MUNICIPAL QUARTERLY

January 2020

What a year to be a bond investor. After rising nearly 200 bps from its all-time low hit in mid-2016, the yield of the 10 Year Treasury entered 2019 at 2.69%, only to give up hard-fought field position and end the year at 1.92%. This large decline in Treasury rates propelled the Bloomberg Barclays US Aggregate Index (the closest thing we have to the S&P 500 on the bond-side) to an impressive 8.72% total return, its highest post-financial crisis annual return.

Across the domestic fixed income landscape, investors were rewarded with healthy returns just about everywhere they looked. The investment grade credit slice of the broader index returned 14.54%, as credit spreads narrowed, while the Treasury portion returned 6.86%. Long Treasuries returned a whopping 15.11%! For their part, municipal bonds had a great year, as well, with the Bloomberg Barclays Municipal Bond Index returning 7.54%, and that is before taking any tax efficiencies into consideration.

**Exhibit 1: 2019 Fixed Income Index Returns**

<table>
<thead>
<tr>
<th>Category</th>
<th>Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Municipal</td>
<td>7.54%</td>
</tr>
<tr>
<td>U.S. Aggregate</td>
<td>8.72%</td>
</tr>
<tr>
<td>U.S. Treasury</td>
<td>6.86%</td>
</tr>
<tr>
<td>Treasury 20+ Year</td>
<td>15.11%</td>
</tr>
<tr>
<td>Corporate</td>
<td>14.54%</td>
</tr>
<tr>
<td>Corporate High Yield</td>
<td>14.32%</td>
</tr>
<tr>
<td>CMBS</td>
<td>8.29%</td>
</tr>
<tr>
<td>ABS</td>
<td>4.53%</td>
</tr>
<tr>
<td>U.S. MBS</td>
<td>6.35%</td>
</tr>
</tbody>
</table>

Source: Bloomberg Barclays Indices

There were two factors at play for much of the year that stood out among others in explaining returns, the Federal Reserve and China. In terms of the Federal Reserve, after raising short-term interest rates nine times since the end of 2015, they went on to cut rates three times over the course of 2019 in what was billed as a “mid-cycle adjustment”, a tweak if you will. In reality, it was more like a complete about-face for Chairman Powell after a near market meltdown in December of 2018. Call it what you will, but it was widely interpreted as a signal that the economy was weakening and that the Fed was more than willing to keep the gravy train of easy money going down the track to prop it up.

Switching from the domestic to the international, the yearlong U.S.-China trade dispute played like a formulaic romantic comedy “will they, won’t they” plot line, only to see the two say I do at the end, or get engaged anyway (no rings were exchanged; nothing has been signed as of this writing). Still, even if it was only an agreement in principal on a phase one trade deal, both equity and fixed income markets breathed a collective sigh of relief. As we have said before, sometimes the one thing markets hate worse than bad news is uncertainty. With uncertainty in abundance, there were times when consensus opinion seemed to toggle between recession and continued expansion. A cooling of U.S.-China tempers later in the year, along with a supportive Fed, provided a sense of stability that moved the needle back toward the continued expansion camp. This provided a runway for interest rates to drift higher in the 4th quarter, though nowhere nearly enough to get back to where they started the year, or erase the gains of the first three quarters.

In the same way that a rising tide lifts all boats, falling interest rates of the magnitude observed last year lifted just about all bond prices, including those of municipal bonds. In fact, the move in broader interest rates went further than any developments within the sector in explaining municipal returns in 2019. This was somewhat of a departure from the previous year when municipal returns were largely shaped by the sector adjusting to the impacts of the newly-passed Tax Cut and Jobs Act (TCJA). Even so, sector-specific developments were mostly supportive, as munis benefitted from a favorable technical backdrop, sound fundamentals, and limited negative credit events.

On the demand side, it was a record year for municipal fund flows, which were positive each month and came in at over $92 billion. To put that in perspective, cumulative fund flows from the previous five years (2014-2018) totaled just north of $96 billion. Banks and other corporate investors did continue to shrink their municipal holdings due to their lower tax rate post-tax reform (21% versus 35%), though they did so at a slower pace than in 2018 and to a lesser degree than fund flows increased. Supply picked up quite a bit and was 21% higher on the year, totaling $417.8 billion, with net issuance coming in at +$51 billion.

Digging deeper into municipal returns, 2019 was a year where it paid to take credit risk and be long duration. Within the investment grade spectrum, AAA, AA, A, and BAA-rated securities returned 6.73%, 7.12%, 8.10%, and 9.94%, respectively. And across the curve, the 1 Year, 5 Year, 10 Year, and Long Bond portion of the index returned 2.46%, 5.45%, 7.70%, and 10.26%, respectively. Revenue bonds outpaced general obligations (7.93% versus 7.30%), though within the GO portion of the index there was quite a bit of separation between state GOs (6.78%) and local GOs (7.86%). Overall,
the curve experienced a bull flattener with the slope of the 2-30 AAA curve falling 18 basis points (bp) to finish at 109 bp, compared to 82 bp for the Treasury curve. When viewed on a percentage-of-Treasury basis, generic AAA 2 Year, 5 Year, 10 Year, and 30 Year municipal yields all ended the year tighter at 67.41%, 67.26%, 77.28%, and 90.08%, respectively.

What was not eliminated was the ability of issuers to issue taxable securities to call tax-exempt ones to a future call date, which is what a taxable advance refunding does. There was a catch, though, and that is taxable advance refunding requires a near perfect storm to make economic sense. For one, taxable yields today need to be lower than tax-exempt yields were when a deal came to market. Also, the curve needs to be reasonably flat to cut down on the scary sounding term of negative arbitrage, which has to do with the fact that short-term securities are purchased and placed in escrow to pay off longer ones.

Thanks to a big move downward in Treasury yields and a curve that was flat (even inverted at times) 2019 could not have been more of a perfect storm for taxable advance refundings to take root if it had starred George Clooney and Mark Wahlberg. As issuers wised up to this, the floodgates opened up and we witnessed the largest amount of taxable municipal issuance since the Build America Bond program of 2009-2010. This trend is widely expected to continue into 2020. At some point, however, the economics will likely stop making sense, at which point the amount of taxable issuance would be expected to slow. Until then, a spike in taxable issuance could pressure option-adjust spreads higher and provide an opportunity for banks and other corporate investors (even international ones) to re-engage with the sector, especially considering that it is a higher quality market than credit where AAA and AA-rated bonds comprise a greater percentage of the overall market.

As we head into 2020, many market pundits are calling for more of the same from the municipal market, though metering expectations for lower returns. After all, 2019 will be a hard year to top in that regard. Municipal demand looks to remain healthy and most are calling for a marginal uptick in supply. Should taxable issuance take off further from here, you could see a situation where that taxable supply begins to cannibalize traditional tax-exempt supply and create some scarcity value for tax-exempt securities. In such a scenario, sourcing bonds could prove difficult and percentages-of-Treasury would likely decline further. Even so, we maintain our preference for high-quality* bonds and advocate a patient approach.

Source(s): Barclays Research, ICI, SIFMA.org, Bloomberg and Bloomberg Barclays Indices
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