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Liquidity Crunch and Swift Federal Support Create a Memorable March for Munis

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C20-15869 | 04/2020 | EXP 04/30/2021

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Municipal Bond Market Insight | April 2020

Liquidity Crunch and Swift Federal Support Create a Memorable March for Munis

Key takeaways

» Municipals weren't immune to COVID-19 concerns, experiencing significant volatility throughout March.

» A liquidity crunch sent prices reeling and yields rising before being largely corrected by the month's end.

» Federal support for the economy and municipal issuers has been swift and unprecedented.

» Fundamental credit analysis is more important than ever as this crisis continues to unfold.

» This month's insight includes a special appendix reviewing the impact of the CARES Act on states, cities, and municipal sectors.

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General market update

A roller-coaster ride is the best description for what municipal bond investors experienced in their portfolios for the month of March. The muni market saw a strong start to performance in January and February, with strong inflows into the asset class driving prices up and yields down. On March 9, the 10-year AAA muni yield set an all-time low of 0.78%. Things changed rapidly from there, with growing concerns surrounding the spread of the COVID-19 virus and the negative impact on the economy. Retail demand for municipals had already started to wane given low absolute yields, while mutual funds started to see heavy redemptions. Dealers entered the period with full balance sheets, no longer providing the backstop bid investors expect.

This resulted in muni bond forced selling at aggressively low prices. Muni mutual funds saw record outflows through March 20 of over $12 billion—three times the previous record for outflows in a week. The result was a swift repricing of the asset class and dramatically higher yields. The quick time frame in which the move happened, along with the magnitude of the move—especially relative to US Treasuries—exceeded anything seen previously. The 10-year AAA muni yield had climbed 201 bps higher to 2.79% by March 20.

The astonishing market sell-off and high-quality bonds yielding in excess of 350% of comparable Treasuries didn't last long. A federal injection of liquidity, together with investors with an eye for value, created an aggressive rally back the next week. Traditional and nontraditional (crossover) buyers alike found value in munis. The Fed announced on March 23 that short-term muni bonds could be used for liquidity facility programs, while the $2 trillion Coronavirus Aid, Relief, and Economic Security (CARES) Act included $400 billion of aid to states, cities, and municipal sectors. By the end of March, the 10-year AAA muni yield had fallen to 1.33%, down 146 bps from its peak. Please refer to the appendix for a breakdown of the federal aid for municipalities and credit commentary on specific muni sectors.

Figure 1: AAA municipal yields as of 3/31/2020

Maturity	Yield	MTD change	YTD change
2-year	1.06%	0.33%	0.02%
5-year	1.09%	0.36%	0.00%
10-year	1.33%	0.40%	-0.11%
30-year	1.99%	0.47%	-0.10%

Source: Thomson Reuters Municipal Market Data, 3/31/2020. For illustrative purposes only. Not a recommendation to buy or sell any security.

Figure 2: US Treasury yields as of 3/31/2020

Maturity	Yield	MTD change	YTD change
2-year	0.25%	-0.67%	-1.32%
5-year	0.38%	-0.56%	-1.31%
10-year	0.67%	-0.48%	-1.25%
30-year	1.32%	-0.36%	-1.07%

Source: Bloomberg, 3/31/2020. For illustrative purposes only. Not a recommendation to buy or sell any security.

Figure 3: Fixed income index returns as of 3/31/2020

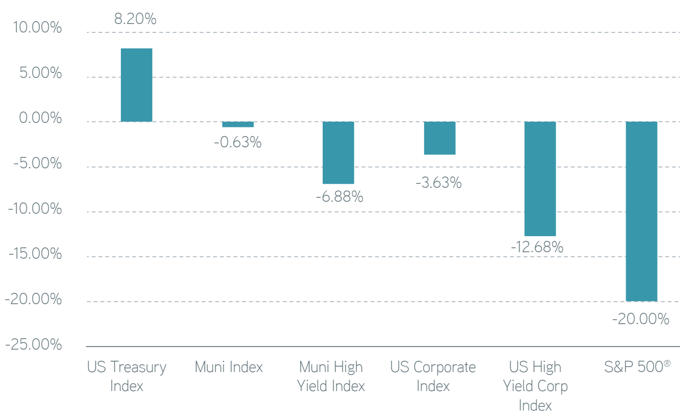
	MTD return	YTD return
Bloomberg Barclays Muni Index	-3.63%	-0.63%
Bloomberg Barclays US Treasury Index	2.89%	8.20%
Bloomberg Barclays US Aggregate Index	-0.59%	3.15%
Bloomberg Barclays US Corporate Index	-7.09%	-3.63%

Source: Bloomberg, 3/31/2020. For illustrative purposes only. It is not possible to invest directly in an index.

Where do muni investors go from here?

Investors have historically used municipals for compelling tax benefits and risk-adjusted returns. Despite recent volatility and the temptation to invest with a tactical mindset, we encourage clients to maintain a long-term perspective. Some of the primary reasons that investors look to the municipal market are the quality and diversification that munis bring to the overall portfolio, particularly in times of distress. In the first quarter of 2020, municipals were doing their job of dampening volatility in the portfolio.

Figure 4: Q1 2020 returns by asset class



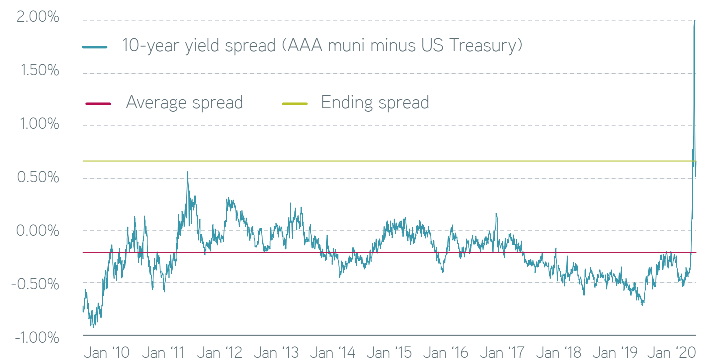
Source: Bloomberg, 3/31/2020. For illustrative purposes. Not a recommendation to buy or sell any security.

A compelling entry point

We see a silver lining to these volatile times: an interesting entry point into the muni asset class. AAA municipal yields have recently diverged from US Treasury yields, a dislocation caused in large part by redemptions from muni mutual funds whose managers have been compelled to sell into weak demand. This forced selling has recently created a rare level of dislocation not frequently seen, which historically hasn't persisted.

The spread between AAA munis and US Treasuries has been -0.21% over the last 10 years. Put another way, 10-year AAA munis have yielded 0.21% less on average than 10-year Treasuries. This makes sense, since munis are tax free. However, at the time of this writing, munis are actually yielding 0.66%—87 bps more than the 10-year average. This translates into a taxable-equivalent yield pickup of 1.23% for an investor in the 30% federal tax bracket. We think this may present an opportunity for long-term investors.

Figure 5: 10-year yield spreads: AAA munis vs. US Treasuries



Sources: Bloomberg, Thomson Reuters, 3/31/2020. For illustrative purposes. It is not possible to invest directly in an index.

Credit impact

Investors are wise to focus on fundamentals at this time of economic uncertainty, given the potential for growing credit distress. Despite these concerns, the municipal asset class is a resilient one with unique characteristics not found in other fixed income asset classes: unlimited taxing power; revenues from essential services, such as electricity and water systems; and additional services integral to everyday life, including transportation and health care. The asset class is also receiving an unprecedented amount of federal support during this crisis.

States receive their revenues primarily from personal income taxes, sales taxes, and federal support. Declines in tax revenue are likely to start showing up in the next few months. Most state reserves were at all-time record levels heading into this crisis, which will help provide some liquidity to counter any revenue declines. State governments have exhibited the willingness to cut expenses when necessary, with the 2008 financial crisis being a good example. New York and California in particular are entering this period with healthier liquidity positions compared with past recessions. Both have exhibited the willingness to meet budget shortfalls post-2008 through a combination of federal stimulus funding, one-time measures, spending cuts, and other revenue actions.

Local municipalities source the majority of their revenues from property taxes based on the prior year's property assessments. Should the economic decline extend to a multiyear crisis and property tax receipts start declining, most high-grade issuers

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at the local level are positioned well from a liquidity standpoint. Specific sectors like hospitals, mass transit systems, and airports will feel the brunt of the current crisis, and it's possible that the market continues to see more volatility for issuers within these sectors. However, the over $400 billion in federal funding that passed for states, local government, hospitals, airports, and transit systems in the CARES Act will help mitigate revenue shortfalls and bolster balance sheets for many issuers in these sectors and more broadly in the muni market.

Uncertainty about the length and severity of this downturn will continue to be a source of muni market volatility. We recognize that not all municipal issuers are created equal; there's no doubt that some issuers will experience greater downgrade pressure and credit spread widening relative to others. However, we believe that this is likely to be isolated to the portion of the market where issuers were liquidity-constrained coming into this crisis. Using the expertise of market and credit professionals is more important now than ever in navigating this evolving landscape and achieving positive investment outcomes.

Economic data

The Federal Reserve and the US government are meeting these economically dire times with extraordinary measures through both monetary and fiscal policy changes. The Fed made an emergency 50-bps rate cut at the beginning of the month, hoping to quell fears about the economic impact of COVID-19. After both the stock and bond markets showed lack of faith in this move, the Fed made another emergency cut to 0.00%–0.25%, along with restarting large-scale quantitative easing and opening up various liquidity programs targeting various asset classes.

Recent data shows a tremendous strain on the employment sector of the economy. This hits hard as consumer spending has been the backbone of any economic stability the US has seen over the past year. With the Fed pulling out all the stops and the government passing a $2 trillion stimulus package, the market is waiting to see if this is enough. The good news is that both are willing to do anything to help mitigate the severe negative growth that the country is set to face.

Figure 5: Key economic data

Change in nonfarm payrolls	-701,000
Unemployment rate	4.4%
Core CPI—YoY change	2.4%
Average hourly earnings—YoY change	3.0%
Real GDP QoQ (Q4 2019)	2.1%
Core PCE—YoY change	1.8%

Source: Bloomberg, 3/31/2020

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The COVID-19 relief bill (CARES Act) and municipal bonds

Now signed into law, the $2.2 trillion dollar Coronavirus Aid, Relief and Economic Security Act (CARES) includes an unprecedented amount of support for municipal sectors and issuers struggling to cope with the effects of the pandemic.

What's included?

In aggregate there's approximately $350 billion in financial support to states, municipalities, and municipal issuers. While not an exhaustive list, some sectors of note and amounts include:

- $150 billion for state and local governments
- $100 billion for hospitals and health care providers
- $28 billion for elementary, secondary, and higher education
- $10 billion for airports
- $25 billion for transit infrastructure

Emergency relief and taxpayer protections

The bill includes approximately $450 billion for a special purpose vehicle for the direct purchases of municipal and corporate bonds in the open market. These purchases will likely occur only in the event that issuers' access to capital is interrupted or the markets lock up. While the bill includes specifics on which corporate bonds may be purchased, it's unclear at this time which municipal securities may be targeted by the Federal Reserve program.

Coronavirus credit impact by sector

States

State liquidity reserves reached an all-time high in fiscal year 2019, which will be needed to buffer higher costs related to the public health response to COVID-19. State tax revenues also reached record levels as of December 2019. However, these will decline because states' main sources of revenue are personal income taxes, sales taxes, and corporate income taxes, which will be hit from the economic slowdown. Moody's reported on March 19 that "most states will endure only modest consequences and withstand the challenges without a substantial reduction in credit quality." We agree with Moody's, but we note that lower-rated states are at risk of downgrade due to low liquidity and low pension-funded ratios. The $150 billion that will be made available to states through the CARES Act will significantly help states with costs related to COVID-19.

Locals

Local government credit tends to hold up well heading into a recession, since their main revenue source is property taxes, which are based on the prior year's assessments. During the last recession, taxes at the local level didn't decline until Q3 2010, when they dropped only 3%. After the 2001 recession local tax revenues didn't decline. Local governments with populations greater than 500,000 may be eligible for a portion of the $50 billion in aid that will be granted to states through the CARES Act.

Hospitals

Hospitals in hard-hit areas are being challenged by overwhelming demand, while most other hospitals are seeing sharp declines in admissions as elective surgeries are being postponed. The federal government is responding by providing hospitals with $100 billion in support through the CARES Act and by increasing the Federal Matching Percentage for Medicaid—the percentage that the federal government reimburses states for Medicaid costs—by 6%. This will result in over $40 billion in revenue flowing from the federal government to states for increased health care reimbursement. Heading into this crisis, hospital credit quality was strong: AA-rated hospitals have an average of 320 days' cash compared with 240 days for A-rated hospitals and 160 days for BBB-rated hospitals. Further, due to significant merger activity in the sector in recent years, the majority of US hospitals are part of larger systems across many markets. Hospitals are the epicenter of the US health care system, and their services will be critical in getting the US population through this pandemic.

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Public transit

Public transportation credits are seeing severe declines in ridership, including MTA ridership in New York City down 60% to 90% and BART ridership in the San Francisco Bay Area down 90%. However, most public transit credits rely not just on fare box revenue but various tax revenues and grants. Those with exposure to higher levels of fare box revenue will face sharper revenue declines in the near term. The CARES Act will help to offset these revenue losses by providing $25 billion to transit agencies, including $3.8 billion to the MTA.

Airports

As airlines rapidly reduce flights, airports are also experiencing sharp revenue declines. Airports will be a major beneficiary of the CARES Act, slated to receive $10 billion in aid compared with $7.6 billion in total annual airport debt service. Further, airports maintain very healthy liquidity positions; airports with Moody's ratings maintain over 600 days of cash on hand, on average.

Higher education

Colleges have closed down their campuses, asked students to vacate their dorms, and begun offering online classes to fulfill course completion requirements. This will negatively impact college ancillary revenue such as sporting events, housing, and dining. Refunds to students could challenge smaller institutions. We believe that colleges and universities with well-established names, as well as diverse student bodies and academic offerings, should be best positioned to manage through the negative impacts of the pandemic. We view smaller and less selective colleges and universities with low unrestricted endowments at higher risk of downgrades. Higher education entitles will have $14 billion in additional funding available through the CARES Act; at this time it's unclear how that aid will be distributed.

Continuing care retirement communities (CCRCs)

CCRCs are highly exposed to COVID-19 risk; an outbreak at a facility would likely result in significant occupancy declines. However, the majority of our senior living credits are stable communities with high occupancy levels, high-quality care, and robust liquidity to offset any short-term declines in occupancy.

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27547 | 04.06.2020