3Q 2020

NEUBERGER BERMAN

Municipal Basis Points

After a period of historic volatility, market liquidity and fund flows are back to healthy levels in the municipal bond market, in large part due to the extraordinary efforts of the Federal Reserve. Still, the economy has endured a deep decline, and the pace of recovery is closely tied to the path of the coronavirus, while state and local governments face meaningful fiscal challenges in the months ahead. In this environment, we believe credit selection is likely to be crucial for investors seeking to generate returns and preserve capital. This report provides more details on our views.

NEUBERGER BERMAN MUNICIPAL FIXED INCOME TEAM

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"The important thing is not to stop questioning. Curiosity has its own reason for existing."
— ALBERT EINSTEIN

JAMES L. ISELIN
HEAD OF MUNICIPAL FIXED INCOME

No Time for Complacency

Recent positive returns obscure the meaningful challenges facing municipal issuers.

If you looked at the municipal bond market's overall return for the first half of 2020, you might think that a fairly boring year was unfolding. Total return for investment grade munis, as measured by the Bloomberg Barclays Municipal Bond Index, was 2.1% for the six months through June 30—effectively an environment of coupon-clipping plus some price appreciation. However, that number greatly obscures the volatility experienced in recent months, as well as the significant challenges that lie ahead as the country battles COVID-19.

Just this past March, the municipal bond market saw record outflows from mutual funds and ETFs, which led to one of its worst monthly returns on record. Thankfully, the Federal Reserve and U.S. government responded in a rapid-fire manner, with liquidity and massive stimulus measures that calmed most financial markets, including the municipal market. Although fund flows have now turned decidedly positive, selling pressure has abated and demand is currently robust, we believe it is far too early to send out an all-clear signal.

In looking forward, it is important to remember that the stock market is not the U.S. economy. It is true that higher stock prices can have a positive secondary effect on the muni bond market, as they can lead to better consumer confidence levels for some individuals and help improve pension funding. However, the overall strength in the economy is what ultimately drives the direction of muni credit quality. Given current estimates that second-quarter GDP declined by roughly 35%, the U.S. economy has its work cut out for it.

The crisis began with COVID-19 and there is still great uncertainty about its spread, future lockdowns, a potential second wave and an eventual medical solution. We saw a sharp initial snapback in employment as the economy went from lockdown to gradual reopening, but consumers remain skittish given all of the unknowns. The CARES Act was helpful to the muni market as it served to offset some of the considerable municipal expenses associated with COVID-19. We believe the federal government would be wise to follow through on additional aid to state and local governments to help offset revenue losses from suppressed economic activity. Also, given the very early stages of this recovery and its fragile state, we believe that if the federal government pulls back too hard on elements of the CARES Act such as supplemental unemployment benefits, it could hurt the trajectory of the recovery. Now is not the time to take money out of the U.S. economy.

Appealing Relative Value, Need for Caution

It is not all bad news. In a lower-for-longer world where every basis point matters and the search for yield is relentless, we think the muni market offers strong relative value. Currently, high-grade munis yield north of 100% of comparable Treasuries across the curve. Investors are effectively getting the value of the federal tax exemption for free. High yield munis have rallied significantly from their sharp selloff in March, but are still at spreads that are much wider than at the start of the year. There is likely room for them to run further in a low-yield environment. Finally, taxable munis have been among the best-performing asset classes this year, but their current spreads are still attractive relative to investment grade corporates, and should see strong demand from investors seeking high-quality fixed income.

There is an old adage that says, "Don't fight the Fed." In the short term, central bankers can completely overpower the markets and fundamentals. Longer term, however, credit differentiation and security selection are likely to drive returns in the municipal space. Muni credit quality tends to move incrementally, which often provides time to trade out of certain investments whose prices may no longer reflect their inherent risks. Now is not a time for complacency, given the many unknowns that remain. Indeed, we believe an investment style that is active in nature and constantly asks if risk is being priced appropriately should be effective in these unprecedented times. We will continue to look for opportunities to upgrade portfolios while also recognizing that opportunities will abound as some investors undervalue certain bonds. It is a complicated but exciting time to invest.

"An appeaser is one who feeds a crocodile, hoping it will eat him last."
— **WINSTON CHURCHILL**

MARKET REVIEW AND OUTLOOK

Wide Open Road

TED VOGEL
PORTFOLIO SPECIALIST, MUNICIPAL FIXED INCOME

The path of the economy, and thus the range of outcomes for municipal issuers, is particularly uncertain.

The recovery of the markets and economy remained intact during the second quarter despite a resurgence in U.S. COVID-19 cases. In this environment, U.S. investment grade fixed income—as measured by the Bloomberg Barclays U.S. and Global Aggregate indices—delivered positive total returns. The U.S. Treasury two-year yield declined 132 basis points (bps) to 0.25%, the 10-year fell 125 bps to 0.67% and the 30-year eased 106 bps to 1.33%. U.S. investment grade credit spreads continued to tighten during the quarter, bolstered by central bank bond-buying facilities and strong investor demand. The focus in credit markets remained on earnings results and estimates as investors gauge the level of deterioration in fundamentals across sectors.

Following regional economic reopenings in May, June saw a resurgence of COVID-19 cases across the U.S. The acceleration of new cases was particularly pronounced in the South and West, leading many states to pause or roll back reopening plans late in the quarter. U.S. economic data improved, with the June employment report surprising to the upside for the second consecutive month; nonfarm payrolls gained 4.8 million (versus

3.2 million consensus), average hourly earnings fell 1.2% (versus -0.8% consensus) and the jobless rate improved to 11.1% from 13.3% the previous month. May core CPI (+1.2% compared to +1.3% in April, both year-over-year) and headline CPI (+0.1% versus April's +0.3% year-over-year) prints came in slightly lower than expected, while retail sales achieved a surprisingly strong +17.7% (month-over-month).

As widely expected, the Federal Open Market Committee left policy rates unchanged following its early June meeting. In its accompanying statement, the Committee introduced language saying that "financial conditions have improved, in part reflecting policy measures to support the economy." As for projections, all members anticipated rates remaining at the lower bound through at least 2021, and all but two expected this to continue through at least 2022. Notably, the Fed also initiated its previously announced secondary and primary corporate credit buying facilities in the second half of June.

The broad muni index earned a 2.72% total return during the second quarter. Returns were positive across the yield curve, with longer maturities generally outperforming shorter maturities. The new issue supply of munis was 18% higher than the same period last year, as governments sought to take advantage of significantly improved borrowing conditions from the first quarter. With regard to credit, lower-rated securities generally outperformed those with higher ratings.

Wide Range of Outcomes

Given the unusual circumstances caused by the pandemic, the path forward for the global economy is prone to a wider-than-usual range of potential outcomes. The recent strength of risk assets reflects a broad assumption of recovery in late 2020 and beyond, but whether conditions meet those expectations remains to be seen and the answer largely depends on the path of the virus.

Even assuming relatively positive outcomes on COVID-19, various data still indicate extensive capacity in the economy, and it will take time to gather momentum and gradually absorb the millions who are now out of work. Returning to pre-crisis levels of output will most likely be a multiyear process. That said, potential additional support legislation, including infrastructure spending, could maintain an economic floor and possibly accelerate improvement. Generally speaking, we believe that this paints a positive backdrop for state and local government debt issuers.

Despite the strong sell-off that occurred earlier in the year, the muni market showed impressive resilience during the second quarter and largely erased earlier declines. Unprecedented levels of stimulus from the Fed, Treasury and Congress to shore up state and local governments have been encouraging, while strong demand from both institutional and retail investors, as well as manageable new issue supply contributed to impressive performance. Our long-term view remains intact: that tax-free munis are one of the few tax-advantaged, high-quality options for high-marginal-tax-bracket investors.

"My dog is worried about the economy because Alpo is up to $3 a can. That's almost $21 in dog money."

— JOE WEINSTEIN

TRADING NOTES

Lots of Stimulus = Normalized Muni Market

RANDY L. GROSS
SENIOR PORTFOLIO MANAGER, MUNICIPAL FIXED INCOME

A return to market "normalcy" comes courtesy of the Federal Reserve.

For May, tax-exempt municipals recorded a total return of 3.3%, one of the largest monthly gains in history and an unthinkable outcome in late March. The genesis for this strong performance lies in the tremendous cash and government support all fixed income markets received, including municipals.

In addition to fiscal support from Congress ($150 billion CARES Act stimulus), the Federal Reserve has provided its substantial lending powers to the municipal market. These programs buoyed confidence for both investors and issuers, helping jumpstart a stalled marketplace.

The Money Market Liquidity Facility (indirectly buying short-term paper from tax-exempt money market funds) was born in March, and was the Fed's opening statement in stabilizing the municipal market. Next came the Municipal Liquidity Facility or MLF (Fed muni bond-buying), which has been expanded several times to include a broader base of recipients, including multistate issuers such as Greater New York's MTA and Port Authority. As a reminder, the Fed can purchase investment grade securities (some exceptions allow junk-rated bonds) with up to a three-year maturity, thus giving issuers more options to address cash-flow needs. The interest rate charged by the Fed is much higher than the current lower yields in the public market, resulting in issuers viewing this borrowing as a means of last resort. With a punitive interest rate and a requirement that borrowers certify their inability to tap the new issue market, very few state and local governments have utilized the MLF to date. However, its use could expand if the Fed reduces borrowing rates, increases maturity limits and extends the program through 2021, as some expect.

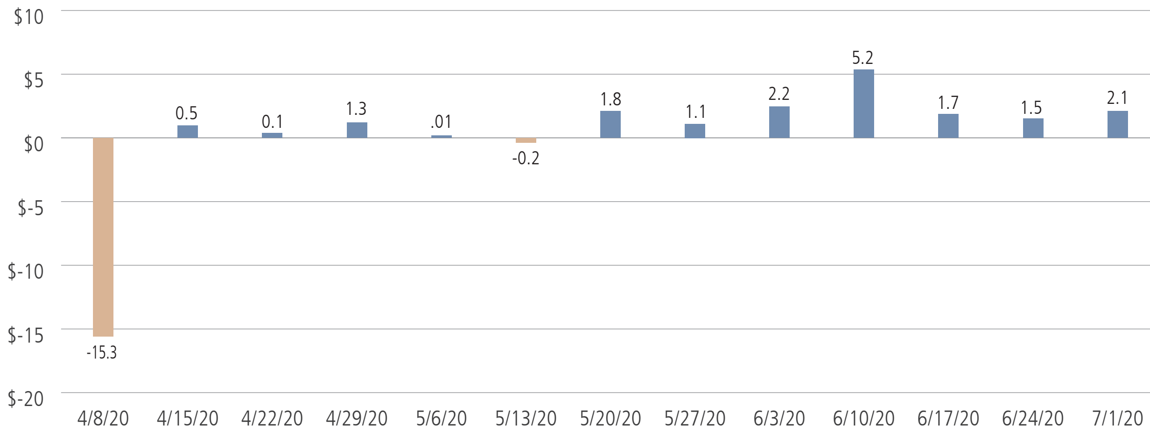
The primary market slowly reopened in April with only the highest-quality issuers entering the marketplace. As the second quarter progressed, the volume of new issuance normalized with issuers across the credit spectrum successfully pricing deals, with substantial demand enabling repricing at lower yields. This strong appetite for bonds greatly helped liquidity as investors began focusing on secondary offerings to source bonds.

Outflows Reverse, Technicals Positive

The COVID-19 mutual fund outflow cycle reversed course around mid-April, with six consecutive weeks of positive inflows totaling roughly $13 billion. High yield municipal bond funds, which had become a hotbed of forced selling and limited liquidity during the sell-off, attracted around $2 billion in this latest period. Peak reinvestment season is also well under way and should continue to be supportive of municipals with projected cash returned to investors via maturities/coupon payments outpacing new issue supply.

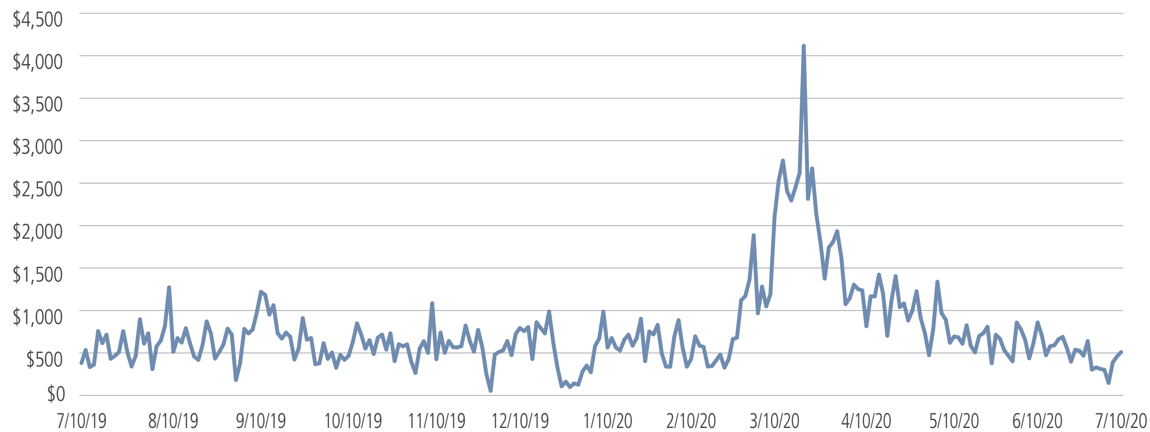
As of June 30, $60 billion of taxable municipal bond issuance has been sold year-to-date, the highest amount since the Build America Bond program expired in 2010. This explosion of taxable issuance is a result of the 2017 tax reform law, which prohibits state and local governments from issuing tax-exempt debt (traditional munis) as part of a practice known as advance refunding (refinancing debt that is not currently callable). The current low/negative rates that prevail globally make it cost-effective for issuers to continue refinancing existing higher-yielding tax-exempt debt with taxable municipals. Some of this taxable supply has come in lieu of tax-exempt debt, further contributing to the supportive demand/demand picture for tax-exempt municipals.

INVESTMENT FLOWS HAVE NORMALIZED
Municipal Mutual Fund Flows ($ Billions)



Source: Lipper.

SELLING INTEREST HAS WANED
Municipal Daily Bid-Wanted Activity ($ Millions)



Source: Bloomberg. Bid-Wanted Activity represents announced interest in sales of securities.

And Lastly … Stay Vigilant

Municipal issuers are still readying for COVID-19-related knocks to revenue and spending, as well as potentially larger unfunded pension ratios, with many states factoring in additional stimulus not yet approved by Congress in their 2021 budgets. Most of the harm to state and local governments is still unknown, as parts of the country are seeing large spikes in positive cases. Currently the trade-off for high quality is yields that are less than optimal for most savers; our hope is that current rates are a temporary but necessary means to an end. Moreover, we caution investors whose goal is preservation of capital not to be lulled into behavior common prior to the pandemic and underreact to credit risk. As events unfold in the coming months, security selection and proactive credit research, independent of ratings agencies, will likely be essential.

The appeal of municipals relative to taxable alternatives (U.S. Treasuries/corporates), the above-mentioned muni market stimulus and recent strong performance all have contributed to the normalization of the municipal bond market and positive fund flows.

“If you owe the bank $100 that’s your problem. If you owe the bank $100 million, that’s the bank’s problem.”
— J. PAUL GETTY

FUNDAMENTAL FOCUS

The State of State Credit Quality

STEPHEN COWIE
SENIOR RESEARCH ANALYST, MUNICIPAL FIXED INCOME

The budget problems are real, and how states respond will be crucial to their long-term financial health.

The economic and financial impact of the coronavirus on U.S. states is unprecedented and will result in financial challenges in both the near and longer term for many state governments. Prior to the onset of the pandemic, many states were benefitting from both positive economic growth trends and prudent, conservative financial management practices. However, the forced shutdown of many state economies resulted in a swift and dramatic reduction to the primary revenue drivers that many states rely on for their financial base. Specifically, the sharp loss of jobs and forced quarantine of many individuals crushed both personal income and sales tax receipts that states need to meet their budgetary goals. While previous economic downturns resulted in revenue declines due to measured economic weaknesses over time, the pace of this downturn was so quick and severe that many states are in desperate need of federal assistance to help address their financial challenges.

Assessing the Damage

The magnitude of budget shortfalls varies by state, but estimates are sizable, with the Center on Budget Policy and Priorities projecting average deficits of 10% for this fiscal year and 25% for 2021. Translated into real dollars, the numbers are huge. The State of California, for example, is facing a $54.3 billion budget deficit that Governor Newsom and the state legislature are attempting to address in the revised budget that recently passed. With a 16.3% state unemployment rate in May, California’s economy is ailing, and the governor and state legislature are increasing political pressure on Congress to pass additional stimulus for states. An important and noteworthy assumption in California’s budget is $14 billion in federal aid that may not materialize. Additionally, the state has deferred $12 billion in education aid to K-12 schools, and borrowed from restricted funds that need to be repaid. These specific line items suggest that the state may be overly optimistic in its revenue projections, even as it delays difficult decisions on expenditures.

On the East Coast, New York State is facing a $13 billion budget gap for 2020 and a $61 billion projected gap over the next four years. As the epicenter of the nation’s largest infection and death rates from the virus, its economic shutdown has come at a great financial cost. With 14.5% unemployment and mounting financial pressures, Governor Cuomo has been vocal in his displeasure with the U.S. Senate and its leader, Mitch McConnell, for not pushing through the Heroes Act legislation from the House of Representatives, which would provide aid to state and local governments. While New York passed a budget for its April fiscal year, the governor has the ability to make subsequent adjustments based upon the trajectory of revenue and expenses. Focus items that could be curtailed include both K-12 education and local government funding.

Options Amid Uncertainty

The states have several options to address budget shortfalls, including direct state aid cuts, reduced cost-sharing with municipalities, program elimination, deficit borrowing and tax increases. For those states with significantly underfunded pension liabilities (e.g., Illinois, Kentucky and New Jersey), additional pressures are likely. Future budget negotiations may become more difficult in a weaker economic environment and may lead to delays in resolution. Due to liquidity concerns, states may issue short-term cash flow notes in the municipal market to help bridge their funding shortfalls. Another option is direct borrowing through the Federal Reserve’s Municipal Liquidity Facility, which was created to give state and local

governments additional liquidity options. Illinois was the first state to utilize the program in a recent $1.2 billion borrowing.

Uncertainty is a growing theme for states as they seek to identify funding sources and project financial needs. No one definitively knows the trajectory of the coronavirus and whether there will be a second wave. Additionally, it is unclear how specific state economies will reopen and what impact that will have on their revenues. Some states have decided to pass short-term budgets or extend their current fiscal years a few months until they have a clearer picture of the economic and financial realities ahead. Some may view these temporary extensions as prudent in that they avoid drastic decisions, while others may argue that those decisions will eventually need to be made. The intense economic and financial destruction caused by the virus will have real implications for state finances, and time will tell whether prudent measures are enacted. As such, we continue to view state issuers with considerable caution.

PERCENT CHANGE IN STATE FISCAL YEAR-TO-DATE TAX REVENUES
July 2019 Through May 2020, Year-Over-Year Percent Change

YOY percent change
> -7.0%
-7.0% to -3.5%
-3.5% to 0.0%
> 0.0%
No data

Source: Urban Institute.

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