



Municipal Comment April 2020

Munis are Boring?

The municipal bond market is often perceived as “dull” but March 2020 was an exciting month for the asset class from an investor’s perspective. Facing an equity market meltdown driven by Covid 19 fears and the rolling economic shutdown, investors engaged in a frenzied grab for both household staples and basic liquidity. The quest for cash affected the muni market in mid-March as investors in large numbers sold tax-exempt bond mutual funds, ending 61 consecutive weeks of positive inflows. Bond fund managers faced more than \$25 billion in redemptions in two weeks. Given the safety and stability of municipals, this selling pressure was a bit unanticipated. However, in down markets one sells the securities that are the easiest to sell. High-grade municipals fit this description.



The muni market also experienced a liquidity mismatch. Bond funds and ETF's can be and *were* sold by holders with a point and click. Unfortunately, on the other side of those redemptions, fund managers were struggling to sell bonds in a falling market to trading desks that already had heavy amounts of municipal paper and who were reluctant to commit capital. The distressed selling resulted in dramatic price action with yields on quality bonds rising 100 basis points or more in three days. Ratios to US Treasury bonds which had been in the 70%-85% range hit astonishing levels of more than 300%. This rapid increase in yield and spread is quite atypical.

March muni madness has subsided over the last few weeks as monetary and fiscal policies were implemented to help counter the downdraft. The Fed stepped in to address market dislocation with liquidity facilities expanding their mandate to purchase short-term muni bonds and to lend to state and local governments. The federal government also passed the CARES Act, making billions available to a host of muni issuers including state and local governments, mass transit authorities, hospitals, airports, school districts, etc. The muni market stabilized in response. Municipal bond fund flows have turned positive, although, these additions are modest. Ratios to UST's remain elevated, but not to the degree that the market experienced in March. New issuance has resumed after a month-long hiatus where issuers held back on pricing deals in the midst of market volatility. Primary market supply is moderate in the \$3 billion per week range as issuers are looking for a continued firming in market tone.

Whither Credit?

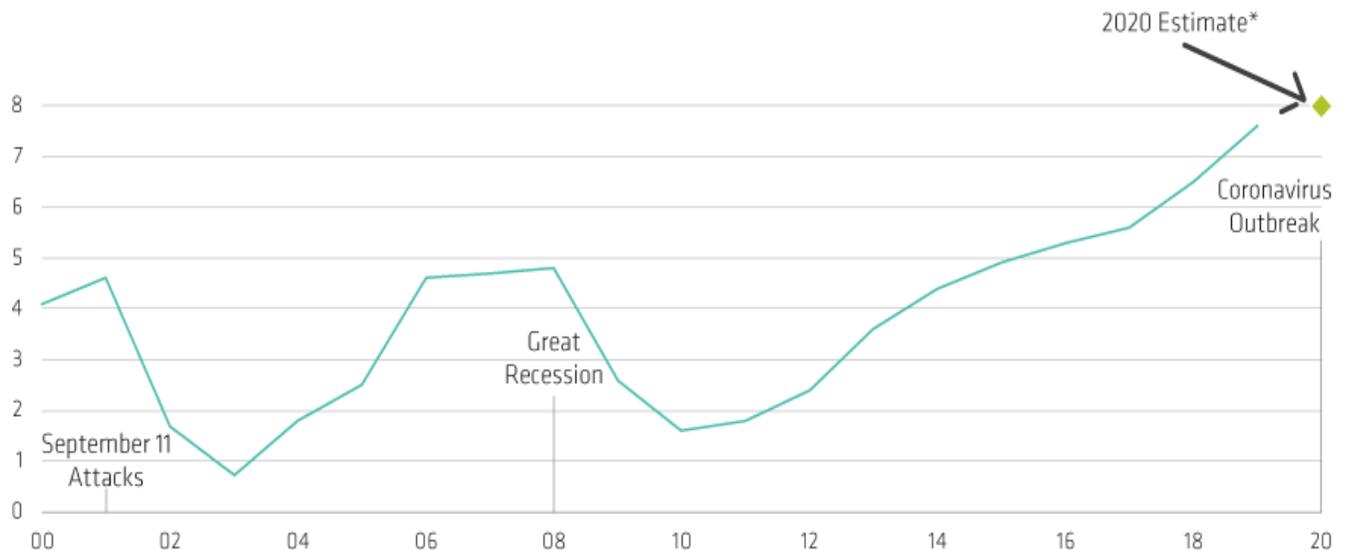
The focus now turns to credit quality as municipal issuers grapple with diminished revenues and the effects of economic shutdown. Various sectors face a range of challenges and will be impacted in different ways. Over the long haul, the municipal market has demonstrated resilience in times of economic difficulty. We expect that most issuers will manage through the Covid-19 crisis, but others will experience a high degree of distress. Credits with strong balance sheets, reserves, and steady cash flows will win the day. We are opportunistic in this market climate, but we will not sacrifice quality to reach for yield.

Go State

The good news is that leading up to the current crisis, state and local governments experienced ten years of approximately 3% annual revenue growth. Most have substantial rainy-day reserve funds that will help cushion their near-term shortfalls. The shutdown of most economic activity and higher unemployment will certainly result in reduced income and sales tax collections. Poor investment performance in public pension funds will necessitate higher annual contributions from states. Demand for social services is increasing, as unemployment rises. However, the CARES Act is providing \$280 billion in direct support to municipal issuers. State governments are large employers. Additional federal aid for them is likely to be forthcoming as federal government seeks to avoid massive layoffs of public employees. State and local governments must balance their budgets on an annual basis. This July 1 is the start of the fiscal year for most states. We will be hearing about the plans to attain budget balance in the near term before the new fiscal year commences.

States in Better Financial Health Now Than Past Crises

State Reserve Funds as Percentage of General Fund Spending



Past performance and current analysis do not guarantee future results.

*Figures for fiscal year 2020 are projected based on states' enacted budgets.

Through December 31, 2019

Source: National Association of State Budget Officers

Land of Lincoln

Illinois stands out among its peers for its exceptional level of distress. Last week the state was downgraded to BBB- with negative outlook last week by Fitch. Illinois' fiscal condition was dire prior to the Covid-19 outbreak. The Illinois Department of Revenue is now projecting a general fund shortfall of \$2.7 billion, although this does not include federal subsidies. An anticipated \$1 billion note issue is scheduled for next month in order to assist with imbalances in cash flow.

If a graduated income tax referendum does not pass in November, the FY2021 deficit is expected to rise to more than \$7 billion. Illinois has no "rainy day" fund for budget stabilization. Senator Mitch McConnell's comments regarding states being allowed to declare bankruptcy are unlikely to result in changes to the policy that disallows it. However, it does reflect a discernment between funding crisis-related priorities and bailing out profligate states that were fiscally challenged well before Covid 19.

We have never purchased an Illinois GO for a client portfolio since the inception of Riverbend Capital given the risks of credit deterioration.

Local Option

Local governments have also benefitted from several years of increasing tax receipts. The primary source of revenue for local governments is property taxes, which are more reliable than sales or income taxes given that they don't vary significantly from year to year. Assessments take place relatively infrequently and adjustments are limited and gradual. Due to the slowdown in economic activity, property turnover is likely to experience a decline that will contribute to slower growth in assessed valuations.

Onward

The municipal bond market has rebounded from last month's brief liquidity crisis and has performed well in April. The positive tone seems to emanate from the Fed's backstop liquidity facility and the expectation that federal aid to state and local governments will continue to flow. These programs are reassuring and go a long way toward bridging the revenue gap that state and local governments are experiencing. However, ratings downgrades are a realistic possibility as economic activity remains suppressed.

As new issuance continues to revive, market technicals could be impacted with the market digesting an increase in supply. Tax-exempt bond fund flows are positive for the time being. High profile downgrades and associated price volatility could once again spook fund investors and lead to redemptions.

Riverbend Capital

We continue to adhere to a disciplined strategy involving high quality credits and lower duration. In the current market environment, we do not consider reaching for yield by lowering credit standards or extending duration to be appropriate.

This a good time for active management. Proceed with caution.

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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