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Municipal Market: Expect Greater Stability

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Municipal market: expect greater stability

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After a significant recovery during May, June and July, the municipal bond market has been trading sideways. Both the investment grade and high yield markets show slightly positive total returns year to date, driven primarily by the steady income component. An accommodative Federal Reserve (Fed), combined with low inflation and an overall economic rebound, suggest that municipals should avoid another pandemic-driven downturn in 2020.

The recovery has been more pronounced in the high quality municipal market.

KEY TAKEAWAYS

- The municipal market has stabilized, with heavy new issuance being met with strong demand.
- Municipal bonds may benefit from either outcome of the U.S. presidential election.
- An emerging fourth quarter supply glut may offer opportunity for investors.

A HEALTHIER MARKET HEADS INTO AN EVENT-DRIVEN FOURTH QUARTER

The municipal market rebounded from its March lows with a strong summer rally, then stabilized with more muted, but still positive, performance in the third quarter. Key drivers of this comeback include the federal government's rapid and forceful fiscal stimulus, Federal Reserve monetary policy easing, and gradual re-openings following the coronavirus lockdowns.

The recovery has been more pronounced in the high quality municipal market, where fund flows have been heavier and valuations have largely normalized. The 10-year municipal-to-Treasury yield ratio has come back down to 126%, while the 30-year ratio has retraced to 111%. These levels remain elevated versus the long-term historical averages of 84% and 93%, respectively. Nevertheless, it represents a substantial normalization since the March panic, when AAA-rated municipals were trading at multiples higher than similar-duration Treasury yields.

High yield municipals are staging their own comeback, despite less-consistent demand than high grades. High yield started 2020 trading at an average spread of 210 basis points (bps), moderately tighter than its long-term historical average. Spreads quickly doubled during the pandemic-driven selloff, before liquidity returned and the normalization process began.

High yield municipal credit spreads on the long end of the yield curve had come back down to 313 bps by the end of the third quarter. This level is significantly better, but still more than 100 bps wider year to date. At the short end of the yield curve, spreads have widened even further for the year, moving from 202 bps in January to 372 bps at third quarter end, or 170 bps wider.

These spread levels appear to represent an opportunity, given that municipal default rates remain low overall and concentrated in the same sectors that dominated defaults in 2019: senior living, multifamily housing and industrial development. In our view, these sectors have more idiosyncratic risk factors and don't indicate a problem with the general municipal credit trajectory.

THE FED COMMITS TO KEEPING CREDIT MARKETS LIQUID

The Fed has been instrumental in restoring liquidity and confidence to the credit markets, including municipals. The zero interest rate policy has reduced borrowing costs throughout the economy and contributed to a positively sloped yield curve, which tends to be healthy for the financial markets. The Fed has increased the impact by adjusting its messaging related to forward guidance and inflation targeting. Perhaps it wants to avoid another taper tantrum, as occurred in 2013.

The Fed established a goal of an average core inflation rate of 2% over the long term. By rephrasing this objective as a long-term average, the Fed indicates it is willing to allow the core PCE deflator, which has been running at approximately 1.5% over the last 10 years, to trend perhaps as high as 3% before it tightens monetary policy. This and similar statements from central banks globally has effectively convinced fixed income investors that rates will remain low for at least the next two to three years.

The zero interest rate policy and forward guidance have been combined with expansive quantitative easing, which entails the Fed purchasing Treasury bonds, corporate bonds (including high yield), mortgage-backed securities and commercial paper. These ultra-accommodative policies have damped the volatility of Treasury bonds and greatly improved the liquidity of credit markets broadly.

Similarly, the Fed set up the Municipal Liquidity Facility (MLF) program in April to help municipalities avoid liquidity-driven credit issues. States, larger cities and specifically designated infrastructure facility revenue bond issuers are eligible. In early August, the board reduced the interest rate spread on tax-exempt notes for each credit rating category by 50 bps. But even with the lower rates, the facility still had only two borrowers as of the end of August: The State of Illinois borrowed $1.2 billion and New York's Metropolitan Transportation Authority borrowed $450.72 million.

We anticipate that the MLF should prove an attractive option for selective borrowers over time. Just the existence of the program may instill enough confidence in municipals to keep the capital markets open for most borrowers. The MLF could end up not being heavily used in terms of dollars, but very important for its messaging.

TECHNICALS PROVE STRONG

Municipals had a strong showing in the third quarter. The Bloomberg Barclays Municipal Bond Index returned 1.23% for the quarter and 3.33% year to date, demonstrating resilience. These returns are higher than just the coupon income of the bonds within these indexes, indicating that prices for high quality bonds have risen. AAA yields are approximately 50 bps lower year to date.

Municipal-to-Treasury yield ratios declined slightly, but remain elevated versus historical averages. The 10-year ratio moved from 136% to 126%, and the 30-year moved from 116% to 111% during the quarter. Historically, the 10-year and 30-year ratios are 85% and 93%, respectively. Ultra high quality municipals of seven years and longer are yielding more than Treasuries, creating an opportunity for taxable investors in the upper income tax brackets.

Supply

Municipal issuers have taken advantage of low interest rates and the recovery of investor demand. New issuance was curtailed at the peak of the pandemic, but many deals were only postponed. Total new issuance was up 24% year over year at the end of September, for a total of $347 billion. Growth has been driven by a 63% increase in refundings, while new money issuances are up only 2.3%. Taxable municipal bond issuance grew 227% to $100 billion as of 30 September.

The growth of taxable municipal issuance is closely related to the increase in refinancing. The Tax Cuts and Jobs Act of 2017 ended the practice of advance refunding tax-exempt bonds with another tax-exempt new issue. Low rates globally, and the attractive relative value of municipals versus Treasuries and corporate bonds, have boosted international and institutional demand for the asset class at interest rates making refinancing possible. Therefore, many tax-exempt municipal bonds are being refinanced with taxable new issues.

On the margin, this has been positive for municipal credit quality, as refunding tends to keep debt service costs in check and falling. This trend is expected to reach a fever pitch in October, which could see an all-time record $65 billion in municipal bonds come to market.

Demand

March saw by far the worst month of municipal outflows on record at -$44 billion. Municipal fund flows have ramped up since turning positive again in May, for 21 consecutive weeks of inflows. Flows for July, August and September were $9.9 billion, $10.9 billion and $6.4 billion respectively. Cumulative flows year to date total approximately $13.2 billion, which would actually be considered a good year. Looking at municipal fund flows alone, one wouldn't know that we've been in this pandemic crisis.

High yield municipal flows were slower to recover, turning positive in June. Flows for July, August and September were $1.1 billion, $821 million and $424 million respectively. Due to the events and volatility of this year, investors have been more comfortable sticking with high quality. Nevertheless, high yield flows are recovering, as defaults have remained isolated and idiosyncratic. The very low interest rates in high quality are probably contributing to the demand for a blend of high yield, given its income contribution amid relatively wide credit spreads.

Credit Spreads

High grade municipal yields have remained stable. In September, yields across the AAA curve shifted no more than 6 basis points for any given maturity. Investment grade spreads declined slightly, as BBB-AAA spreads narrowed from 157 to 143 basis points.

Overall, municipal credit spreads remain wider than the long-term historical average, representing opportunity for enhanced income plus the potential for total return as spreads continue to grind tighter. At the end of June, average high yield municipal credit spreads were 346 basis points above the AAA scale. They steadily narrowed to roughly 313 bps above AAAs by the end of September.

Defaults

Municipal defaults totaled roughly $1.6 billion par value as of the end of July, which is a very small percentage of the overall market. Nursing homes and industrial development revenue bonds represent more than two-thirds of all municipal defaults year to date. We do not anticipate municipal defaults will become widespread, and believe that downgrades and in some cases reserve fund draws are more likely between now and a post-pandemic economy.

MUNICIPAL CREDIT REGROUPS AMID COVID CHALLENGES

State revenues are faring much better than expected

Questions have swirled around how the coronavirus pandemic is affecting the health of state revenues. Broadly speaking, states are seeing only modest declines so far this year, rather than the steep shortfalls predicted in March and April.

A survey by the National Association of State Budget Officers found that state revenue, which was expected to increase by 3.0% in fiscal 2020, fell by -3.0% year over year. Revenue from personal income taxes dropped by -3.7%, while corporate income tax receipts were off by -9.5%, and sales tax receipts were down by -0.5%. However, most states deferred the due date for filing income tax returns from April to July. When adjusted for the deferred payments received in July, total general fund revenue was only -1.6% lower than in 2019, with personal income taxes down by -1.1% and corporate income taxes down by -6.8%.

According to the Census Bureau, property tax revenue of local governments increased by 4.8% in the year ended 30 Jun 2020, compared to the prior 12 months.

One factor that has limited the damage to personal income and sales tax receipts has been that the greatest increase in unemployment has tended to be in low-wage jobs. For example, between February and August, the unemployment rate for management, professional and related occupations increased by 3.7% to 5.5%, while the unemployment rate for service occupations rose by 8.8% to 13.4%, and by 5.8% to 11.1% for production, transportation and material moving occupations.

Chicago's budgetary constraints have been exacerbated

Chicago's longstanding budget challenges are worsening due to the pandemic. The city faces a $798.8 million deficit for the fiscal year (FY) ending 31 Dec 2020 and projects a $1.2 billion budget gap for FY21. Chicago indicates it has already identified $550 million of solutions to close the FY20 gap, including $350 million of CARES Act funding and $200 million from debt refinancing. With only a few months left in the fiscal year, the city has fewer options for balancing the budget.

For FY21, the projected deficit equates to about one-third of revenues. City officials attribute $783.2 million or 65% of the gap to revenue loss due to COVID-19 and $421.3 million to rising expenses including increased costs for personnel, pensions and debt service. FY21 will be the second year Chicago contributes on an actuarially determined basis to its public safety pension plans. Non-public safety pension contributions are entering the last year of a funding ramp before switching to actuarial based contributions in FY22.

Solutions for closing the FY21 gap will be proposed when the mayor introduces the budget in October. Even during periods of economic expansion, Chicago has consistently relied on one-time measures to plug budget deficits. Challenges stemming from the pandemic will make working toward structural balance more difficult and increase the risk of rating downgrades.

MTA bondholders remain well positioned

Due to an unprecedented decline in ridership, New York's Metropolitan Transportation Authority (MTA) projects shortfalls of $3.2 billion in FY20 and $5.8 billion in FY21. However, MTA bondholders remain well positioned. Pledged revenues legally securing MTA's bonds continue to cover debt service comfortably, and state law prohibits MTA from filing Chapter 9 bankruptcy.

MTA has three substantial bond programs: Transportation Revenue Bonds (67% of debt portfolio), Triborough Bridge and Tunnel Revenue Bonds (18%) and Dedicated Tax Bonds (13%). Transportation Revenue Bonds are most exposed to ridership declines, but they are supported by a gross pledge of certain MTA-generated revenues that prioritize bondholder debt service. Debt service coverage is anticipated to drop from 8.0x in FY19 to 4.8x in FY20.

Triborough Bridge and Tunnel Revenue Bonds are secured by net tolling revenue generated from seven bridges and two tunnels. Debt service coverage on the senior-lien bonds is expected to drop from 2.8x in FY19 to 2.3x in FY20.

Dedicated Tax Bonds are secured and payable from various taxes levied throughout the state and MTA's service area. These dedicated tax revenues covered debt service by 5.6x in FY19, and could decline as much as 80% without affecting payment of debt service.

The federal government has offered some assistance. The CARES Act included $4 billion for the MTA and, as a designated revenue bond issuer, MTA can access the Federal Reserve's Municipal Liquidity Facility for an additional $2.9 billion.

While meaningful, these measures will not cover the MTA deficits. Additional federal funding and strategic cuts to MTA's operations will likely be necessary for a balanced FY21 budget. The outcome of the U.S. elections in November will provide clarity regarding the probability and size of additional stimulus.

American Dream reopens

The American Dream mall reopened in October, with limited capacity at the water and theme parks, ice rink and mini-golf arcade. Located in New Jersey, approximately 80 retailers are opening this month, with the largest tenants being Primark, Zara and Uniqlo. Roughly 50% of the tenant spaces are in some stage of buildout, and retail openings are expected to continue through the second half of 2021.

Despite the project's delay and temporary closure, it has been generating sufficient revenue to support Series 2017 PILOT Bonds since mid-2019 through assessment payments on constructed value. The 2020 total net value of the project was $3.41 billion (compared to $2.63 billion for 2019). Projected full-year charges pledged to pay debt service on the bonds are $54.9 million, compared to $54.1 million in annual interest costs (a 1.02x debt service coverage ratio). Due to the timing of reassessment, billing and collection, there may be a modest draw on the debt service reserve to fully fund Series 2017 PILOT Bonds, but the project remains well reserved from a liquidity standpoint.

The developer has challenged both the 2020 and 2019 assessed values. Any adjustments resulting from appeal would require additional support from reserves, but ultimately full value of construction is anticipated to be reflected in assessed valuations (with reserves expected to be sufficient for funding requirements on the debt at this time).

The Series 2017 Grant Revenue Bonds are supported by a 75% pledge of sales tax receipts on qualifying purchases at the mall. Capitalized interest on these bonds is funded through 01 Feb 2021. Given the delays experienced in space completion and tenant occupancy, sales tax receipts are anticipated to miss projections for the near term. Grant Revenue Bonds are expected to utilize some of their reserves to fund debt service, until annual sales needed to generate revenues sufficient to cover interest payments on the bonds are achieved.

Yankee Stadium seeks refinancing

The New York City Industrial Development Agency issued Series 2020 Refunding Bonds for its Yankee Stadium Project. Bonds will refund Series 2006 and 2009 PILOT Bonds, which were issued to partially fund construction of the project. The project, located in the Bronx, New York, consists of a 51,000 seat stadium (plus 2,000 standing room only) for the New York Yankees major league baseball franchise. The refinancing creates present-value savings of more than $200 million for the borrower, while funding structural liquidity in excess of $105 million within the PILOT Bond Indenture. Debt service requirements are also adjusted down for the next three years, providing cushion for revenue impacts resulting from COVID-19 restrictions and collective bargaining agreement uncertainties.

Series 2020 Bond payments will continue to be derived from ticket sales and suite revenues. The bonds also carry a subordinate mortgage on the stadium, and foreclosure can commence if debt service payments are not cured within six months. It is believed that equity owners would be incentivized to provide additional liquidity if needed. The credit benefits from the strength of the Yankees franchise, loyal fan base and a non-relocation agreement that provides that the team pay liquidated damages if it attempts to relocate the Yankees during the remaining term of the debt.

OUTLOOK

Year-end uncertainties and supply pressures create opportunities

As we approach year end, municipal bond investors have been expressing concerns about three key issues, leading to cheaper relative valuations. We believe some of these fears may be overblown. If so, they may create an attractive entry point for the asset class.

U.S. election. As of this writing, polling indicates a substantial lead for former Vice President Joe Biden, but the market does not appear to be pricing in a consensus view. In addition, we see a general feeling of nervousness around the prospect of a contested election centered on a high volume of mail-in ballots.

Second coronavirus wave. COVID-19 cases are ticking up again, but we have not yet seen a full blown resurgence. Testing continues to increase, therapies and treatments have improved and the mortality rate is low and declining. One or more viable vaccines may become available in the coming months, at least to health care professionals.

Phase four stimulus: The most recent funding of Payroll Protection and other key components of the CARES Act are significantly depleted. Airlines and other impacted industries have increased the pace of furloughs and layoffs, while Congress remains in partisan gridlock. The economy appears to have solid momentum right now, but that trend could weaken without another stimulus package.

We see a potential buying opportunity

Nervousness and uncertainty around these three important issues, along with a heavy supply calendar, softened the municipal market somewhat in September and early October. We believe this may create a fourth quarter buying opportunity for these reasons:

The municipal market should benefit from either election outcome. In a so-called blue wave scenario, in which the Democrats win the White House and take control of the Senate, a post-election stimulus package would most likely include substantial fiscal assistance to state and local governments and mass transit facilities, as well as funding for education, health care and infrastructure. Demand for tax-exempt municipal bonds would grow as the Trump 2017 tax cuts are reversed.

If President Trump wins reelection, the post election environment should clear a path toward a bipartisan stimulus agreement. And a divided government with significant deficits will make any near-term tax cuts highly unlikely.

Either way, financial markets will likely breathe a sigh of relief, and politicians will refocus their energy on stimulating the economy and defeating the pandemic.

A second coronavirus wave does not have to mean another economic shutdown. Leading vaccine development companies offer reasonable hope that a vaccine with at least an emergency-use designation for front line workers will likely be available by November or December, with broader approvals and distribution during 2021. Importantly, despite the uptick in cases in some parts of the U.S., improved treatments have had a positive impact and the fatality rate has not increased.

Our municipal bond outlook remains constructive

State revenues are more stable than expected. Defaults have increased slightly, but remain a small percentage of the market and concentrated in a few sectors with idiosyncratic risk. Usage statistics for hospitals and toll roads have returned to normal as people go back to their lives. The Fed is holding rates steady and taxes will not decline, regardless of who wins the U.S. presidential election.

Municipal issuance will remain heavy, but that creates opportunities to stay invested, and we expect international buyers to absorb any excess supply.

With rates on short to intermediate AAA-rated municipals near all-time lows, opportunity exists further out on the yield curve and in high yield to enhance income. Given investors' needs to sustain tax-exempt income, we anticipate that high yield spreads should continue to grind tighter, especially if the economic recovery continues.

For more information, please visit nuveen.com.

Endnotes

Sources

Gross Domestic Product: U.S. Department of Commerce. **Treasury Yields and Ratios:** Bloomberg (subscription required). **Municipal Bond Yields:** Municipal Market Data. **ICI Fund Flows:** http://www.ici.org/research/stats. **Municipal Issuance:** Seibert Research. **Defaults:** Municipals Weekly, Bank of America/Merrill Lynch Research. **State Revenues:** The Nelson A. Rockefeller Institute of Government, State Revenue Repor. **State Budget Reserves:** Pew Charitable Trust. **Global Growth:** International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD). **Standard & Poor's and Investortools:** http://www.invtools.com/. **Flow of Funds, The Federal Reserve Board:** http://www.federalreserve.gov/releases.pdf. **Payroll Data:** Bureau of Labor Statistics. **Bond Ratings:** Standard & Poor's, Moody's, Fitch. **New Money Project Financing:** The Bond Buyer; **State revenues:** Bureau of Labor Statistics, National Association of State Budget Officers. Chicago: City of Chicago 2021 Budget Forecast..

Glossary

One basis point equals .01%, or 100 basis points equal 1%. The Municipal Market Data AAA scales (MMD) are compilations of the previous day's actual trades for AAA-rated insured bonds. The personal consumption expenditures (PCE) deflator indicates the average increase in prices for all domestic personal consumption. The S&P Municipal Bond Investment Grade Index consists of bonds in the S&P Municipal Bond Index that are rated investment grade by Standard & Poor's, Moody's and/or Fitch. The S&P Municipal Yield Index provides a measure of an investing strategy that allocates a specific percentage to bonds rated both above and below investment grade.

A word on risk

Investing involves risk; principal loss is possible. All investments carry a certain degree of risk and there is no assurance that an investment will provide positive performance over any period of time. Investing in municipal bonds involves risks such as interest rate risk, credit risk and market risk. The value of the portfolio will fluctuate based on the value of the underlying securities. There are special risks associated with investments in high yield bonds, hedging activities and the potential use of leverage. Portfolios that include lower rated municipal bonds, commonly referred to as "high yield" or "junk" bonds, which are considered to be speculative, the credit and investment risk is heightened for the portfolio. Bond insurance guarantees only the payment of principal and interest on the bond when due, and not the value of the bonds themselves, which will fluctuate with the bond market and the financial success of the issuer and the insurer. No representation is made as to an insurer's ability to meet their commitments. This information should not replace an investor's consultation with a financial professional regarding their tax situation. Nuveen is not a tax advisor. Investors should contact a tax advisor regarding the appropriateness of tax-exempt investments in their portfolio. If sold prior to maturity, municipal securities are subject to gain/losses based on the level of interest rates, market conditions and the credit quality of the issuer. Income may be subject to the alternative minimum tax (AMT) and/or state and local taxes, based on the state of residence. Income from municipal bonds held by a portfolio could be declared taxable because of unfavorable changes in tax laws, adverse interpretations by the Internal Revenue Service or state tax authorities, or noncompliant conduct of a bond issuer. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager.

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