OPPENHEIMER

MUNICIPAL STRATEGY AND RESEARCH

Municipal Basis Points – Weekly

September 2, 2021

# Municipal Market Comments

## Powell Wows And Ida Slams Gulf Coast

If the rampant spread of California's wild fires wasn't enough to cast a sobering reminder that climate-related events can leave behind catastrophic damage, the passage of Hurricane Ida, attaining category 4 status as it made landfall, wreaked havoc upon the New Orleans area. Last week's hurricane brought about some horrific reminders of the devastation caused by Hurricane Katrina in 2005, 16 years ago to the day. ***Thankfully, however, both the physical and human toll extracted by Ida were far less consequential compared to some of the more recent hurricanes, although we would maintain that the loss of even one life is of enormous proportion. If history is any guide, the overall economic impact of Hurricane Ida will become more exact over the days and weeks to come. With President Biden's swift emergency declaration for Louisiana as well as for Mississippi, access to FEMA money can now take place.***

As preparations were being made in anticipation of Ida's arrival, market stakeholders were eagerly awaiting the start of this summer's Jackson Hole, Wyoming economic summit hosted virtually by the Kansas City Fed, with a keynote speech scheduled to be delivered by Chairman Jerome Powell last Friday. ***Without seeming like we are bestowing gratuitous accolades upon Mr. Powell, we were quite impressed with his messaging and while there was some degree of nuance in his delivery, we do not think that market stakeholders could have received a more thoughtful, balanced, and transparent commentary.***

Let's not forget that this speech was widely anticipated to provide guidance on the level of Central Bank support for a tapering of the Fed's balance sheet before the end of the year. ***Leading into Jackson Hole, a number of key policymakers argued for near-term, decisive moves to slow the pace of asset purchases even in the wake of expanding Delta variant transmission rates. Some were also open in their views of when the tapering sequence should conclude and factored quite heavily into their policy calculus current thoughts of economic and inflationary metrics as well as the expectation that perhaps Delta is nearing its peak with a national economy proving its adaptability to the new health policy normal.***

Interestingly, not only will the voter composition of the FOMC shift at the beginning of next year, Mr. Powell's

**Jeffrey Lipton**
**Managing Director, Head of Municipal Research**
**Fixed Income Research**
(212) 667-5365
jeffrey.lipton@opco.com

Oppenheimer & Co. Inc. 85 Broad Street New York, NY 10004 Tel: 800-221-5588 Fax: 212-667-5925

term as Fed Chair expires in February, 2022, although President Biden has yet to announce his decision as to whether or not he intends to re-nominate Powell to a second term. ***In our view, Chair Powell has represented himself and the Fed with distinction and the utmost integrity and we assign a high probability of him being nominated/confirmed to a new four-year term.*** As we listened to the Chair's speech, ***there was clear indication that meaningful progress has been achieved on meeting the Fed's objectives for tapering asset purchases and that the process to pull back historical levels of accommodation is likely to begin this year with conclusion to come sometime in the first half of 2022.***

Having said this, ***we have to acknowledge that the risks associated with the COVID variants are significant and that a slowing impact upon the economic rebound should not be ruled out, thus exposing the outlook for monetary policy to potential timing adjustments.*** While there is little concern that current economic momentum may be derailed, we could see some softening in labor market advances. In our view, the Fed understands the risks on both sides of the timing issue and so policymakers have taken careful steps to orchestrate an orderly process that would minimize any disruptive effects upon the financial markets. Some Central Bankers believe that the asset purchases have overstayed their welcome given, for example, overly inflated housing values that seem to be locking out certain first-time homebuyers and other lower-income candidates.

***As part of his messaging, Chair Powell made it quite clear that the timing and pace of the tapering cycle would not signal the Fed's thought process on future hikes in the fed funds rate, which will be subject to a more stringent test.*** "We have said that we will continue to hold the target range for the federal funds rate at its current level until the economy reaches conditions consistent with maximum employment, and inflation has reached 2% and is on track to moderately exceed 2% for some time", according to Mr. Powell. He further noted, "We have much ground to cover to reach maximum employment, and time will tell whether we have reached 2% inflation on a sustainable basis."

During his speech, ***Chair Powell reiterated his transitory outlook for inflation and observed that global disinflationary forces remain, but noted that inflation at current levels may be a cause for concern and that Central Banks cannot rely on inflation being transitory***, further admitting that it is difficult to distinguish transitory inflation from more sustained inflation. With wage growth consistent with the Fed's longer-term inflation expectations, there is little concern for a wage/price spiral and there is reason to believe that supply/demand imbalances should exhibit continued improvement. Mr. Powell reiterated the Fed's desire to anchor inflation at 2%, even if inflation spends some time above its 2% target.

We continue to maintain that the recovery demonstrates uneven performance, with certain sectors trailing others. We agree that initiating a rate tightening sequence could be harmful if it comes too early and if substantial slack remains in the labor market. Acknowledging that employment gains arrived faster than expected, Chair Powell commented that there is still a lot of ground to cover for achieving maximum employment. Market participants are awaiting the release of August's labor data for signs of further acceleration in job formation.

While there was no express timeline given for the Fed's balance sheet tapering, he did provide assurances that the Central Bank is prepared to adjust policy as needed. As it presently stands, ***liftoff is priced in for early 2023, but we may see a migration to higher government bond yields given the emergence of several technical conditions during the tapering process as Treasury securities dealers lose their buyer of last***

***resort and find themselves formulating new risk assessment models. Having said this, continued strong foreign demand for U.S. Government securities, evolving COVID-19/ variant transmission concerns, and a still-dovish-biased global central banking community may very well combine to limit yield advances. For now, we would be hard-pressed to envision a 10-year benchmark Treasury yield much above 1.75% by the end of the year.***

We began this week's commentary discussing the aftermath of Hurricane Ida and, again, we must be grateful that the impact was not far worse. With sustained winds of 150 miles per hour, Ida blew down over 2,000 miles of utility transmission lines and 216 substations owned and operated by Entergy Corp., leaving more than 1 million homes and businesses in Louisiana without power, with another 100,000 users left in the dark in Mississippi. ***As of this writing, while a number of customers in Louisiana have been brought back on line, Entergy Corp. has indicated that its system endured "catastrophic damage" and that it could take "weeks' to restore power to all of the company's customers.***

***Thankfully, while the power grid suffered extensive damage, the levees and other critical infrastructure rebuilt following Hurricane Katrina largely survived Ida's impact.*** Area hospitals, already crowded from COVID patients, came under intense capacity pressure. Now, rising water tables and area flooding create a primary concern. Chemical plants, refineries and the Louisiana Offshore Oil Port found themselves directly in Ida's path, significantly curtailing daily crude production and refining capacity. Damage to critical agricultural export infrastructure and container terminals are directly affecting grain shipments.

***Typically, the impact to municipal credit following a natural disaster is manageable with FEMA recovery allocations made available to those jurisdictions under a national state of emergency declaration. Furthermore, various municipalities are benefitting from comfortable cash reserves and federal stimulus funding tied to pandemic recovery efforts.*** We do note that some of the weaker area municipalities may realize unexpected liquidity pressure and may take on greater credit risk. ***While it will take some time to assess fully the damages upon the oil and gas industry, prices at the pump have been driven higher, and can be expected to display volatility ahead of the extended Labor Day weekend.***

Let's remember that the refining industry had already experienced a number of plant closures thanks to pandemic-induced demand weakness and last winter's Texas deep freeze. According to a number of reputable sources, Hurricane katrina was the most expensive U.S. natural disaster with a price tag approximating $125 billion in total damages (2005 $). With damages still being tallied, the latest figures place overall costs of between $20-$30 billion for Ida.

Prior to and following Jackson Hole, tax-exempt muni yields largely held steady. Throughout the month of August, long-dated muni yields rose 13 basis points, but much of that price weakness was captured within the first two weeks of the month. ***We suspect that had it not been for supportive summer technical conditions, munis would have likely exhibited even more volatility last month. Parsing the performance data for August, we can see the challenges of booking additional positive returns given such low absolute yield levels and the more limited potential for higher valuations. Of course, uncertainty and anxiety over Central Bank policy did not help matters. We would note, however, thinner secondary trading volume during August may have somewhat skewed overall performance for the month.***

Throughout August, individual retail investors exhibited some resistance given frothy bond prices and a relatively greater degree of luxury to be more discerning when it comes to searching for value. With this in mind, municipal bond mutual fund flows have now been positive for 25 consecutive weeks as cash continues to be deployed, and we do not see anything on the horizon that would disrupt these substantive inflows. Against this backdrop, ***we do not foresee a material loosening up in credit spreads or even a substantive reversal in the currently rich muni valuations that have characterized the market for some time now.*** Of course, ***when the technical drivers alter course, let's be prepared to take advantage of likely investment opportunities.***

It has been a while since the muni index displayed negative monthly returns, but this is what occurred in August. Although U.S. Treasury securities underperformed munis in early August with both benchmark indices turning negative thanks, in part, to the strong July employment report, UST returns for the month, while negative, outperformed the broader muni index, a loss of 17 basis points versus a loss of 37 basis points respectively. Year-to-date, munis are still outperforming UST, 1.53% versus (-) 1.43% respectively. ***Again, a weaker technical environment for munis would have likely widened last month's performance gap.***

The 10-year and in tenors all outperformed the broader muni index in August, with the 15-year and out maturities underperforming. ***The stronger shorter-end returns last month likely reflect weaker pent-up demand for longer-dated securities despite advancing reinvestment needs given sidelined expectations for higher tax rates and more visible market volatility against a backdrop of more prevalent inflationary concerns and a closer pivot in Fed policy that could pressure Treasury yields higher.***

General Obligation bonds outperformed revenue bonds during August, a loss of 34 basis points versus a loss of 40 basis points respectively. We note that hospital revenue bond performance was somewhat softer than that of the broader revenue sector following previous months of outperformance. Various hospitals are being deluged by rising COVID/Delta caseloads with a renewed shift to less profitable ICU admissions from higher margin procedures such as elective surgeries.

Muni high-yield once again decidedly outperformed the broader index with a contained loss of 16 basis points and far outperforming the market through August 31st, returning 7.23%. ***Muni IG spreads remain tight with frothy (albeit we have seen some recent cheapening), less attractive valuations particularly for higher quality cohorts, interest rates still remain historically low, and the search for yield amid improving credit conditions continues unabated and high yield investors are willing to take on heavier credit risk in order to book more compelling yield.***

***Accordingly, we can point to better high yield flow activity relative to other segments of the municipal bond market and we think that this dynamic could continue for a while longer, although it remains questionable as to how much more performance there is to unlock.*** As concern over rising interest rates mounts, high yield can act as a defensive strategy, yet for many names availability can be challenging. We note that certain sectors are normalizing in terms of spread and are being priced accordingly, yet others remain under pressure as the credit story plays out longer term.

***Should there be sustained market disruption in the pace and/or direction of municipal fund flows with a market correction of material consequence given the currently low base level of yields, the muni high***

***yield sector could see a more pronounced widening-out in spreads (perhaps brought about by a credit event). While value can be found with acquiring high yield securities, high yield investors should exercise care when seeking alpha, as various credits are being structured with weaker covenants. We believe that tightly secured covenants are of particular benefit in a contractionary period whereby revenue disruption could occur.***

***We acknowledge that certain high yield issuers are diluting credit protection as a way to preserve some degree of debt flexibility with the knowledge that high yield product is in tight supply and above-market income is in high demand. We note that high yield municipal bond defaults are rising (especially among more highly speculative business models), against a generally stable high yield credit backdrop, with more recent transactions showing impairment and transitioning into eventual monetary default. Currently, we do not envision acute credit stress in the high yield space that could undermine performance through year-end.***

***With four months remaining in the year, we remain sanguine on the performance trajectory for munis as we continue to see new issue supply unable to keep pace with bond redemptions and maturing securities.*** Furthermore, now that the Fed appears to be approaching the beginning stages of the tapering process, with interest rate liftoff still a long way off, perhaps market participants can be less reactive to monetary policy pronouncements through the balance of the year (yes, we know this is wishful thinking). Although ***we believe that munis still have the ability to generate positive performance, admittedly such performance could be compromised should technicals become much less constructive and prospects for higher taxes fade considerably, even from currently elevated levels of doubt.***

***While technicals should remain supportive of muni performance, just how munis perform relative to UST will be largely determined by the Treasury market's response to Fed-speak, future inflationary data and viral transmission rates.*** In August, UST continued to reveal confidence in Central Bank guidance and held off from showing adverse reactions to the inflationary narrative, although volatility did emerge later in the month. The Fed is working overtime so as to avoid a repeat of the 2013 "taper tantrum", referring to the future easing of the Fed's QE program.

***Even without a lift in federal tax rates, munis should continue to offer very desirable credit quality and diversification attributes, and these very attributes are expected to further entice foreign investment into the asset class. As for domestic banks and insurance company interest, we would expect to see continued value in the muni tax exemption for regional banks and P&C insurance companies. Of course, ongoing interest in taxable munis from foreign buyers should elevate muni placement upon the global investment stage. We advise a careful assessment of all muni portfolio holdings and we would encourage investors to engage in swap opportunities as a way to bolster overall portfolio credit quality and tighten in duration where appropriate.***

While taxable muni returns turned negative in August, they still outperformed the broader muni index, declining 19 basis points and bringing year-to-date (through August) taxable returns lower to 1.76%. For several months now, we have seen less interest rate sensitivity exposure for the taxable muni index. August also saw more muted concerns over (i) advancing inflation, despite evidence of noted price pressure (ii) prospects for heavier stimulus, and (iii) a market hold-out for a balance sheet tapering – which is now just around the corner.

However, we think that ***taxable technicals had a heavier hand in the outperformance last month given lighter taxable muni supply and foreign buyer interest seeking favorable yield advantages, diversification attributes and above average credit quality. With more limited supply of taxable munis, domestic institutional buyers, which tend to have a heavier appetite for these securities compared with that of individual investors, actively participate in taxable offerings as a relative value play regardless of deal size, thus creating an attendant tightening of taxable spreads.***

August saw a drop in taxable muni supply by 40% year-over-year as overall muni volume declined by 8.4% during the same time period. ***Lower taxable issuance comes as little surprise given prior quarters of outsized taxable volume. We think that a shift in issuer sentiment contributed to the lower August volume with a number of factors to consider.*** The infrastructure debate continues as Congress has yet to finalize infrastructure legislation and in the meantime, issuers are trying to assess their capital needs. Further, there are new state and local funding allocations that issuers are still trying to figure out how best to incorporate such funds into the budgetary process. The uncertainty surrounding Central Bank monetary policy and the added market volatility in the Treasury market was a contributing factor.

***As long as rates are low enough and if you have a compelling enough spread environment that produces fertile ground for taxable advance refunding issuance, this structure will continue to be viable. We do note, however, part of that advance refunding need has been satisfied, and the rate and spread relationships are not necessarily as compelling as they were at the beginning of the year.*** With the August volatility and the attendant back-up in rates, such resultant market conditions have served to create lower taxable muni volume. We continue to expect aggregate taxable sales for 2021 to be around 20% of total muni volume as opposed to the 30% of full-year 2020 issuance.

Lower taxable muni volume can also be attributable to the use of financing alternatives such as forward-delivery bonds, private placements and the marketing of certain debt issued with corporate CUSIPS. Forward delivery bonds are a vehicle that provides, from an issuer perspective, a way to avoid or reduce interest rate risk and lock in savings by utilizing a structure that works like a current refunding, thus getting around existing call constraints. With forwards, however, an issuer may run the risk of a deal not closing should the purchase contract allow for certain investor outs, such as failure to attain a rating assignment, issuance of a qualified legal opinion, or loss of tax-exemption.  Investors typically benefit from additional yield spread given the potential that they may be unable to take delivery of the securities.

## Important Disclosures and Certifications

***Analyst Certification –-***The author certifies that this research report accurately states his/her personal views about the subject securities, which are reflected in the ratings as well as in the substance of this report. The author certifies that no part of his/her compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in this research report.

***Oppenheimer Credit Rating System:***

| Rating | Description |
|---|---|
| Outperform (OP) | The analyst thinks that the security will outperform the average total return of similar securities over the next 6 – 12 months. |
| Market Perform (MP) | The analyst thinks that the security will match the average total return of similar securities over the next 6 – 12 months. |
| Underperform (UP) | The analyst thinks that the security will underperform the average total return of similar securities over the next 6 – 12 months. |
| Not Rated: (NR) | Oppenheimer does not rate the security. |

***Conflicts of Interest -*** Oppenheimer & Co. Inc.'s fixed income research analysts are compensated from revenues generated by various Oppenheimer & Co. Inc. businesses including the Oppenheimer & Co. Inc. Investment Banking Department, Taxable Fixed Income Capital Markets Department and Municipal Capital Markets Group. Research analysts do not receive compensation based upon revenues from specific investment banking transactions, specific sales and trading transactions or on revenues derived from investment banking services provided to a specific issuer or industry sector. Oppenheimer & Co. Inc. generally prohibits any research analyst and any member of his or her household from executing trades in the securities of a company (or entity) that such research analyst covers. Additionally, Oppenheimer & Co. Inc. generally prohibits any research analyst from serving as an officer, director or advisory board member of a company (or entity) that such analyst covers.

Oppenheimer & Co. Inc. trades as principal the fixed income securities (or related derivatives) that are the subject of this research report and may at any time have proprietary positions in the securities (or related derivatives) that are the subject of this research report. Oppenheimer & Co. Inc. may have a long or short position or deal as principal in the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon.

Oppenheimer & Co. Inc. has or may seek to have an investment banking, underwriting, advisory, lending or other credit relationship with the company (or entity) that is the subject of this report., This may at times give rise to potential conflicts of interest.

This report does not take into account the investment objectives, financial situation or specific needs of any particular client of Oppenheimer & Co. Inc. or any particular investor. The securities mentioned in this report may be thinly traded; their prices, value and/or income they produce may be subject to extreme volatility. These debt securities are not suitable for all types of investors. Investors that are not "Qualified Institutional Buyers" or "QIBs" (as defined in SEC 144A) should not purchase or sell any of the securities mentioned herein without contacting a financial adviser in such investor's jurisdiction to discuss the investors particular circumstances.

This report is based on public information. Oppenheimer & Co. Inc. makes every effort to use reliable, comprehensive information, but Oppenheimer & Co. Inc. makes no representation that it is accurate or complete. All estimates, opinions and recommendations expressed herein constitute judgments of the Oppenheimer & Co. Inc.'s research analyst as of the date of this report and are subject to change without notice. Oppenheimer & Co. Inc. has no obligation to update this report. No statement contained in this report should be misinterpreted as a guarantee of the future performance of any recommended securities.

This research contains the views, opinions and recommendations of Oppenheimer & Co. Inc. fixed income research analysts. Research analysts routinely consult with Oppenheimer & Co. Inc. trading desk personnel in formulating views, opinions and recommendations in preparing research. Trading desks may trade or have traded as principal on the basis of research analysts' views and reports. Therefore, this research may not be independent from the proprietary interests of Oppenheimer & Co. Inc. trading desks, which may conflict with an investor's interests. In addition, while research analysts do not receive compensation based on any specific investment banking transactions, specific sales and trading transactions or on revenues derived from investment banking services provided to a specific issuer or industry sector, research analysts do receive compensation based, in part, on the quality and accuracy of their analysis, client feedback, trading desk and firm revenues, and competitive factors..

This report is provided for informational purposes only, and does not constitute an offer or solicitation to buy or sell any securities discussed herein in any jurisdiction where such offer or solicitation would be prohibited.

To the extent this report references municipal securities, investors should consult with their tax or accounting advisor(s) regarding the suitability of tax-exempt investments in their portfolio as Oppenheimer & Co. Inc. does not offer tax or accounting advice. Income generated from investments in municipal securities may be subject to state and local taxes as well as the Alternative Minimum Tax. Municipal securities are subject to gains/losses based on the level of interest rates, market conditions and credit quality of the issuer. Non-rated municipal bonds or municipal bonds rated below investment grade are speculative in nature and may not be suitable for all investors.

This research is distributed in the UK and elsewhere throughout Europe, as third party research by Oppenheimer Europe Ltd, which is authorized and regulated by the Financial Conduct Authority (FCA). This research is for information purposes only and is not to be construed as a solicitation or an offer to purchase or sell investments or related financial instruments. This research is for distribution only to persons who are eligible counterparties or professional clients and is exempt from the general restrictions in section 21 of the Financial Services and Markets Act 2000 on the communication of invitations or inducements to engage in investment activity on the grounds that it is being distributed in the UK only to persons of a kind described in Article 19(5) (Investment Professionals) and 49(2) (Financial Promotion) Order 2005 (as amended). It is not intended to be distributed or passed on, directly or indirectly, to any other class of persons. In particular, this material is not for distribution to, and should not be relied upon by, retail clients, as defined under the rules of the FCA. Neither the FCA's protection rules nor compensation scheme may be applied.

Distribution in Hong Kong: This report is prepared for professional investors and is being distributed in Hong Kong by Oppenheimer Investments Asia Limited (OIAL) to persons whose business involves the acquisition, disposal or holding of securities, whether as principal or agent. OIAL, an affiliate of Oppenheimer & Co. Inc., is regulated by the Securities and Futures Commission for the conduct of dealing in securities and advising on securities. For professional investors in Hong Kong, please contact researchasia@opco for all matters and queries relating to this report.



Oppenheimer & Co. Inc. transacts business on all principal exchanges.

Additional Information Available

Please log on to http://www.opco.com or write to Oppenheimer & Co. Inc. 85 Broad Street, New York, NY 10004, Attn: Municipal Research