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MUNICIPAL STRATEGY AND RESEARCH

Municipal Basis Points – Weekly

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Municipal Market Comments

The Muni Money Train Holding Tight On The Rails

With the latest FOMC meeting now in the rear-view mirror and Fed officials free to speak their minds until the onset of the next “blackout period”, a generally unified message from our Central Bank is being telegraphed giving Jerome Powell strength in numbers. ***Building inflationary pressure - both forecast and actual - is welcome, particularly with the more traditional Fed hawks signaling a lack of persistent inflationary pressure over the longer term***. ***Any taper talk among policymakers is being largely kept at bay with broad contentment to hold the benchmark funds rate and balance sheet management right where they are without the need for a near-term shift in forward policy guidance.***

In our view, the Fed seems to be exhibiting a more blurred distinction between policy hawks and doves, with a more dovish bias shaping Central Bank guidance. Acknowledging an ample pipeline of government spending that appears likely, Chair Powell and team expect inflation to rise to their long-range target of 2% and likely higher for a bit, yet remaining manageable throughout the foreseeable future. The markets will be paying very close attention to June’s policy meeting as the FOMC will be releasing revised economic projections and we will assuredly be looking for signs of any meaningful break in consensus among the participants. Over the coming days and weeks, we expect to have a better handle on the implications of the recent ransomware cyber-attack targeting the major Colonial east coast pipeline that remains closed, particularly with respect to supply disruptions.

For much of last week, a muted tone kept munis and Treasuries largely range-bound until Friday’s release of April’s labor report showing an outsized miss of historical significance to the downside in non-farm payrolls (+266,000 vs. consensus of +1,000,000) even with a rise in labor force participation. ***The surprise headline print adds weight to the Fed’s policy stance and would seem to fray the “string” of payroll advances Chair Powell indicated would be necessary to initiate the taper talk and a return to monetary policy normalization. It further fits into our narrative of a delicate and uneven recovery with the employment rolls still short by over 8 million employees from pre-pandemic levels, and prompted slight bumps in the MMD throughout most of the curve post release.***

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It comes as no surprise that the weak job formation last month along with a slight increase in the unemployment rate to 6.1% had become quickly politicized with a post mortem revealing a number of contributing factors, none of which seem to suggest an issue with demand, including anticipated federal policy, extended government stimulus payments and unemployment benefits to a wide swath of the population, supply chain disruptions and higher prices, remaining virus-related concerns, lack of adequate child care, and even a global chip shortage.

This week, market participants are standing by to interpret the retail and wholesale inflation data and are eager to hear what Fed members have to say regarding price pressure and labor force expectations. Last week, we saw that Treasury Secretary Janet Yellen walked back some market-unnerving comments concerning inflation and rate increases within the context of President Biden's spending initiatives. Surely, Secretary Yellen must remember from her days as Fed Chair that every word uttered tends to elicit a market response and so we are confident that her new role and market behavior will find themselves in sync soon enough.

Muni spreads continue to grind tighter, thus making it challenging to locate value. We are presently observing a tale of two retail buyers, one that is searching for value and is tough to commit, and one that is consistently looking for tax-efficiency and high credit quality and is an easier sell. The new issue market continues to show strong and welcoming reception as supply remains manageable and reinvestment needs are about to intensify for a while.

Going forward, tighter spreads and richer relative value ratios can come about, particularly as looming tax increases amplify the value of tax-exemption, although we have to question just how much lower ratios can go and how much tighter spreads can become.

As a sign of muni market inspiration, one simply has to parse the April volume and performance data. According to Refinitiv, overall municipal issuance rose 6.2% in April year-over-year totaling $33.65 billion. With just one-third of the year behind us, the April advance places 2021 volume on track to surpass last year's record issuance of just over $480 billion. Through the end of April, volume stood at $142.98 billion, almost 21% higher than reported issuance during the same period last year.

Much of the rise in volume last month can be ascribed to new-money transactions, which almost tripled April's refunding issuance as the universe of refunding candidates thinned a bit given interest rate sensitivities and as issuers took advantage of a strengthening credit backdrop supported by multiple rounds of fiscal relief. Refinitiv shows new-money issuance spiking almost 41% to $23.74 billion, while refunding volume rose only 10.7% to $7.95 billion year over year.

Against this backdrop, a month/month decline of 5.5% for taxable issuance was not a surprise as taxable refunding activity eased a bit. If conditions persist, we do not see taxable transactions matching last year's contribution to overall supply of 30%, and we think our beginning-of-the-year projections for taxable issuance coming in at closer to 20% seem more realistic given a higher rate environment and what may be a more desirable appetite for tax-exemption with prospects for higher corporate and individual tax rates.

We suspect that new-money issuance through the balance of the year will be guided by the state of muni credit and levels of capital needs just as refunding activity will likely remain influenced by interest rate shifts. At the beginning of the year, we forecasted aggregate issuance between a range of $420

- $440 billion predicated upon a more conservative view of issuer willingness to take on new debt at a time of severe budgetary challenges and constraints.

A stronger-than-anticipated recovery with a sooner-than-expected return to a stable outlook for various sectors would seem to loosen up this range and so we are compelled to revise our volume forecast higher to a new range between $450 - $470 billion. While events and circumstances may impact issuance trends, there are very real prospects for a record issuance year in 2021 as long as the stars line-up.

While it is true that the April tax filing date gives rise to a seasonal event whereby investors may liquidate certain muni holdings to cover their tax liabilities, such cyclical phenomenon does not always generate meaningful sales. Furthermore, we believe that the muni technical dynamic will more than overshadow this short-lived occurrence. We would also posit that a filing extension to May 17th for federal tax returns, with states following suit, is not likely to have a substantive credit impact one way or the other as states maintain financial cushions such as reserve funds and they could also postpone spending until the tax receipts are collected.

Treasuries had a much better month in April than in March, yet volatility was more evident than what was experienced in the muni space. Benchmark muni yields trended lower at mid-month and kept to a very tight trading range through the balance of April. According to the Bloomberg/Barclays performance indices, munis outperformed UST in April, 84 basis points versus 75 basis points respectively. ***We suspect that had it not been for the constructive muni technicals, the performance variance between the two asset classes may have been even tighter, but we think with still stronger muni returns. Year-to-date, munis are visibly outperforming Treasuries, 48 basis points versus a loss of 3.53% respectively.***

For now, we see continued outperformance by the muni asset class as long as technicals hold in, and we think they will. We note rather lofty amounts of sidelined cash still seeking investment guidance, and with the potential for higher, more attractive yields (although likely to be tempered by prospects for higher individual and corporate taxes) along with a generally favorable credit outlook, infrastructure buzz, and ESG investment needs, there is ample room to put much of this money to work.

Fund flows and ETF contributions have been quite active, although we note some recent slowing that should not signal a shift in trajectory, and we expect a trend of ample flows to continue given such intersecting factors that are making munis the desired fixed income investment of choice. Bloomberg data supports this thesis as net negative supply conditions are expected to intensify this summer with about $150 billion ready to get placed and likely keeping ratios to their currently frothy range.

After showing recurring losses, taxable munis returned 1.52% in April to outperform the broader tax-exempt market, narrowing year-to-date taxable losses to just over 2%. We ascribe the turnaround to much less interest rate sensitivity exposure for the taxable muni index. Compared to the prior two months, April seemed to bring about more muted concerns over advancing inflation, prospects for heavier stimulus, and a market hold-out for a Fed pivot. Taxable technicals also had a hand in the outperformance given lighter taxable muni supply and foreign buyer interest with an attendant tightening of taxable spreads.

The 15-year and out tenors all outperformed the broader muni index, with the 10-year and in maturities underperforming, especially the ultra-short cohorts, essentially repeating the March maturity performance breakdown. ***The stronger longer-end maturities last month likely reflect ongoing demand for longer-dated securities with prospects for higher taxes and heavier reinvestment needs against a backdrop of less prevalent inflationary concerns along the back end of the muni yield curve. We still maintain that compelling market technicals coupled with a favorable credit outlook have the ability to unlock further performance this year.*** General Obligation bonds underperformed revenue bonds during April, 73 basis points, versus 94 basis points respectively.

Muni high-yield decidedly outperformed the broader index in April with a return of 1.46%, and is far outperforming the market year-to-date through April returning 3.61%. Muni IG spreads remain tight with frothy, 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.

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.

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