Municipal Market Comment

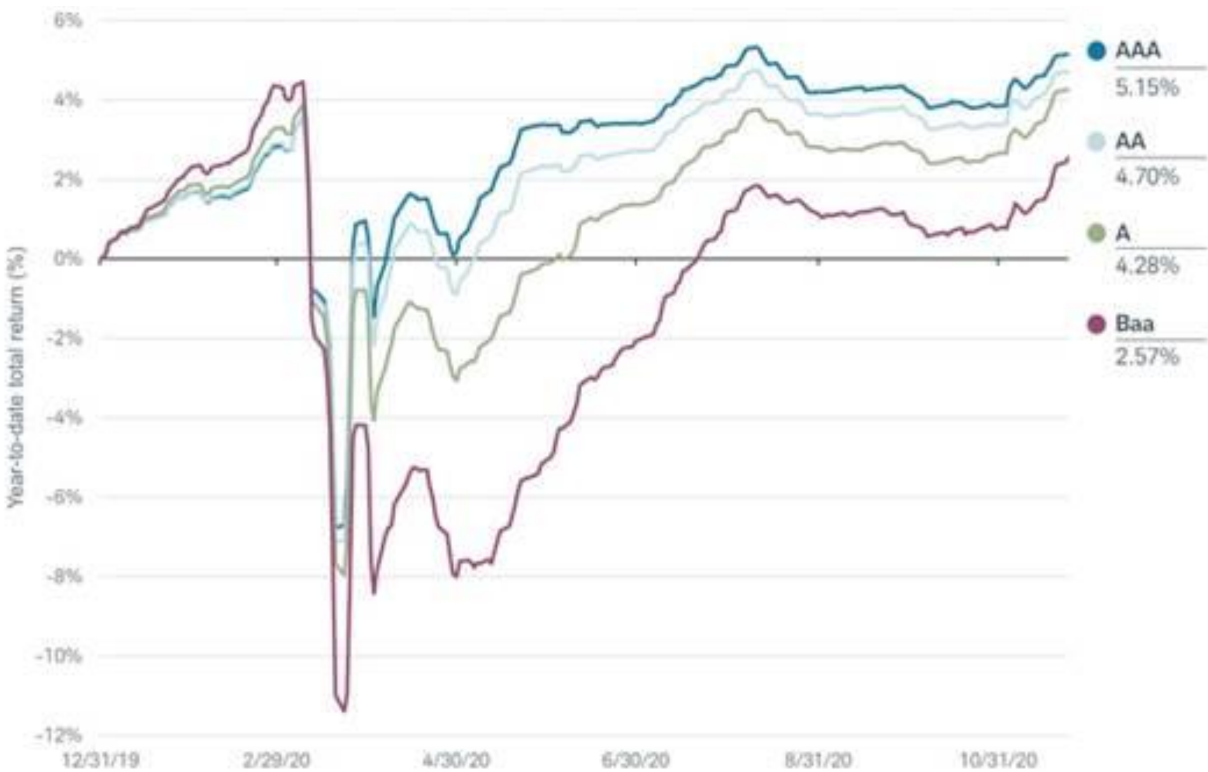
December 2020

Better Than Expected

When Covid struck back in March, the initial outlook for the municipal bond market appeared dire. Economic activity was grinding to a halt. Revenues were plunging for a broad range of issuers Comparisons to the 2008 financial crisis abounded and the expectation was that many would end up in the fiscal abyss. However, the recovery from the Great Recession occurred in the aftermath of significant disruption to the financial system, and in the absence of direct aid to state and local governments. Most municipals issuers entered this crisis in much stronger condition than in 2008. With budget cuts, tax increases, federal assistance from the CARES Act, and better fiscal management, most have weathered the storm and will rebound more quickly this time around.

While municipal issuers have experienced a range of challenges this year, defaults are only up slightly from 2019 and downgrades have been relatively modest. They have been concentrated in non-rated high yield issues, such as senior housing and project financings that were already risky pre-Covid.

Higher quality has outperformed in 2020.



Bloomberg Barclays Total Return Indexes: AAA, AA, A, Baa

Tax Revenue

Early predictions of 25%+ declines in state and local government tax revenue have not materialized. With 47 states reporting, year-over-year state tax revenues are down 2.9% overall. Fourteen states are actually up in 2020! To highlight a few, California reported 1Q FY21 revenue was almost $9 billion ahead of budget due to increased estimated personal income tax payments and corporate income tax collections from accelerated corporate profitability. New York's comptroller expects FY21 tax receipts to be $3.8 billion above the state's midyear FY21 budget revision. Florida reported positive general tax collections under a new budget forecast, The revenue excess is attributed in part to sales tax revenue tied to a release of pent-up demand and escalated consumer spending.

Large city governments have not fared as well as they have experienced the impacts of declines in business activity, tourism and events. Chicago was assigned a negative outlook and New York City was downgraded by Moody’s in October. Tax increases and deep spending cuts are the unfortunate reality and will continue to be in the foreseeable future.

Some local governments with high exposure to sales and income taxes may experience slower recoveries, but most are more reliant on property taxes, which has been a positive as residential real estate values have soared in 2020. The Case-Shiller Index has climbed more than 5% from 2019 levels. Local government budgets will benefit from this increase.

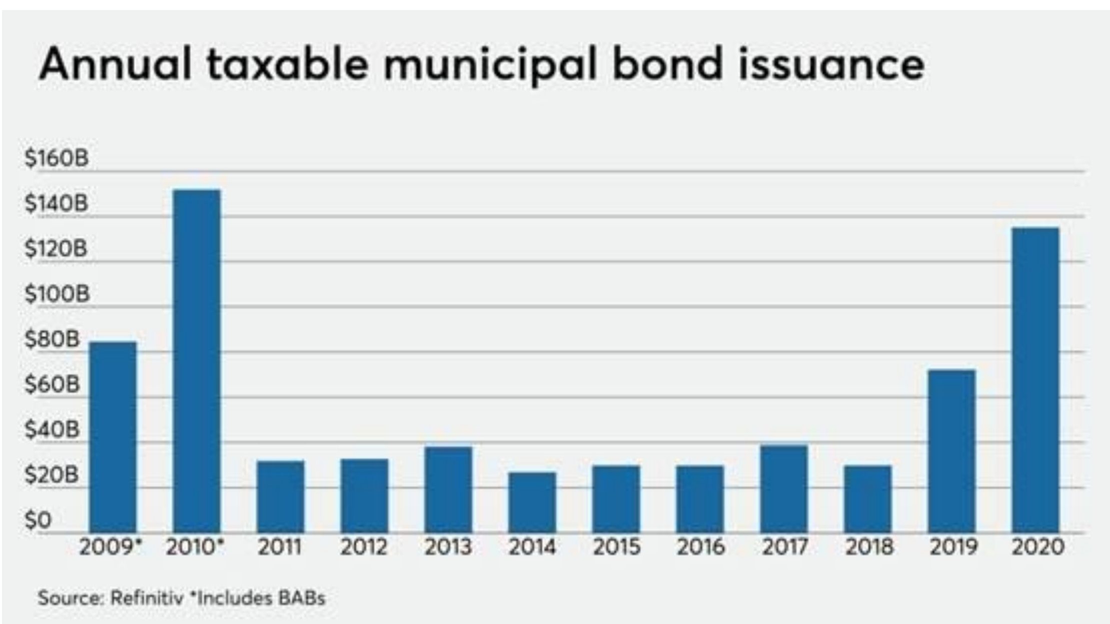
While there may be some intermediate-term growth in defaults for high risk muni sectors such as continuing care facilities and retirement communities, the vast majority of issuers in this asset class are servicing debt in full and on time. States are required to balance budgets and they have many tools available to meet this obligation, including the ability to cut expenditures and raise taxes. The distribution of Covid vaccines and treatments and the subsequent easing of restrictions are likely to be positive for muni credits at the state and local level in 2021. However, the pace may be uneven as certain issuers, such as convention centers, stadiums, and senior housing facilities, will face more headwinds.

MLF

The Municipal Liquidity Facility, which was established to be the lender of last resort for state and municipal issuers at the start of the crisis, is set to expire at the end of the year. Only two cash-strapped issuers have found it necessary to borrow from the facility since its inception, Illinois and New York Metropolitan Transportation Authority. New Jersey and Suffolk County (NY) considered borrowing from the Fed but were easily able to issue bonds in the public markets at a lower interest rate. New Jersey paid only 1% yields for three-year debt. Treasury Secretary Mnuchin's request that the Fed terminate the MLF at the end of the year has had no discernable impact on the broader market.

Taxable Pinnacle

State/Local governments, hospitals, universities, and issuers in every sector participated in an astounding $180B issuance of taxable munis in 2020. This represents a 40% increase in new issue muni supply this year. The increase of taxable muni issuance began late last year. Falling interest rates and the 2017 tax-cut law that eliminated the ability of municipalities to sell tax-exempt bonds for a refinancing process known as advance refunding started the wave. This year's taxable new issue volume spiked even higher as borrowing costs dropped to record lows. Issuers were able to refinance older, higher interest rate tax-free debt with new issue taxable debt at lower rates.



Taxable munis also appeal to overseas buyers, who have become a bigger presence in the market. With yields on much of the world's sovereign debt near zero or in negative territory, foreign investors are attracted to the higher yields and credit quality of taxable municipals versus comparable corporate bonds. Overseas buyers typically buy recognizable high-grade bonds, preferring state GO's and top-tier universities. Approximately 80% of taxable munis are rated AA or better. Taxable munis can also be suitable for IRA's and generally appeal to fixed income investors who do not benefit from the tax-exemption of interest on traditional munis.

Onward 2021

- Despite pockets of economic stress, from a credit perspective the biggest risks are ratings downgrades and spread widening, rather than widespread defaults. Throughout history, municipal credit has been remarkably resilient through a range of economic challenges and we expect the same this time around.

- Essential service utility revenue bonds continue to experience stability, while mass transit, stadiums, airports, and nursing homes face continued challenges. The shakeout in higher education was underway pre-Covid, but the ramifications of remote learning are likely to accelerate the process. Expect credit dispersion within the lower end of the rating spectrum.

- Talk of higher taxes, both individual and corporate, could make tax-free muni income more attractive.

- Federal stimulus, including aid for state and local governments, would alleviate budgetary pressure and provide additional support for at-risk credits.

- The first quarter of 2021 is likely to have lower-than-normal issuance, due to deals that were pulled forward because of election uncertainty, lower rates, and pandemic-related refinancing to lower interest expense

- Taxable munis will continue to constitute a large percentage of primary issuance volume as long as rates stay low, representing a structural change in the municipal market.

- An uptick in economic activity may lead to yield curve steepening. Portfolios with holdings spread across the yield curve rather than long or short duration are well-positioned for this scenario.

Why Munis and Why Riverbend?

- Investors look to municipal bonds for attractive taxable-equivalent yields and low default rates. The muni market provided tax-advantaged income and portfolio diversification throughout 2020. Municipals are a resilient asset class for the long-term.

- This market is highly fragmented, consisting of more than one million outstanding municipal securities. Municipal indexes can overweight unattractive sectors or fiscally challenged state and local issuers in order to replicate market-weighting. A passive, index approach to investing in this asset class may lack credit judgement and miss opportunities.

- Customized and separately managed accounts are structured to take advantage of prevailing market conditions. Our conservative process is designed to identify attractive issues with low default risk and align risk exposures with client investment parameters and objectives.

- We are a boutique fixed income manager focused in the municipal bond market. Our approach is proactive and tactical as we seek to capitalize on market inefficiencies for the benefit of our clients. We customize portfolios according to each client's tax status, risk profile and investment objective, and can accommodate state-specific, taxable, and high-yield mandates.

Please feel free to contact us anytime if you'd like to discuss the topics cited in this update, or any others related to the municipal bond market.

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