October 5, 2021

Municipal Market Comments

Munis Entering The Home Stretch And Volatility May Provide Investors With Some Holiday - Time Opportunities; But The Operative Word Is May

Thinking about the publication date of this week's ***Municipal Basis Points***, we have to ask ourselves how did the time pass by so quickly as it seems like we just turned the calendar to January 1, 2021. While the COVID transmission rates, with the Delta variant now mixed in, have once again made a normalized back-to-school experience elusive for so many parents and students, Labor Day is now in the rear-view mirror, fall is upon us, and the traditional year-end holiday season is quickly closing in. With six policy meetings on the books and two remaining for the year, ***the FOMC is likely to make some rather consequential decisions of historic significance before the conclusion of 2021.***

Ahead of last month's FOMC meeting, the Fed was hoping to convey a message of calm while signaling to the markets that a tapering of its unprecedented bond-buying spree was upon us. Unfortunately, the debt crisis surrounding Chinese property developer Evergrande and advancing contagion fears resonated throughout global financial assets, thus setting up an unexpected wave of volatility and making it easier for stakeholders to seek cover as the Central Bank was set to convene its two-day policy session. Political stalemate in Washington with a looming deadline to raise the debt ceiling only added fuel to the fire. Throughout the first three weeks of September, U.S. Treasury yields, while clearly unsettled thanks, in part, to heavy government and corporate bond sales earlier in the month, kept to a tighter trading range before the 10 and 30-year benchmarks jumped about 25 basis points during the final week of the month.

By most accounts, the FOMC meeting did not conclude with any revelations surrounding the tapering of Central Bank balance sheet asset purchases, nor did Chair Powell's remarks at the post-meeting press conference signal any unanticipated deviations from his market-tested script. The policy statement indicated, "If progress continues broadly as expected, the Committee judges that a moderation in the pace of asset purchases may soon be warranted." Although no direct specifics were offered, it seems as though a gradual tapering campaign can be expected to conclude mid-way through 2022, assuming that the recovery holds the

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course. ***Perhaps the timing of interest rate lift-off caught some market participants by surprise as about half of the members now anticipate raising the Fed Funds rate by the end of 2022, as compared to a slight majority telegraphing lift-off in 2023 with June's revised economic projections.***

As the economy continues to move closer to the Fed's goals on "substantial further progress" on inflation and employment, prospects for a late 2022 rate hike become increasingly more likely and we would expect policymakers to move closer to consensus over the coming FOMC sessions. Chair Powell commented during the press conference that, "For inflation, we appear to have achieved more than significant progress, substantial further progress. That part of the test is achieved in my view and the view of many others." Although Chair Powell retains his transitory bias towards inflation as continuing supply constraints make it difficult to meet outsized demand, he does acknowledge "frustrating" price pressures that he sees extending into next year. Mr. Powell continued, "My own view is the test for substantial further progress on employment is all but met."

All eyes will be focused upon this Friday's release of September's labor report, with a particular interest in last month's nonfarm payrolls given the outsized miss and seven-month low in August job creation of only 235,000 while consensus called for 725,000 new positions. Clearly, delta variant driven viral transmissions and the associated concerns over our nation's growth trajectory weighed heavily on the employment backdrop as many employers held off on hiring and so many in the candidate pool took to the sidelines, with the more COVID-sensitive sectors showing the most impact, especially the leisure and hospitality space which came in virtually unchanged. Retail trade employment was down during the month largely due to weakness across food and beverage services. Although nonfarm employment has advanced by 17 million since April 2020, it remains suppressed by 5.3 million jobs, or 3.5%, from a pre-pandemic level posted in February 2020.

September payrolls are forecasted to come in at about 500,000 with record vacancies guiding the optimism and the national unemployment rate is expected to drop to 5.1% from 5.2%. ***Given the vagaries of the public health crisis, we have maintained that while the recovery will likely continue to move forward, it will do so at an uneven pace with a direct impact to GDP despite accelerating wage gains.***

In our opinion, the "law of diminishing returns" now envelops the unprecedented levels of monetary policy accommodation that have been provided by the Fed and the economy has absorbed sufficient stimulus with now being the time for growth to take on a more organic path. While it is reasonable for us to pare back our growth expectations for the second half of 2021, real GDP can still be expected to post full year annual growth of around 6% year over year.

While the labor data points form the Fed's narrative for meeting its goal of full employment, the August print did nothing to alter the policy course and we do not see anything on the jobs horizon that would shift sentiment away from the "substantial progress" bias. We think that the termination of supplemental unemployment insurance benefits and ongoing, albeit slowing, efforts to seek the COVID vaccination should help to lift employer confidence and drive a more encouraging jobs report for September.

While one data print should not necessarily alter the investment thesis, we are mindful that evolving public health conditions could elevate volatility and dissuade workers from re-engaging with the workforce or returning to the office, particularly if homeschooling and general child-care issues are a

primary concern. Again, the strong August wage growth indicates that labor supply as opposed to demand was responsible for the soft print.

Further, while school re-openings have yet to normalize, we are seeing more consistency in staying on track year over year and there is growing evidence that perhaps the transmission rates have peaked and are now on the decline overall. The September labor report would only provide one additional month of employment data ahead of the early November FOMC meeting, yet economic resiliency is firmly in place and participants are not necessarily looking for an outsized number, even though job formation trails the Central Bank's employment goals. ***Thus, we would not be surprised to receive a taper announcement next month, but delta will remain a key determinant.***

At this point, any specifics on the Fed's looming tapering schedule is subject to conjecture and so we choose to refrain from making any prognostications as to the individual levels of tapering for U.S. Treasury and mortgage backed securities respectively. ***More recent inflation data has demonstrated some variability, yet there seems to be a fairly unified front among the Fed, ECB, and other Central Bankers that inflationary surges are transitory given the perceived temporary effects of supply-chain disruptions (which may give rise to disappointing Christmas deliveries) against a thickening wall of demand driven by the realities of a re-engaging economy.***

As we have indicated, while Central Bank theory has a place in our investment calculus, we are concerned that perhaps inflation may become more heated and remain above the Fed's 2% target longer than currently envisioned. If this turns out to be the case, we cannot rule out the need for unexpected monetary policy intervention. Having said this, the impact would likely have more influence on the timing of the Fed's "lift-off" sequence. For now, we are just starting to assess the impact of a shifting composition in Fed membership given the recently announced retirements of Dallas Fed President Kaplan and Boston Fed President Rosengren, particularly with an anticipated tight split among voting participants during the 2022 policy session.

Interestingly, the dot-plot illustration does not distinguish between voting and non-voting members. President Rosengren's departure seems more consequential as President Kaplan would not be casting a vote until 2023 and so there now exists less predictability over lift-off. Furthermore, there will be a number of vacant seats on the Board of Governors in 2022, and although we expect Chair Powell to serve a second term, President Biden has yet to advance his nomination. ***In our view, Jerome Powell has demonstrated a steady hand as Fed Chair and we think that it would be a disservice to the Central Bank, the economy, and to the financial markets to inject uncertainty into the system at a time when stability and a sense of the familiar are of critical importance.***

While monetary policy is certainly driving market sentiment, Washington discourse is creating a more urgent call to action. Against a backdrop of debating infrastructure and the Democrats' consideration of reconciliation legislation, Congress must move to raise the Federal debt ceiling or risk defaulting on U.S. government debt and missing payments to military personnel and senior citizens. Treasury Secretary Janet Yellen has called upon legislators to reach a deal by October 18th and Fed Chair Powell has made similar pleas. Let's recall that S&P downgraded the debt of the U.S. government in 2011 from "AAA" to "AA+" when the Treasury came close to missing essential payments. As of this writing, House-passed legislation to avert a government shutdown and suspend the debt limit appears to be encountering resistance in the Senate.

With all of this volatility, it is no wonder why bond yields have climbed appreciably in September. The benchmark 10-year UST yield remains just under 1.5% as of this writing, yet we do envision a level closer to 1.75% by year-end with tapering expected to set in by December. Such a move can be expected to lift bond yields going forward and test those YTD highs achieved last spring even before the onset of "lift-off" beyond 2021. The risk of not suspending the debt ceiling will only fuel bond yields higher, contributing to a steeper Treasury yield curve. The Treasury Department reports that Congress has elevated or suspended the debt ceiling 78 times since 1960, with the last time being in 2019.

Throughout September, 10 and 30-year benchmark muni yields advanced by 20 and 15 basis points respectively, driven primarily by the sell-off in the Treasury market. As we approach year-end, we are wondering just how much of what we loved about munis in 2021 can be salvaged. ***Our optimistic bias suggests that munis will finish the year with more than just an honorable mention. Given the noted back-up in rates, there is still ample cash awaiting investment guidance and retail investors are still seeking value opportunities, but apprehension lingers. For 30 consecutive weeks, muni fund flows have remained positive, although the pace of deposits is showing signs of waning.***

It is worth observing that retail seems distracted by the Puerto Rico restructuring offers now being disseminated as directional clarity has become high priority. New issue deal placement has seen some improvement as compared to the prior week, with deals being bid at wider spreads, and more competitive offerings are showing zero syndicate balances. ***In our view, primary issuance should continue to be absorbed through the balance of the year as technicals hold in, yet certain issuers will remain fixated on health policy directives and political uncertainty, which may impact marketing decisions.*** Inflationary pressure may prove less transitory and we are seeing a greater focus on receding policy accommodation over the coming months.

We have a lot of uncertainty in the market right now, and when there is a lot of uncertainty, that gives the issuer community pause. State and local government officials are struggling to handicap the effects of delta transmission rates while at the same time they are seeking to expand the penetration of COVID vaccinations. Long-dated tax-exempt muni yields are moving closer to testing their highs of last March, with more enticing relative value ratios now being offered throughout the curve. As of this writing, ten and 30-year benchmark ratios stand at 77% and 82%, respectively, a considerably higher zip code than what has back-dropped the muni market for much of the year.

As stated this time last month, it had been a while since the muni index displayed negative monthly returns and now we have two consecutive months of losses to end Q3 in the red. ***Parsing the performance data for September, we can see the headwinds confronting the bond markets, yet we observe that munis outperformed UST. We suspect that had it not been for supportive summer technical conditions, emerging prospects for relaxed eligibility issuance guidelines, and renewed optimism for higher taxes, munis would have likely exhibited even more volatility and perhaps weaker returns last month and for the quarter.*** Last month, munis lost 72 basis points while UST returned (-) 1.08%. YTD, munis are still outperforming Treasuries, 79 basis versus a loss of 2.5%.

The 7-year and in tenors all outperformed the broader muni index in September, with the 10-year and out maturities underperforming. ***The stronger shorter-end returns last month likely reflect weaker pent-up demand for longer-dated securities with less active reinvestment needs 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 modestly outperformed revenue bonds during September and we note that hospital revenue bond performance closely tracked that of the broader revenue sector following more visible underperformance throughout August. ***We suspect that hospitals are managing the higher COVID caseloads, which have likely peaked, and have not moved significantly away from higher margin procedures such as elective surgeries.***

Muni high-yield outperformed the broader muni index with a loss of 65 basis points, yet the monthly performance gap between the two has narrowed. YTD, high-yield still significantly outperforms the broader index. ***Last month witnessed some spread within IG space, and we are now at cheaper relative value ratios and valuations for higher quality cohorts have created some relative interest. As we posited some time ago, any significant market sell-off would likely impact high-yield performance the most with a more pronounced widening in credit spreads, and we have even witnessed the first outflow in high yield cash in quite some time.***

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. Although it remains questionable as to how much more performance there is to unlock in the high yield space, high yield can act as a defensive strategy as concern over rising interest rates mounts.

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 three months remaining in the year, the performance trajectory for munis is less clear even though new issue supply is unlikley to keep pace with bond redemptions and maturing securities. Now that the Fed appears to be approaching the beginning stages of the tapering process, with interest rate "lift-off" 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, prospects for higher taxes and President Biden's overall legislative agenda fade considerably, and should Washington's political dysfunction create further bond market dislocation and spread widening.***

Even without a lift in federal tax rates, however, 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.***

Not only were taxable muni returns negative in September, taxables significantly underperformed the broader muni market with a loss of 1.24%, bringing YTD (through September) taxable performance down to 50 basis points. Parsing the volume data for September provides some counter-intuitive observations. September saw a drop in taxable muni supply by over 60% year-over-year as overall muni volume declined by about 33% during the same time period. Although ***lower taxable issuance comes as little surprise given prior quarters of outsized taxable volume, we would have thought that the dearth of taxable supply would have produced better performance.***

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 were contributing factors. With the September 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.

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.

Nevertheless, a number of issuers who have been waiting on the sidelines in anticipation of some muni-friendly legislative provisions may want to step in and take advantage of still attractive rates before they move higher. As we consider the forward calendar, we do see elevated taxable deals on deck. ***While taxable munis may be lagging the broader muni index YTD, taxable munis have demonstrated better performance relative to a number of taxable alternatives, and we suspect that this trend will continue through year-end.***

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.

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