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The 2nd quarter of 2020 comes to a close amid what continues to be a relentless news cycle. The rapid fire nature of information to process brings to mind the song “We Didn’t Start the Fire”, where its writer, one Billy Joel, chronicled the cultural and political events of a post- WWII world. Rather than,

“Einstein, James Dean, Brooklyn’s got a winning team; Davy Crockett, Peter Pan, Elvis Presley, Disneyland”

it has been more a matter of,

State G.O. bankruptcy, quick re-open fallacy, GDP growth is over, muni yields getting lower; Depression, recession, spread blowout then compression, budget cuts getting deeper, yield curve getting steeper

Okay, that is probably not as commercially viable, but hopefully you get the idea. Trying to digest it all has truly been like drinking from a fire hose and has proven to be a near-insurmountable task.

Making matters worse, most of the news has been really, really bad. If the old adage was that no news is good news, the updated version seems to be that bad news is good news because at least it is better than it was yesterday. But here is the kicker, one would never know the tone had been so ugly by looking at returns; municipal bonds had a great quarter. In fact, at times it seemed as if the worse the narrative, the better the performance. It was reminiscent of another piece of popular culture, the Mel Brooks movie-turned-play *The Producers*, where the protagonists discovered they could make more money by producing a flop than a hit.

Intensive care units nearing capacity? The hospital sector was up 2.41% on the quarter, or in line with the broader municipal bond index. Mass-transportation ridership off 80%? No worries, the largest mass-transit system in the country, the Metropolitan Transportation Authority of New York, can just tap the market to cover their estimated $8.5 billion deficit resulting from ridership being down approximately 95% at one point. And while they are at it, they might as well upsize their deal and lower yields by 10 bp from preliminary price talk due to strong buyer demand (this actually happened). The transportation sector was up 2.76%, or 4 basis points more than the market. It was not just sector-related either. Rather, it was full-on, risk-on in the 2nd quarter, with lower-quality securities outperforming higher-quality ones and the back-end of the yield curve faring better than the front-end.

Exhibit 1: Municipal Market Returns Breakdown

	2Q20	1Q20	YTD
Municipal Bond Index	2.72%	-0.63%	2.08%
GO Bond Index	2.86%	0.11%	2.98%
State GO	2.85%	-0.02%	2.83%
Local GO	2.87%	0.24%	3.13%
Revenue Bond Index	2.73%	-1.01%	1.69%
Electric	2.87%	-0.07%	2.80%
Hospital	2.41%	-1.26%	1.12%
Housing	1.72%	0.12%	1.84%
IDR/PCR	5.68%	-4.30%	1.14%
Transportation	2.76%	-1.68%	1.04%
Education	2.55%	0.03%	2.58%
Water & Sewer	3.01%	0.34%	3.35%
Resource Recovery	1.60%	0.22%	1.82%
Leasing	2.72%	-2.50%	0.15%
Special Tax	1.77%	-0.10%	1.67%
Aaa	2.86%	0.54%	3.42%
Aa	2.69%	0.03%	2.73%
A	2.70%	-1.30%	1.36%
Baa	2.79%	-4.72%	-2.05%
Muni Short (1-5)	2.19%	-0.41%	1.77%
Muni Intermediate (5-10)	3.19%	-0.82%	2.34%
Long Bond (22+)	2.93%	-1.19%	1.70%

Source: Bloomberg

So how is one to reconcile this apparent disconnect between returns and the general state of affairs? In a word, stimulus. To date, there has been roughly $3 trillion in fiscal policy enacted through three separate “phases”, plus a Federal Reserve that has moved closer-and-closer to a lower-forever central bank policy. Not to be left out, the municipal market had a seat at the table, with state-and-local governments receiving $150 billion from the CARES Act, the Federal Reserve establishing the Municipal Liquidity Facility (MLF), and a number of beleaguered sectors, such as hospitals and mass-transportation systems, receiving direct support.

That is not necessarily the end point, though. Negotiations for a phase-four stimulus package are underway and more aid to state-and-locals, as well as general support for the municipal market, is on the line. This goes a long way towards explaining the disconnect between performance and tone. The better things get, the less likely it becomes that there will be more aid, and vice versa. This is why in the eyes of the municipal bond market, the blowout jobs report in May could be viewed as “bad” thing, while burgeoning public sector budget shortfalls could be viewed as a “good” thing.

As counterintuitive as this logic seems, it does make sense. Of course, it only holds water so long as defaults remain at bay. So far, they have, though it is entirely too early to draw any conclusions on that note just yet. Still we do not envision there being a widespread default wave. Ratings downgrades are a different story; we do think there will be a lot of them. Surprisingly, or even shockingly, we have seen the number of upgrades relative to downgrades increase recently, with upgrades actually exceeding downgrades in May, according to Moody’s. Even if that does prove to be unsustainable, it is a testament to the core quality and resilience of the asset class.

Yields on municipal bonds tell a similar story. Thanks to very strong 2nd quarter returns, benchmark municipal yields are now considerably lower across the board than they were at the beginning of the year, prior to the COVID-19 pandemic (Exhibit 2). It is a harder argument to make that issuers are in better shape today than they were in January and that yields appropriately reflect the trade-off between risk and reward. While it does seem as if municipal valuations have abandoned their fundamentals, it is important to not lose sight of the bigger picture. Treasury yields are down a lot, too, as are corporate yields. Municipal valuations may appear extremely rich on an absolute basis, but they continue to be attractive on a relative basis. Looking at percentages-of-Treasuries, the 2-year, 5-year, 10-year, and 30-year finished at 171%, 158%, 130%, and 121%, respectively. These levels are far lower than their late-March peaks but remain very elevated compared to their five-year averages of 91%, 87%, 93%, and 102%, respectively.

Considering where the 1st quarter left off, it is frankly an enviable position to be in where perhaps the biggest grievance about the municipal market is that yields may be too low to adequately compensate for inherent risks. We'll take stretched valuations to a full-blown liquidity crisis any day. It has been a bumpy ride to say the least, but the market has pulled back from the edge and is in better shape today than it was back in March. The problems have not gone away, but the market is at least functioning properly once again. Liquidity has dramatically improved and new issuance is back and being met with strong demand as fund flows have turned positive.

We are not out of the woods yet, however, and fully expect bouts of volatility to continue. With the election just a few short months away, the news cycle shows no signs of letting up any time soon. Though it is hard to imagine, the next verse to the song could even be more impactful than the one that just played. Who knows, instead of,

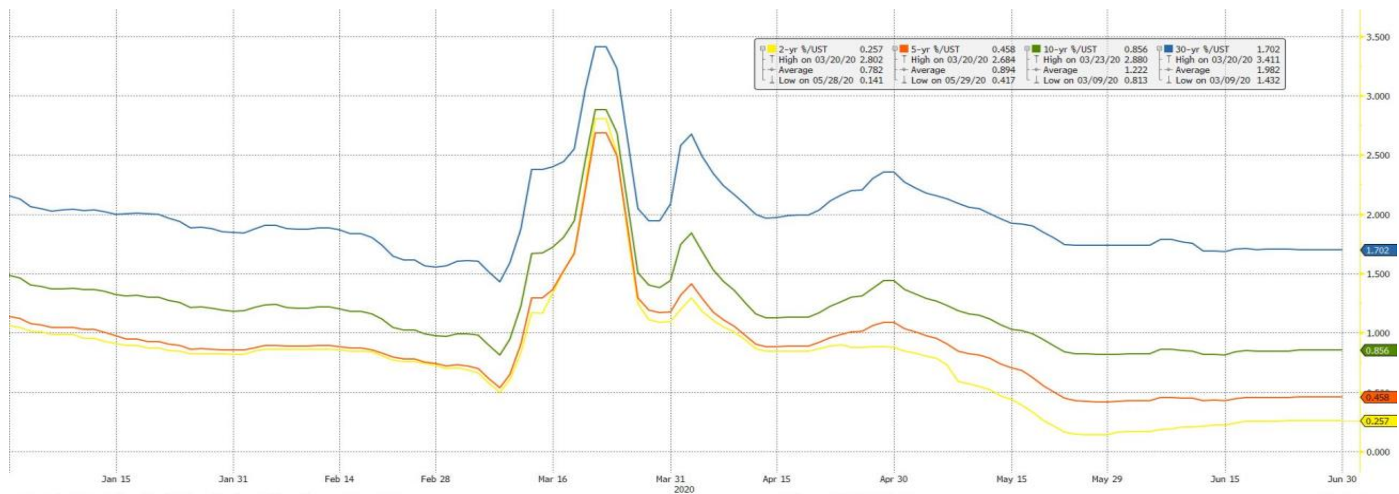
"Eisenhower, vaccine, England's got a new queen; Marciano, Liberace, Santayana goodbye"

we could be looking at something like,

Stimulus, more aid, states and locals get paid, SALT cap, roll back, fate of ACA; COVID cases trending down, interest rates hold zero bound, GDP, CDC, less talk of COVID on TV

On second thought, let's give it to the Piano Man on this one, as his version includes a "vaccine".

Exhibit 2: Municipal Benchmark Yields



Source: Bloomberg

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