3Q 2021

NEUBERGER BERMAN

Municipal Basis Points

Winds Are Changing

Throughout the pandemic, the Federal Reserve has maintained its commitment to supporting the economy and markets. As the Fed starts to consider slowly reducing its level of stimulus, the Municipal Fixed Income team believes that the recent certainty around monetary policy enjoyed by investors could erode, adding to market volatility but also potentially increasing opportunities for security selection. The team provides its views in this report.

NEUBERGER BERMAN MUNICIPAL FIXED INCOME TEAM

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“If everybody’s thinking the same thing, then nobody’s thinking.”
— **GEORGE PATTON**

JAMES L. ISELIN
HEAD OF MUNICIPAL FIXED INCOME

Winds Are Changing

Shifts in policy could make conditions more interesting in municipals and fixed income markets generally.

Ever since the pandemic started, the Federal Reserve has left market participants with little doubt that it would do whatever it takes for as long as it takes to support the flow of credit, keep markets functioning in an orderly manner, and, in turn, help foster a broader economic recovery and recapture lost jobs. While COVID-19 has remained a formidable and unpredictable foe, the commitment of the Fed in helping get the economy back on track has never been in question. At the Fed’s press conference after its June meeting, Chairman Jerome Powell may have topped Alan Greenspan’s famous “irrational exuberance” line when he said, “we are not even thinking about thinking about raising rates.” While he was clearly trying to reassure markets that the Fed is committed to supporting the economy, it is probably a safe bet that, in the not-too-distant future, the Fed will let the markets know that it is, in fact, thinking about tightening monetary policy.

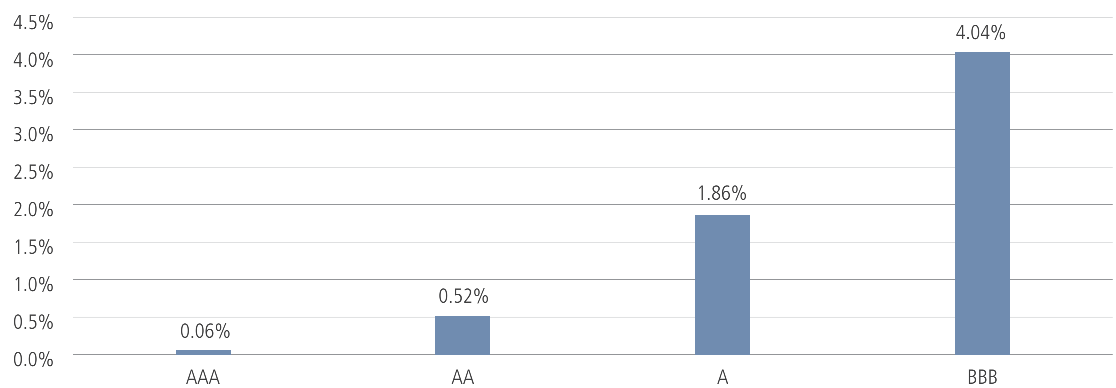
We bring up this point as a reminder that things are likely to get a lot harder for the Fed as it tries to slowly walk back some emergency measures that are probably no longer needed and also avoid turning inflationary pressures that it deems “transitory” into something more permanent.

Slowly letting the air out of a balloon sounds easy, but with markets having come so far so fast, the Fed will want to avoid a “pin prick” leading to a “pop.” Market participants now realize that the Fed may be transitioning to somewhat tighter monetary policy, and there are differing views about the timing and pace with which it may pull back. The days of everyone being certain about Fed policy are probably already in the rearview mirror.

Municipal bonds of almost all stripes delivered some of the best returns in fixed income in the first half of 2021. Not surprisingly, the strongest performance came from lower-rated bonds that were lifted by demand for spread in a low-yielding world, a strong economic bounce-back driven by the solid vaccine rollout and reopening of the economy, sizable fiscal stimulus and supply/demand imbalances for municipal bonds. Except for a brief sell-off in February, volatility in municipal bonds was incredibly muted in the first half of the year. While it can be calming for investors to be in a period of lower volatility, it is often frustrating to the security-selection process when confidence is universal on the directionality of the market.

Based on our view that the Fed’s transition to slightly tighter monetary policy may be clumsy at times and lead to more volatility, we are hopeful that opportunities to add value through security selection will increase in the second half of the year. In addition, munis are more tightly wound given their strong rally, so volatility from the Fed could cause larger price swings. We have always believed that the best and most consistent way to add value in the municipal bond market is through security selection. Although most people shun volatility in most aspects of their lives, as bond pickers we love it. We think our investment style, which is centered on a spirited relative value debate as we consider investments, is very well suited to the type of environment which may lie ahead.

LOWER-RATED BONDS HAVE BEEN LEADING THE MARKET
Year-to-Date Performance by Rating



Source: Bloomberg. Data through June 30, 2021.

"I'm glad it's finally hot enough to complain about how hot it is."
—KAT ATWELL

TRADING NOTES

Active Patience

RANDY L. GROSS
SENIOR PORTFOLIO MANAGER, MUNICIPAL FIXED INCOME

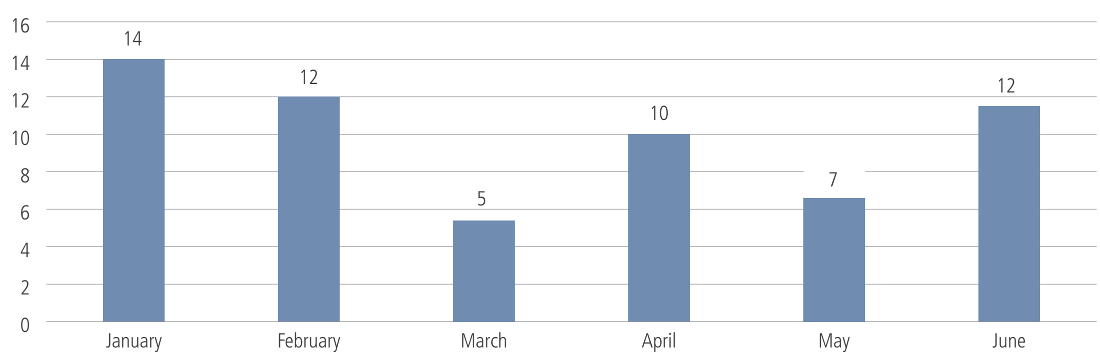
Compressed valuations reinforce the value of manager selectivity in duration and credit.

The twin tailwinds of record-breaking positive mutual fund inflows and scarcity of bonds have propelled the municipal asset class to outperform U.S. Treasuries so far this year, as reflected by current overvalued ratios. Positive mutual fund inflows have totaled around $60 billion year-to-date, comfortably eclipsing last year's $40 billion. Should this trend continue, this year could outpace 2019's tax reform (i.e., SALT cap) induced inflows of $90 billion. We believe the prospect of higher tax rates coupled with improving credit fundamentals has led to this boom in new cash entering the municipal marketplace. To illustrate the improving tax collections, state and local government tax receipts increased 10% year-over-year in the first quarter,[1] leading rating agencies to revise outlooks to stable and positive across most sectors, as the great economic reset continues.

As an active manager, we have many tools at our disposal to navigate the current compressed valuations in the marketplace. One tool is being patient and very selective when adding to duration and credit sectors.

At the conclusion of the June Federal Open Market Committee meeting, market participants witnessed the volatility the Fed can inflict when deemed hawkish, as longer-maturity municipal yields moved higher. We believe all markets, including municipals, should prepare for sporadic episodes of Fed-related volatility as the recovery continues and emergency monetary tools are removed. This reinforces our confidence in "active patience" as we await better buying opportunities.

MUNICIPAL MARKET FUND FLOWS
$ Billions



Source: Lipper.

[1] Source: U.S. Census Bureau.

Coupon Liquidity Premium

With interest rates hovering near historical lows, investors may have become complacent about buying lower-coupon bonds and feel they are overpaying for bonds with higher coupons. The yield volatility for par bonds spiked after the June FOMC meeting, as markets reacted to a somewhat more hawkish Fed. Par bonds became less desirable in the marketplace as rates were rising, leading to more price erosion than for premium bonds with similar maturities. This reinforces our preference for premium coupon bonds, as investors have feared that par coupon bonds may become subject to *de minimis* tax implications, where purchasers must include a concession to compensate for taxes.

Since the premium 5% coupon is coveted for its above-market income stream and market-defensive qualities, such bonds tend to be more liquid and less volatile than par bonds of similar maturities in a rising rate environment.

And Lastly… Summertime Demand

This summer, cash that returns to investors organically (i.e., via maturities, calls and coupon payments) is likely to greatly exceed expected new issue volume in July and August. This phenomenon could lead to "net-negative new issue supply" as the municipal market temporarily shrinks in size. That, in turn, could make it harder for investors to replace their tax-exempt holdings—an issue magnified in California, New York and other states where the income tax rates are high—creating outsized demand for in-state municipal bonds. This strong summer technical factor could lead to continued outperformance of municipals versus comparable taxable alternatives. By the fall, the imbalance should be reversed, which could portend better entry points to add value.

"It's clearly a budget. It's got a lot of numbers in it."

— **GEORGE W. BUSH**

FUNDAMENTAL FOCUS

The Doomsday That Wasn't

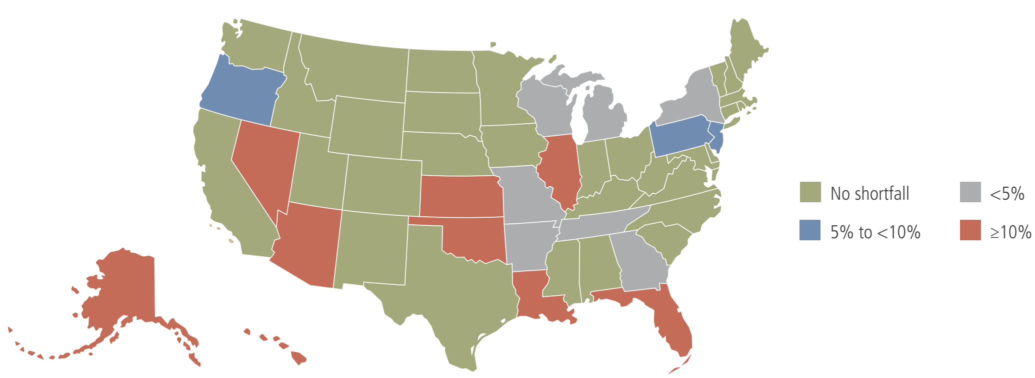
STEPHEN COWIE
SENIOR RESEARCH ANALYST, MUNICIPAL FIXED INCOME

Federal stimulus dollars are helping making state budget processes the smoothest in recent memory.

The fiscal doomsday scenario that many states anticipated in the early days of the pandemic has not materialized, and this year's budget cycle is likely less problematic than recent years. State finances are in significantly better shape and tax receipts continue to rebound. As several states have already passed their fiscal 2022 budgets or are in the midst of negotiations between state legislatures and governors, this year appears less divisive and we anticipate less political gridlock that would preclude passage of state budgets. In fact, the few skirmishes we hear of between state legislatures and governors are regarding how to allocate and spend their unanticipated surplus funds. We would describe this as a good problem relative to what could have occurred if earlier, pessimistic forecasts had come to fruition.

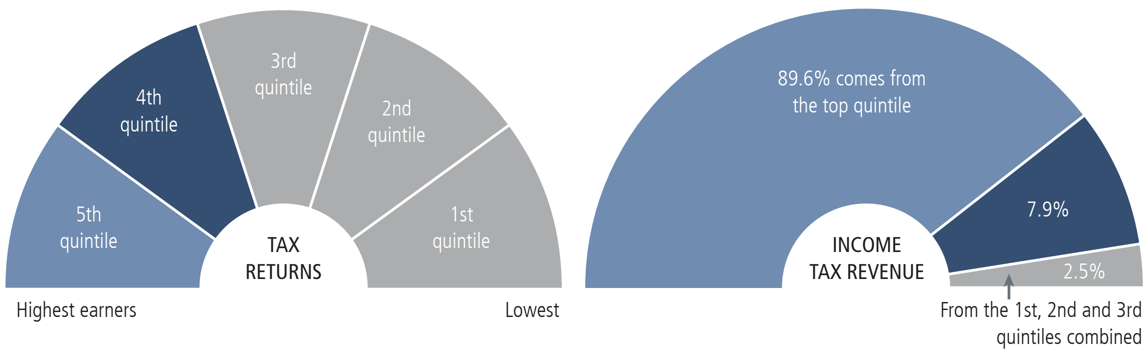
In short, the federal aid distributed directly to individuals and state and local governments has had a significant and positive impact on state finances. Specifically, the American Rescue Plan, approved in March, provided $350 billion to state and local governments, creating significant breathing room and easing near-term budgetary pressures. The aid has not only helped states address revenue losses due to COVID, but also allows states to address pandemic-related cost pressures and direct aid to individuals, households, industries and essential service workers. It's important to note that, even before this legislation was passed, tax receipts were beginning to exceed forecasts, while reserves built up during previous strong economic years helped ease budgetary pressures. As such, this federal aid provided extra resources to some states that were already operating with adequate finances.

STATE SHORTFALLS NET OF FEDERAL AID, RESERVES
% of Fiscal 2019 General Fund



Source: CRFB, Moody's Analytics.

THE BULK OF CALIFORNIA TAX DOLLARS COME FROM HIGH EARNERS

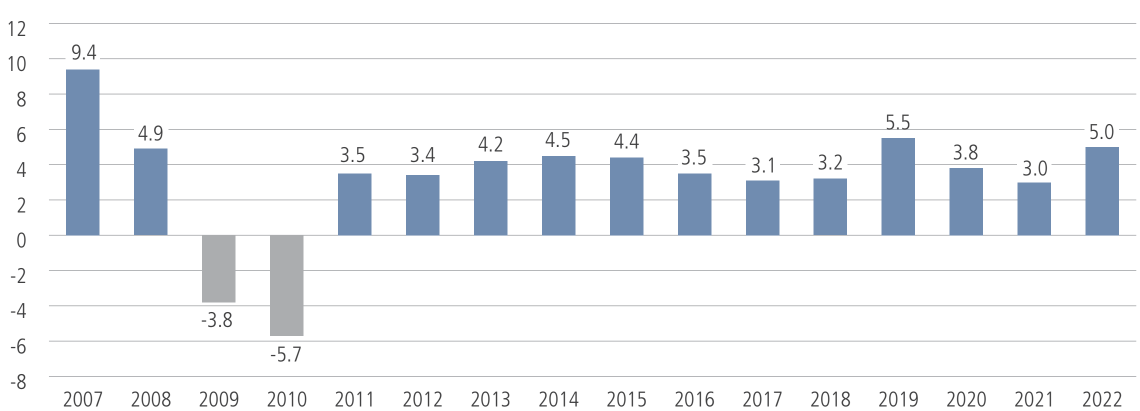


Source: California Franchise Tax Board, The *Wall Street Journal*. 2018 personal income tax samples.

It's also important to note that high income workers fared better than lower income workers, helping to generate high personal income tax receipts and augment sales tax generation. In short, states that are heavily dependent on personal income tax receipts did well largely due to this economic group. California is a case in point (see display above).

As per the National Association of State Budget Officials, 38 states have reported fiscal 2021 revenues that are higher than original expectations. Additionally, rainy day reserve levels have held relatively stable at 8.4% in fiscal 2020, 7.6% in fiscal 2021, and 8.3% in fiscal 2022. This positive trend has helped contribute to an average 5% fiscal 2022 budget spending increase relative to 2021.

ANNUAL GENERAL FUND SPENDING (% YOY CHANGE)



Source: NASBO. Shows fiscal years. 2022 figure is based on governors' recommended budgets.

A prime example of a state's good fortune and recent improvement is Illinois. Although the state had been on the brink of a downgrade into junk territory, its finances have improved significantly due to its enhanced tax collections, increased federal aid and less political gridlock. Both Moody's and Standard & Poor's have upgraded the state's credit rating and assigned it a stable outlook, while Fitch has actually assigned a positive outlook. This scenario was almost inconceivable a year ago, and the market has responded by tightening the state's credit spreads.

It's not all good news for states, however, as pension pressures continue to mount and future budgetary concerns remain, given that the American Rescue Plan was a one-time event. The ability of states to address their economic, financial and social priorities will likely be a challenge in future years. Several states could take longer to rebound due to their concentrated exposure to the leisure and tourism industries, which were devastated over the past year. While recent trends are more favorable, the ability to rehire labor in these more volatile sectors is proving a challenge, while the timeframe for recovery is uncertain. As a whole, though, states are in much better position than originally anticipated and most can breathe a collective sigh of relief this budget cycle.

ILLINOIS BOND SPREADS HAVE TIGHTENED

Source: Bloomberg. Data through June 30, 2021.

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