EATON VANCE

Coronavirus: Municipal Bond Market Insight March 2020

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Municipal Bond Market Insight | March 2020

Muni Investors Rewarded for Staying the Course Amid Coronavirus Worries

Key takeaways

- The Fed brought in an emergency 50 basis point rate cut to calm the markets as worries grow about impacts of the coronavirus.
- Muni bonds performed well in February, returning 1.29% as investors sought safety and liquidity in high-quality fixed income asset classes.
- As current bond yields are low and technical factors may weigh on bond valuations, we advise new investors to be patient and look for better entry points in the future.
- Specific muni credit sectors, such as hospitals, airports, and port authorities, may see an impact to their credit ratings if there are long-term implications from the coronavirus.

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General market update

Many investors have been half-expecting an equity market pullback in some form or fashion, following a stellar run that began in late 2018. Since the US economy has been in its longest-ever expansion, a cyclical recession would be understandable. At the end of February the market got a correction from an unexpected global health pandemic in the form of the COVID-19 coronavirus. While the jury is still out on the ultimate health impact, the global concern over a fast-spreading respiratory virus is becoming undeniable.

As economic risks increased for consumer spending, global and domestic travel, and supply chains, US Treasuries responded by moving lower in yield. In response US Treasuries continued a move lower in yield that began in January. Other fixed income asset classes also moved lower in sympathy. The Bloomberg Barclays US Treasury Index returned 2.65% for the month, and the Bloomberg Barclays US Corporate Index returned 1.34%. Municipals also had a solid February with the Bloomberg Barclays Municipal Bond Index returning 1.29%. The S&P 500® Index moved into correction territory from recent highs, returning -8.41% in the month of February.

Municipal bond market update

Municipal bonds have happily gone along for the ride on this leg down in interest rates, picking up significant price performance. The Bloomberg Barclays Municipal Bond Index has returned 3.11% year to date, following a strong return of 7.54% for calendar year 2019. However, the flipside of the price performance is that the market has reached historically low yields.

Throughout this move, particularly late in February, investors continued to focus on municipal bonds exhibiting negative correlation to riskier assets in general, most notably equities. Benefits of diversification across the portfolio were again on display in February. As was the case in 2008, however, even high-quality fixed income asset classes have had difficulty keeping pace with Treasuries as the market has sought safety and liquidity. A byproduct of this dynamic is that municipals have become more attractive relative to Treasuries, despite strong price performance.

Figure 1: AAA municipal yields as of 2/28/2020

Maturity	Yield	MTD change	YTD change
2-year	0.73%	-0.10%	-0.31%
5-year	0.73%	-0.11%	-0.36%
10-year	0.93%	-0.22%	-0.51%
30-year	1.52%	-0.28%	-0.57%

Source: Thompson Reuters Municipal Market Data, 2/28/2020. For illustrative purposes only. Not a recommendation to buy or sell any security.

Figure 2: US Treasury yields as of 2/28/2020

Maturity	Yield	MTD change	YTD change
2-year	0.92%	-0.40%	-0.66%
5-year	0.94%	-0.37%	-0.75%
10-year	1.15%	-0.36%	-0.77%
30-year	1.68%	-0.32%	-0.71%

Source: Bloomberg, 2/28/2020. For illustrative purposes only. Not a recommendation to buy or sell any security.

Figure 3: Fixed income index returns as of 2/28/2020

	MTD return	YTD return
Bloomberg Barclays Muni Index	1.29%	3.11%
Bloomberg Barclays US Treasury Index	2.65%	5.16%
Bloomberg Barclays US Aggregate Index	1.80%	3.76%
Bloomberg Barclays US Corporate Index	1.34%	3.71%

Source: Bloomberg, 2/28/2020. For illustrative purposes only. It is not possible to invest directly in an index.

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Supply

New issue supply in the muni market was up sharply again in February, an increase of 38% over February 2019 driven largely by taxable municipal bond issuance. Persistently low interest rates continue to make bond refinancings attractive despite the Tax Cuts and Jobs Act making certain types of refinancing more difficult to execute. The market response has been to refinance tax-exempt debt with taxable debt, a strategy made possible by exceedingly low market interest rates. Due in large part to these refinancings, taxable municipal issuance spiked to $9.54 billion in February 2020 from just $2.03 billion in February 2019.

Year-to-date issuance is up 32% to $67.8 billion after a strong January. Issuers appear to be taking note that these borrowing costs may present an opportunity. Not surprisingly, fixed-rate coupon issuance was up nearly 40% year-over-year while variable-rate issuance fell, again reflecting a desire by issuers to lock in current market borrowing costs.

For muni investors, what now?

As volatility in the equity markets persists due to the expansion of the coronavirus outbreak, investors have turned to the safety of US Treasuries, driving yields lower. What does this mean for investors in municipal bonds? We observe the following:

Municipal bonds provide diversification, and they're doing that now. Muni bonds are a valuable building block of investor portfolios due to their tax advantages, low historical default rates, and diversification benefits. They've thus far again exhibited negative correlation during the coronavirus outbreak, delivering a positive return as equities have plummeted.

As a result, investors owning muni bonds likely have unrealized gains in their portfolios, so they should carefully consider any attempt to reposition their holdings. Realizing these gains, especially net of taxes, may not be prudent if the reinvestment goes back into a safe-haven asset class.

For investors with long time horizons, it may be more advantageous to stay invested and focus on the book yield of existing holdings—the rate at which they've put their money to work. The generally higher book yields will continue to provide some cushion against higher rates while also providing the safe haven many investors continue to look for.

Lastly, with respect to new-money investments, patience may be appropriate, along with slowly taking advantage of more attractive entry points into the market.

Technical factors and retail sentiment may weigh on bond valuations. Once fear subsides, muni bond market technical factors may garner more attention. Historically, March and April see a resurgence of new-issue supply from lighter issuance at the start of the year. This may be particularly elevated this year as issuers take advantage of record-low yields.

However, retail investors may begin to lose enthusiasm for the same reason, causing tax-exempt municipal bond funds to see accelerating outflows. While shifting safe-haven assets doesn't make sense, if equity markets erode further, investors may reallocate to risk assets. All of which means that we're likely to see some volatility in the muni bond market in the short to intermediate term. We view this as an opportunity.

Specific muni sectors may face unique effects from the coronavirus. A principal concern of muni investors is credit quality. Depending on the direction the coronavirus outbreak takes, it has the potential to affect some issuers' credit ratings. Let's look at five muni sectors and how this could play out.

Hospitals: If the coronavirus outbreak turns out to be similar to the typical seasonal flu, it could be modestly positive for hospitals. A bump in patient volumes could lead to revenue increases, assuming hospitals effectively minimize patients' length of stay and commercially well-covered patients seen exceed those that are poorly covered or indigent.

Credit concerns include the extent of impact derived from the following factors:

- Cancellation or postponement of more profitable elective procedures and diagnostics out of contagion fears
- Disruption of the health-care-related supply chain and consequent scarcity of such items as pharmaceuticals, medical supplies, and protective gear
- Higher unbudgeted wage costs related to overtime

Large-scale, well-capitalized health care systems are more insulated from these concerns than stand-alone academic medical centers, community providers, and rural hospitals with limited cash reserve cushions and weaker payer mixes.

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Transit: With more companies imposing work-from-home mandates, public transit could be affected due to less commuter travel. Other types of trips could also decline, since people will have more incentive to shop online to avoid crowds. Keep in mind that on January 20, public transit was suspended in Wuhan, China, due to the outbreak.

Hotels: The US economy continues to be robust. However, an economic downturn stemming from the coronavirus outbreak could have a deep negative impact on hotels and convention centers. A potential decrease in room prices and occupancy levels could reduce net operating income and thus stress coverage of debt obligations.

Airports: In the initial wake of the coronavirus epidemic, some international travel has been curtailed and companies recently have reduced work travel domestically. Most airports rely not only on passenger enplanement levels but also on concession revenues. Agreements with aiports also require air carriers to meet operating costs as related to their use.

In general, larger airports with greater international travel and overall volume, such as LAX and JFK, continue to be supported with strong balance sheets and strong local markets. If auto traffic ebbs across the country longer term, airports reliant on customer facility charges from rental car companies could experience a downturn as demand falls.

By way of comparison, US airports during other crises (such as the SARS outbreak of 2002–2003, 9/11, and the global financial crisis) did experience sharp downturns in air traffic, but they didn't experience the kind of financial distress that resulted in credit defaults.

Port authorities: Chinese export volumes are expected to decline in the first quarter of 2020. The effect on US ports may hit shortly thereafter due to the time it takes to sail to the US, especially if there are extended factory closures leading to more shipping cancellations. However, US ports receive most of their revenues from fixed payments from tenants, which will mitigate the effects of short-term volume declines.

West Coast ports will likely be the most affected. The Port of Los Angeles and the Port of Long Beach have the most exposure to two-way trade with China. However, at least 70% of the revenue for both ports comes from minimum annual guarantees.

Economic data

The coronavirus and its potential economic impact on US growth resulted in the Fed making an emergency 50-basis-point rate cut on March 3—the biggest one-time rate cut enacted since the financial crisis in 2008. This cut to a range of 1–1.25% was made prior to the scheduled Fed meeting, indicating that a drastic measure had to be taken to calm the markets and possibly credit-tightening conditions. As China already feels the effects of closed factories, as indicated in the record-low PMI print of 35.7, concern is growing that lower demand, slowing tourism, and supply chain disruptions will start to negatively affect US economic indicators in the coming weeks. More importantly, the greater concern is that the weakness starts showing in consumer spending and confidence, which has been the backbone of the US growth. We hope that the actions taken so far from central banks around the world, along with additional fiscal support, will be enough to combat any negative impact to growth due to the virus—but only time will tell.

Figure 5: Key economic data

Change in nonfarm payrolls	+225,000
Unemployment rate	3.6%
Core CPI—YoY change	2.3%
Average hourly earnings—YoY change	3.1%
Real GDP QoQ (Q4 2019)	2.1%
Core PCE—YoY change	1.6%

Source: Bloomberg, 2/28/2020

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