U.S. Municipal Bond Market

A Playbook to Navigate Municipals in the 2nd Half of 2022

- The evolving U.S. political dynamic could threaten both an economic recovery and U.S. public finance credit conditions if there is limited to no appetite for emergency fiscal policy in response to a U.S. recession.
- The U.S. Federal Reserve is expected to continue to tighten its monetary policy into a declining macro-economic landscape. Fed Chair Powell says recession is a "possibility." Now, a 100 basis point increase is possible in July.
- We review the municipal bond market buying opportunities in 2008, 2011, 2013, 2020 and today so investors can establish their playbook for municipal bond investing for the second half of this year.
- In June we revised our issuance forecast to $410 billion. If rates rise substantially and issuance continues to fall we may need to revise it lower again.
- Negative municipal fund flows slowed toward the end of June and into July. Thursday we saw $206 billion flow into municipal funds, per Lipper data. This was the first positive flow number we have seen since June 2.
- We are not ready to call an end to the Golden Age of Public Finance. U.S. public finance credit quality will remain strong over the last half of 2022, and we still expect public finance upgrades to outpace downgrades.

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U.S. POLITICAL DYNAMIC

Voter Sentiment Souring on Direction of Country, Democrats

The government experiment that is the United States of America is experiencing another profound shift just about a year and a half after voters rallied around hope for normalcy in 2020, and 2021. The results from the 2020 U.S. elections were an important driver of public finance in 2021 and so far for the first half of 2022. The key reason the Democrats were able to pass the sixth phase of COVID relief, also known as the American Rescue Plan Act of 2021, was because Democrats somewhat surprisingly won both run-off Senate elections in Georgia. Democrats did not secure a mandate from the voters. Nor did these victories create the Blue Wave the Democrats were seeking. But, a tie-breaking vote gave Democrats a method to slam through the Rescue Plan Act legislation via a path known as budget reconciliation.

We review the municipal bond market buying opportunities in 2008, 2011, 2013, 2020 and today so investors can establish their playbook for municipal bond investing for the second half of this year.

Political Dynamic Weakening for Democrats Going Into Second Half of 2022

Poll Result	Topic
77%	Believe the country is headed in the wrong direction
64%	Of Democrats don't want Pres. Joe Biden as Nominee in 2024
94%	Of Democrats (ages 18-29) don't want Pres. Joe Biden as Nominee in 2024

Source: New York Times/ Siena Collge poll July 5-7, and HilltopSecurities.

Now, just a year and a half after the surprise results in Georgia voter sentiment is very much souring on Democrats and their progressive agenda. Almost everywhere, and almost daily we see negative stories and worsening polling data painting a difficult road ahead for Democrats. The building of undesirable trends are harming reelection hopes for sure. This sentiment was reaffirmed at the beginning of July in a New York Times/ Siena College poll taken between July 5-7. An easier path to power for Republicans is developing as a result.

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The NYT/Siena poll results indicated that 77% say the country is headed in the wrong direction. More importantly for Democrats' chances in Nov. 2022 and 2024 elections are that 64% of Democratic primary voters do not want President Joe Biden as their nominee. This message gets even worse for Democrats. This is because 94% of those polled (who would vote in the Democratic primary) between the ages of 18-29 do not want President Biden as their nominee.

Why the Politics Matters – Potentially Limited Appetite for Emergency Fiscal Policy

These political trends could have massive implications for not only U.S. public finance but for the U.S. economy especially if, or when there is an economic downturn. The political whiplash building throughout the country is likely going to at least split control of Congress. It is also possible Republicans take control of both the House and Senate in November. If that is the outcome it is going to be very difficult to envision any type of meaningful emergency fiscal policy spending materializing in a situation where the White House is controlled by the left and Congress by the right. This dynamic is especially important to consider because of the increased risk of a potential recession that may occur in 2022, 2023, or even right around the 2024 Presidential election.

We expect there to be limited to no political appetite in D.C. for significant fiscal policy once an economic downturn is experienced. This would be a negative not just for the prospects of a quick economic recovery, but also for credit conditions in U.S. public finance.

Since March of 2020 voters, politicians (on each side of the aisle), and even the private sector became accustomed to a massive amount of U.S. fiscal policy spending. In 2020 and 2021 Washington spent over $6 trillion on its COVID-19 response and much of that has been questioned. Therefore, we expect there to be limited to no political appetite in D.C. for significant fiscal policy once an economic downturn is experienced. This would be a negative not just for the prospects of a quick economic recovery, but also for credit conditions in U.S. public finance.

U.S. ECONOMIC LANDSCAPE

General concern about economic problems have risen in 2022. When asked in June 2022, "What do you think is the most important problem facing the country today?" 40% of those polled by Gallup included topics such as: inflation (18%), economy in general (13%) and, fuel/ oil prices (5%). Only 1% of those polled included "recession," in the June poll. In February 2022 only 30% cited economic problems.

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Even within the month of June the concern about economic problems increased. A Monmouth University poll conducted between June 23-27 reported that 66% of those polled are concerned with economic issues such as inflation (33%), gas prices (15%), the economy (9%), everyday bills (6%), and job security (3%). 42% of those polled say they are struggling to remain where they are financially. It should not be surprising that 88% of those polled indicated that the Country is headed in the wrong direction.

Inflation-Watch Transitions to Worries About Recession

Inflation concerns and the U.S. Federal Reserve's potential response were chief issues for financial markets in the first half of 2022. Market concerns about a potential economic recession are rising as the second half of the year gets underway. Jobs data from Friday staves off immediate concern of recession but labor market data is being closely watched. Friday's non-farm payroll release showed that 372,000 jobs were added in June, this is well above the 265,000 Bloomberg median forecast. At the end of last week this meant that the Fed was likely to raise their target rate later in the month by at least 75 basis points.

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A data release this week showed an important inflation indicator, the consumer price index, increased by a significant level or 9.1% year-over-year. This was above the median forecast of 8.8% and also a 41-year high. This indicator even more importantly is telling the markets that the Fed may have to act with more punch when they meet July 26-27. After July the Fed's next scheduled meeting is for September 20-21. In the middle to the end of this week support for a 100 basis point hike on July 27 gained more attention and support. The Bank of Canada tightened their policy by 100 basis points on Wednesday June 13. The potential for a 100 basis-point increase by the U.S. Fed is rising for July.

Fed Tightens Into a Declining Macro-Economic Landscape

The action and/or inaction of the U.S. Federal Reserve Bank has been among the leading storylines of 2022. Wednesday (June 15) the Federal Reserve barely surprised the market with a 75 basis point rate hike. The largest rate hike in nearly 30 years was a little bit expected and a little bit of a surprise at first glance. When viewed another way, a more realistic way, it is probably just not enough monetary policy action at an inappropriate time. The battle to achieve the goal of conquering inflation was going to be long and painful at best. The Fed's June 15 action illustrated that volatility and uncertainty is something financial markets and policy makers will need to get used to. For now, the Fed's overnight target rate is set between a range of 1.50%-1.75%. We can't say June's action was a complete surprise because by the afternoon of Monday June 13 over half of financial firms were calling for or expecting a 75 basis point increase compared to the 50 basis point action earlier expected. It will not be surprising if we see a similar dynamic develop before July 27, especially considering the hot CPI data we saw on Wednesday (July 13).

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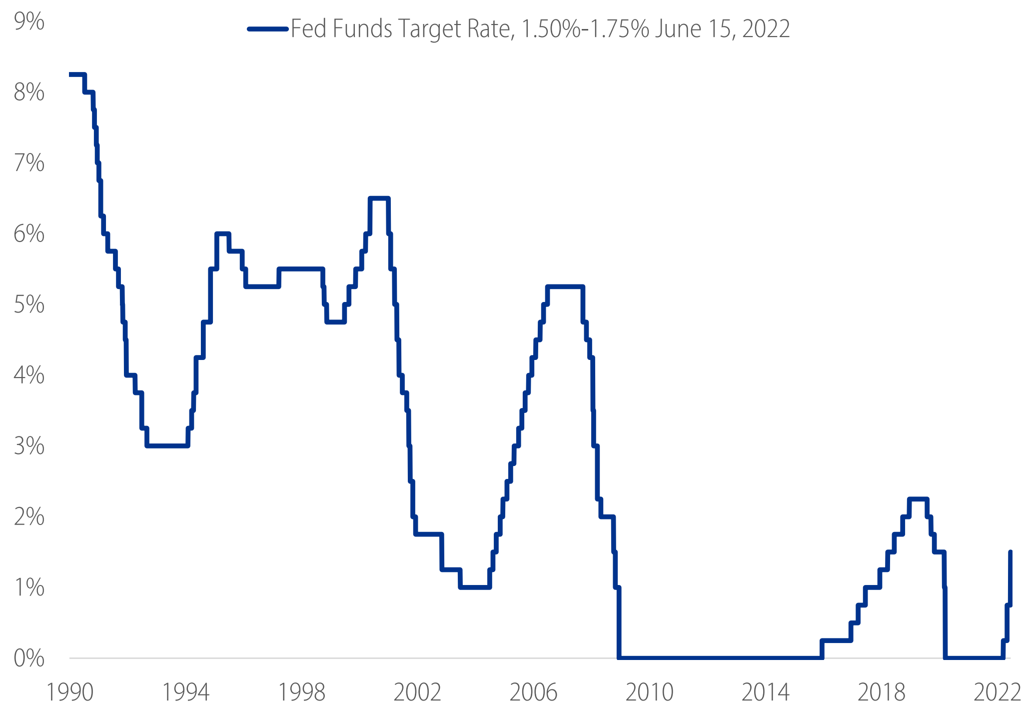
U.S. Interest Rates are Steeply Rising in 2022



Source: U.S. Federal Reserve Bank and HilltopSecurities.

Fed projections released in June now project their benchmark short-term rate to rise to 3.4% by the end of 2022.

This change in June's Fed expectation occurred very quickly. The adjustment occurred because questionable economic data was capped off the previous Friday by a very hot consumer price index number, the highest in 40 years. Sound familiar? Financial markets tumbled on June 10 and analysts quickly revised their forecasts. Fed projections released in June now project their benchmark short-term rate to rise to 3.4% by the end of 2022. In his comments to the public on June 15 Fed Chair Jerome Powell noted that more rate hikes were coming. In comments to Congress he admitted a soft landing will be difficult, and recession is a "possibility."

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Financial markets have become increasingly fearful and most participants are expecting pain economically, financially and even politically (for the party in control for the time being as we highlight above). Whether or not you buy into the potential or likelihood of a recession, one cannot deny that the economic data and analysis is mostly becoming more negative every day. There are some like Mark Zandi, of Moody's Analytics who are leaning toward the positive side. Then, again there are some who would say that it already feels as though a recession is already here. Inflation is costing the average American family $460 a month, according to Moody's Analytics. The 30-year mortgage rate rose to just under 6.00% amounting to a more than 40% increase in the monthly payment for a $300,000 mortgage compared to the end of 2021. Credit card interest charges are higher, and rising as well.

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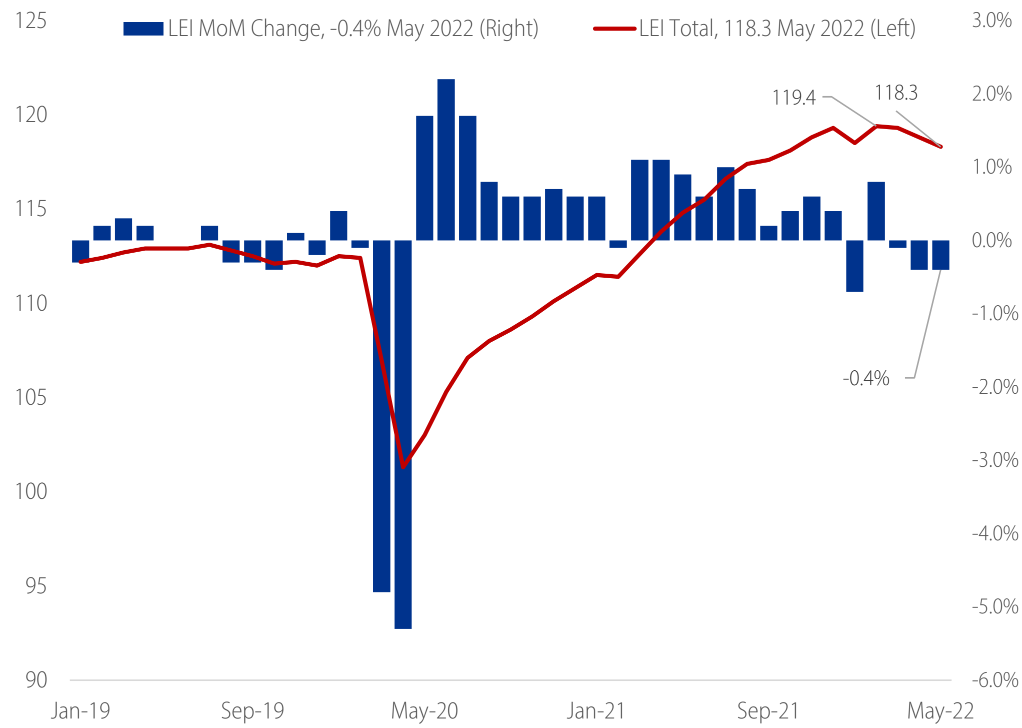
Some data indicates the economic landscape is in fact deteriorating. The Conference Board's Leading Economic Index (LEI) which is made up of ten meaningful indicator components such as jobless claims, the S&P 500, and average workweek data dropped 0.4% in May (June 17). This was the third straight month the LEI fell and the fourth time in five months.

Leading Economic Index Down Fourth Time in Five Months



Source: Conference Board and HilltopSecurities.

The GDPNow model has been consistently showing a negative second quarter result since the end of June.

Many observers have also been closely watching the Atlanta Fed's GDPNow model to gauge the likelihood of a U.S. recession. The GDPNow model has been consistently showing a negative second quarter result since the end of June.

SECOND HALF PLAYBOOK FOR MUNICIPAL INVESTORS

Among the Finest Environments for Municipal Bond Investing in Last Decade or So

Uncertainty often uncovers opportunity for investors. We are continuing to see one of the best environments for municipal bond investing that we have seen when compared to others over the last ten years, or so. We examine a few briefly below. Common themes among many of the historical investing opportunities usually include one or more of the following characteristics:

- Economic uncertainty,
- Asset and price volatility,
- Favorable technical indicators, and
- Lack of liquidity in certain market segments.

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Federal Reserve policy also played an outsized role in most cases. Below we compare and contrast the similarities and differences amongst the municipal bond market opportunities in 2008, 2011, 2013, 2020 and today so investors can establish their playbook for investing in municipal bonds for the second half of this year.

The World Financial Crisis, 2008-2009

Financial history was shaped by the events of 2008-2009. The world turned so sharply that even Warren Buffett became a regular reader of The Bond Buyer. What this period is more commonly known for are the waves of negative major financial events between 2008 and 2009 that are known as the World Financial Crisis and Great Recession. The U.S. mortgage market meltdown occurred during this period as well. During this time several major financial firms merged, or were forced to merge. In September 2008 the Lehman Brothers bankruptcy (Sept 15, 2008) coincided with the more major negative financial market reactions.

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Municipal to Treasury (M/T) ratios were trading at relatively attractive levels, around 100%, leading up to the Lehman bankruptcy. In the weeks after M/T ratios rose well above even levels we would have described as attractive levels. It was not until the end of 2008 that the 30-year M/T ratio peaked just over 200%. They eventually retreated about nine months later but this was even well after the almost $1 trillion 2009 Recovery Act was passed, which included the taxable direct pay Build America Bond financing option.

The 30 Year M/T Ratio Peaked at Just Over 200% Just After Lehman Filed

Source: Refinitiv and HilltopSecurities.

Although M/T ratios (some at least) can still be described as somewhat attractive to attractive we have still not seen enough force that would cause M/T ratios to come close to the elevated levels we saw at the end of 2008. Municipal credit quality declined significantly during this time.

The Meredith Whitney Municipal Bond Selloff, 2011

At the end of 2010 Meredith Whitney, a former bank analyst, shifted her focus to the municipal bond market. In September 2010 she published The Tragedy of the Commons for her private client roster. Then at the end of December she told an interviewer that she expected 50-100 state and local government related defaults that would amount to hundreds of billions of dollars. See the State Budgets: Day of Reckoning segment for more details. Whitney was not the only financial pundit punching at the U.S. municipal bond market around this time. Bloomberg's Joe Mysak created a timeline of some of the "Muni Mania" that occurred (see page 3) in his The Muni-Meltdown That Wasn't (Nov.

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2014.)
Whitney was completely wrong about the municipal bond market. She was completely wrong about the big picture and the details. Some investors, especially retail investors, bought into Whitney's advice because just before the World Financial Crisis she published an against-the-market analysis of Citigroup, that soon thereafter became true. She quickly became known as a truth-telling, oracle, and darling of Wall Street wrapped into one package. So, it should not be considered a surprise that some investors listened to her also in December of 2010 and into 2011.

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The 2011 municipal landscape is probably more well known for those municipal investors who maintained their positions and added to them despite the fear. The situation offered a buying opportunity, but relative value indicators like M/T ratios were no where near as attractive in 2011 as they were at the end of 2008 or even in March/April of 2020. In 2011 M/T Ratios were mostly above 100% in the first half of the year (peaking around 130%), until the Debt Ceiling showdown in the summer of 2011.

The Taper Tantrum, 2013

A defining financial event for all of 2013 is still known as The Taper Tantrum. Some may still think of 2013 as the year of the taper tantrum. In May of that year then U.S. Federal Reserve chair Ben Bernanke made mention of the Fed's intention to begin to wind down quantitative easing measures. He specifically said, "If we see continued improvement and we have confidence that that's going to be sustained then we could in the next few meetings ... take a step down in our pace of purchases." That is all it took for bond yields to leap.

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The 30 year AAA Municipal Market Data (MMD) benchmark rose almost 150 basis points peaking around 4.40% in September 2013 compared to the 70 basis point increase in the 30 year U.S. Treasury. Municipal and Treasury yields did not fall back to pre-tantrum levels until over a year later, around November 2014. Relative value indicators in the form of M/T ratios (30 year) rose from 95% to almost 120% by September then fell back down to the mid to high 90% range over the next year.

COVID-19, Mid-March to Mid-April 2020

From the middle of March to the middle of April of 2020 policymakers seemingly did everything they could do to maintain financial market stability as economic activity grinded to a quick halt as COVID-19 related shutdowns occurred throughout the U.S. This period included rapidly increasing yields, which elevated M/T ratios to among the highest we have seen (at over 250% in the 30 year spot) since the 2008 World Financial Crisis. Record amounts of money flowed out of municipal funds and liquidity was all but non-existent on the institutional and retail side of the municipal bond market. Municipal fund flow activity reversed quickly in 2020 and this positive fund flow activity continued through 2021.

Municipal bond investors have had to make adjustments in 2022, but luckily the investing landscape for municipals is looking more attractive as we begin the second half of the year than it was in January.

The U.S. Fed's Unwind, 2022

Municipal bond investors have had to make adjustments in 2022, but luckily the investing landscape for municipals is looking more attractive as we begin the second half of the year than it was in January. We are seeing neutral to positive technical indicators still. Some indicators are not as constructive as what we observed around May 11 when we published Municipal Bonds are an Exceedingly Appealing Fixed Income Opportunity Right Now, but there are some investors putting money to work here. We think this makes sense. In the middle of June we also indicated that Municipals [were] Still Investable. This is still the case, municipal bonds remain very investable right now and we think that is still a good way to approach the market landscape. We may not be as enthusiastic as we were in the middle of May, but the argument in favor of municipals are still plentiful here nonetheless because of relatively higher yields and somewhat attractive M/T Ratios in the mid to longer range maturities. Credit quality remains very strong.

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Supply - Municipal Bond Outlook Second Half of 2022

We revised our issuance forecast for 2022 down to $410 billion from $495 billion in June. However, June issuance did not come close to what we expected. Furthermore, we are seeing indicators that July municipal bond supply could be lower than our revised forecast as well. If issuance slows like it did in June for the rest of the year we could see annual issuance this year under $400 billion. We did note in our June revision report that slower issuance was a possibility, and we noted that we may have to revise our forecast again in August. We need to see what is happening on the ground and gauge sentiment before we make another revision.

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Where July issuance is concerned there may be a push for issuers to get primary market activity done ahead of the Fed's July 26-27 meeting, but it does not seem a significant amount of issuance is likely to hit the calendar for the week of July 18. Therefore, July issuance is likely to be around $30 billion. July of 2021 saw $37 billion and we saw $47 billion in July 2020. A lighter amount of supply this July would be in-line with the supply dynamic we have seen so far in 2022.

Demand - Municipal Bond Outlook Second Half of 2022

The significant selling we have seen in municipals over the first half of 2022 has been a surprise. About $22 billion flowed into municipal funds in 2020 and another $66 billion was added in 2021. So far, through the middle of July we have seen about $47 billion flow out of municipal mutual funds. We think municipal bonds have been oversold over the first six months of 2022. We think demand is going to come back, but the numbers maybe not flow in as enthusiastically as they did in 2020 and 2021.

The negative flows slowed toward the end of June and into July. On Thursday July 14 we saw $206 billion flow into municipal funds, per Lipper data. This was the first positive flow number we have seen since June 2. We have only seen five weeks (out of 28) this year where municipal flows were positive.

We are not ready to call an end to The Golden Age of Public Finance. It is under threat from hybrid work, and macro-economic, and political forces for sure. But, we expect it to last at least through the end of this year.

HTS Still Expects Public Finance Upgrades to Outpace Downgrades in 2022

We are not ready to call an end to The Golden Age of Public Finance. It is under threat from hybrid work, and macro-economic, and political forces for sure. But, we expect it to last at least through the end of this year. We raised our credit sector outlooks for state and local government, and school districts at the beginning of the year in REVISED: The Municipal Market in 2022, Due to the COVID-19 Paradigm Shift to "positive" from "stable". We still expect public finance upgrades to outpace downgrades in the second half of 2022, mostly because of the substantial fiscal policy aid that flowed to almost the entire U.S. public finance sector. This year there will be more positive upgrade activity in the tax backed versus the revenue backed sub-sectors. Political pressure could develop into credit deterioration depending upon what happens in the macro-economic environment in upcoming years, as we indicated in the first section of this commentary, however.

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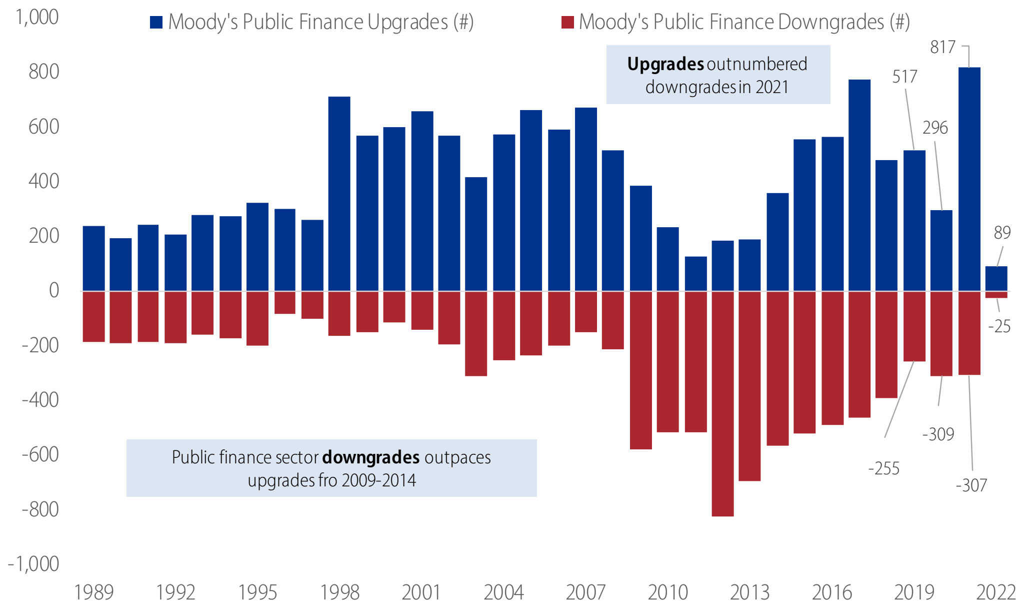
Public Finance Upgrades Massively Outpaced Downgrades in 2021



Source: Moody's and HilltopSecurities.

Recent HilltopSecurities Municipal Commentary

- Municipals Still Investable in Front of Fed's June 2022 Announcement, June 14, 2022
- REVISED: Our 2022 Municipal Bond Issuance Forecast, June 13, 2022
- School District Credit Quality is Strong, Former Mayor Bloomberg is Overreaching, June 2, 2022
- Voters Want Normalcy – This is Not It – More Political Change is Likely, May 31, 2022

Readers may view all of the HilltopSecurities Municipal Commentary here.