversification and returns.

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Questions?

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