1Q 2020

NEUBERGER BERMAN

Municipal Basis Points

After an exceptional year for municipal bonds, we believe the asset class appears in for a coupon-clipping environment. Economic growth should remain positive, while the Federal Reserve is likely to remain on hold. Among municipals, continued strong demand should provide technical support; and although political developments could contribute to price volatility, they are unlikely to affect credit fundamentals. We provide more details on our views in the pages that follow.

NEUBERGER BERMAN MUNICIPAL FIXED INCOME TEAM

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"I SKATE TO WHERE THE PUCK IS GOING TO BE, NOT WHERE IT HAS BEEN."
—WAYNE GRETZKY

JAMES L. ISELIN
HEAD OF MUNICIPAL FIXED INCOME

Less 'Perfect' but Still Appealing

That's more like it! Following 2018, which saw poor returns in most asset classes, 2019 was a banner year for equities and fixed income. Municipal bonds of all kinds delivered stellar returns on an absolute and tax-adjusted basis. Specifically, the Bloomberg Barclays Municipal Bond Index returned 7.5% in 2019. High-yield munis did even better as measured by the Bloomberg Barclays High Yield Index, which returned 10.7%. Topping investment grade and high-yield munis were taxable municipal bonds, which delivered a 14.3% return as measured by the Bloomberg Barclays Taxable Muni AGG Eligible Index.

It really was a "perfect" environment for munis. Demand was strong, as evidenced by record inflows into municipal mutual funds. When Federal Reserve Chairman Jerome Powell pivoted early in 2019 and said future rate increases would be data-dependent and not on autopilot, investor concern about rising rates diminished. In addition, the tax reform act of 2017 led to higher effective state tax rates and less tax-exempt muni supply, both of which supported the market in 2019. Although the U.S. economy delivered the soft landing we had anticipated, slower but steady growth continued to support municipal credit quality and contributed to solid state tax receipts.

An Enduring Question: What's Next?

When it comes to investment results, human beings are not apt to savor the moment. Instead, they want to know what comes next. In terms of degree of difficulty, the prediction business is up there with starting a successful restaurant. That said, I will give it a whirl:

We have strong conviction that the U.S. economy will not experience a recession in 2020, due to continued growth in consumer spending. The consumer is in a good place given low unemployment, growing wages and a high savings rate. Interest rates may drift higher as central banks question the efficacy of negative rate policies and economic growth remains solid, but their path higher will be constrained by the gravitational pull of low rates outside the U.S. As a result, investment grade munis will probably deliver more of a "coupon-clipping" result in 2020 as opposed to 2019, which saw strong price gains as rates plunged. In light of decent economic growth and an accommodative Fed, we have a favorable view of municipal high yield return potential. Finally, for low-tax-paying clients, we favor taxable muni bonds, given their attractive spread relative to investment grade corporates and an uptick of supply that could create inefficiencies to be exploited through security selection.

Still, risks abound—as the rise in tensions between the U.S. and Iran clearly underscores. The 2020 election could have a wide range of potential outcomes—from President Trump's reelection to a Warren or Sanders presidency. We also believe that credit differentiation will come into greater focus this year. In 2019, most municipal bonds traded as if they were the same, regardless of true underlying quality or rating. At some point, however, the rubber always hits the road; and investors will eventually begin to pay for (or get paid for) their security selection decisions. As we have previously pointed out, most tax-paying U.S. investors should avoid thinking about their muni bond allocation as a binary decision of having some exposure or none at all. Indeed, munis make sense as a permanent allocation for most U.S. investors given their tax-efficiency, longstanding ability to preserve capital, and "safe-haven" status in periods of turmoil.

In conclusion, we don't think things will be as smooth in 2020 as they were in 2019. But we plan to work tirelessly to preserve capital and stay true to our time-tested belief that prudent security selection drives long-term results in the muni market.

> "MY FRIENDS, AS I HAVE DISCOVERED MYSELF, THERE ARE NO DISASTERS, ONLY OPPORTUNITIES. AND, INDEED, OPPORTUNITIES FOR FRESH DISASTERS."
> —BORIS JOHNSON

MARKET REVIEW AND OUTLOOK

Improving Risk Sentiment, Technical Supports

TED VOGEL
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Interest rates on longer-term U.S. Treasuries increased and the yield curve steepened during the fourth quarter of 2019. The yield on the two-year note declined three basis points to 1.57% while the 10-year moved up 14 bps to 1.92% and the 30-year increased 19 bps to 2.39%. Despite the increase in rates, municipal bonds posted positive returns across the yield curve, with the three- to seven-year portion of the curve posting the strongest performance. Overall, the broad municipal index returned 0.8% for the quarter and 7.5% year-to-date. Gross municipal new-issue supply was approximately $39.1 billion in December and $411 billion for the year. Quarterly volume was nearly $100 billion more in 2019 than in 2018, representing a 30% increase. Despite this significant growth, demand has persisted, aided by 47 consecutive weeks of mutual fund inflows into municipals.

Risk sentiment continued to improve in the fourth quarter, as the market's optimism surrounding deescalating geopolitical and global trade concerns continued to take root. In mid-December, the U.S. and China announced that they had reached a tentative "phase-one" trade deal. The agreement calls for the repeal of some existing tariffs on Chinese goods and canceling new levies that were scheduled to be enforced later in December. In return, China has agreed to increase purchases of select U.S. goods and agricultural products. President Trump signed the deal on January 15 in a ceremony at the White House. Also of note, the U.S. launched an unexpected drone attack in early January that killed a top Iranian military commander, Qassem Soleimani. The attack raised tensions in the region, with a worst-case scenario involving potential larger-scale regional conflict.

Data Provides Mixed Picture

U.S. economic data was mixed during the quarter. The December employment report slightly disappointed, with nonfarm payrolls (+145,000 vs. +160,000) falling short of expectations, average hourly earnings (+2.9% vs. +3.1% year-over-year (YoY)) missing consensus, and the jobless rate (3.5% vs. 3.5%) unchanged. November core CPI prints (+2.3% vs. +2.3% YoY) and headline CPI (+2.1% vs. +2.0% YoY) were broadly in line with expectations, while retail sales came in short at +0.1% vs. +0.3% (month-over-month). Finally, The Conference Board's Consumer Confidence Index was at the low end of its two-year range, which could suggest a divergence between consumer sentiment on the one hand and fresh stock-market highs and historically low unemployment on the other.

As widely expected, the FOMC kept the policy rate unchanged following its December meeting. The accompanying statement indicated the group's belief that its current monetary stance is appropriate to support a continued U.S. expansion; notably, it removed any mention of uncertainties tied to global trade. The Committee's "dot plot" reflected a flat path for policy rates in 2020, with one hike each in 2021 and 2022; however, in his post-meeting press conference, Chairman Jerome Powell emphasized that "significant and persistent" inflation pressures would be needed before any increase in rates would be considered. The FOMC next meets at the end of January, when it is widely expected to keep policy unchanged once again.

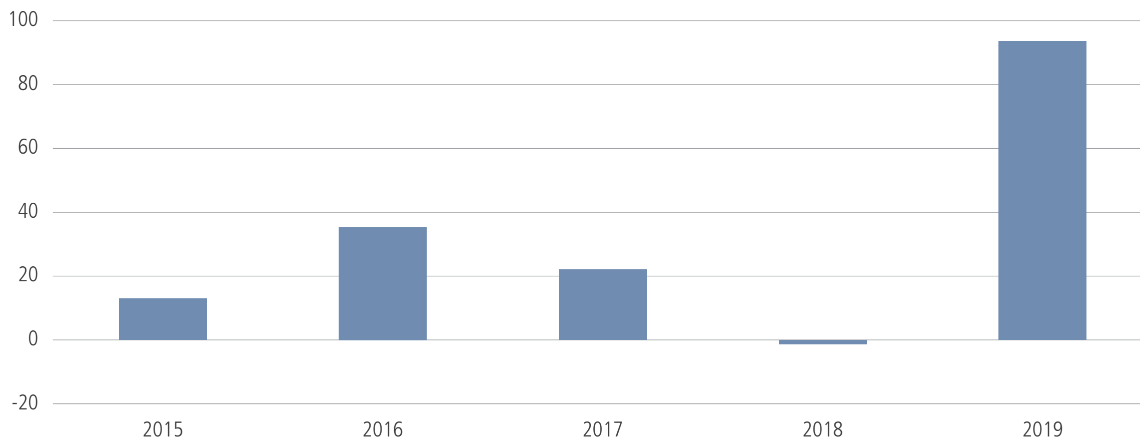
Consumer Is Key

The consumer remains a key support for the U.S. economy, with continued tight labor markets supporting wage growth. Although manufacturing and capital spending rates remain subdued, after weakness in 2019 the potential for modest upside in this category is finally plausible in 2020. We also believe the renewed strength of the housing market, bolstered by low rates and more appealing valuations, is an underappreciated factor in current economic stability. Our strong conviction is that U.S. growth will remain at or above 1.5% in 2020, with potential for reacceleration, particularly

in the second half, as a combination of consumer spending, housing market improvement and external market improvements takes hold.

Likewise, even with last year's strong performance, we believe the 2020 outlook for the muni market is constructive. Strong demand from retail and institutional investors will likely mitigate additional supply. Moreover, much of that supply will be taxable issuance, and may actually reduce the availability of the tax-exempt bonds favored by most U.S. retail investors. The moderate growth and inflation environment will likely continue in the near term, which should be supportive of muni credit in general. That said, we see the potential for market volatility emanating from geopolitics, trade and elections.

DEMAND FOR MUNIS HAS SURGED
Mutual Fund Flows Into Municipal Market ($ Billions)



Source: Lipper.

"HINDSIGHT IS GOOD, FORESIGHT IS BETTER, BUT SECOND SIGHT IS THE BEST OF ALL."
— EVAN ESAR

TRADING NOTES

Hindsight Is 20/20

RANDY L. GROSS
SENIOR PORTFOLIO MANAGER, MUNICIPAL FIXED INCOME

Looking back, most market pundits did not foresee the large drop in interest rates experienced across the entire yield curve in 2019. A shift to dovish Federal Reserve policy, manageable new issue supply, and record-breaking positive inflows into mutual funds and ETFs ($93 billion) all contributed to strong municipal market performance. In addition, 2019 was the first calendar year to record inflows over all 52 weeks. This resulted in most investors experiencing capital appreciation in an asset class known for preservation of capital and tax-advantaged benefits—a welcome outcome.

Still, 2020 ushers in a new decade burdened with the same global economic risks and political uncertainties witnessed last summer when the U.S. Treasury yield curve inverted (with the 10-year yielding less than the two-year note). This year's returns could be more muted and more like "coupon clipping" as investors potentially lean on the high-quality defensive characteristics often relied upon as a late-cycle haven. However, if U.S. growth slows in the coming months and/or geopolitical concerns worsen (Iran conflict/trade with China/election), longer-maturity interest rates could potentially test last year's August lows and increase total return prospects.

Surge in Taxable Muni Supply

Taxable municipal bond issuance totaled $70 billion in 2019, the highest yearly amount since the Build America Bonds program expired at the end of 2010. This explosion of taxable issuance was a result of the 2017 federal tax reform, which barred state and local governments from issuing tax-exempt debt (traditional municipals) in a practice known as advance refunding (refinancing debt not currently callable). Current low/negative rates make it cost-effective for issuers to continue refinancing higher-yielding tax-exempt debt with taxable municipals. It's a savings boon for municipalities, and should the low-rate environment continue, it's estimated that taxable issuance could amount to around $100 billion in 2020, or 20% of total new issue supply.

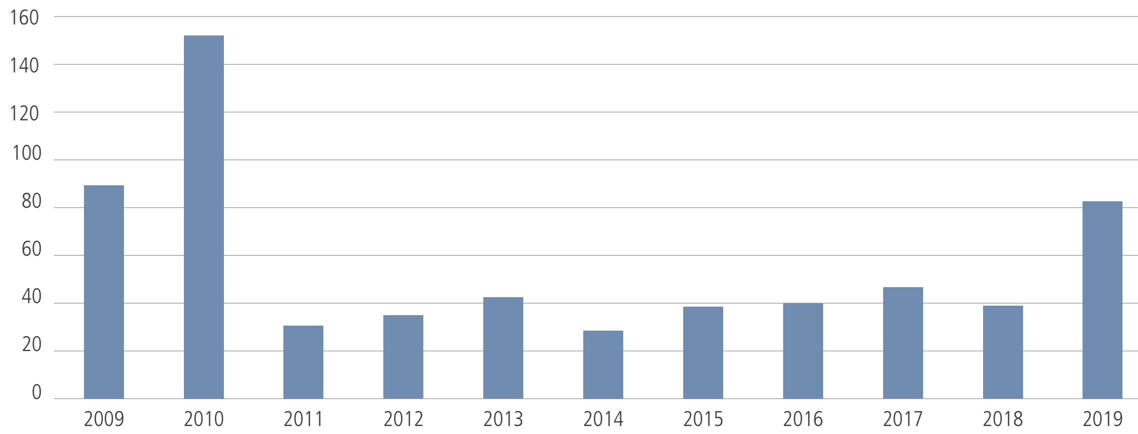
And Lastly…

Many of the factors that were supportive of municipals last year have the potential to continue. The cap on state and local tax (SALT) deductions was effectively a tax increase that continues to be supportive of flows into municipal mutual funds and ETFs. Additionally, taxable municipals could continue to remove a healthy amount of tax-free debt from the market, resulting in periods of undersupply, which could prove to be a strong technical positive.

All the above highlights the benefits of professional active management, which should bring with it the ability to constantly assess volatility in the marketplace and implement prudent decisions based on a disciplined approach.

BOOM IN TAXABLE MUNIS
The recent surge in issuance is likely an anomaly and represents an investment opportunity for 2020.

Issuance of Taxable Municipals ($ Billions)



Source: Bloomberg.

"GEORGE WASHINGTON IS THE ONLY PRESIDENT WHO DIDN'T BLAME THE PREVIOUS ADMINISTRATION FOR HIS TROUBLES."

— **UNKNOWN**

FUNDAMENTAL FOCUS

Municipal Credit and the 2020 Election

JAMES A. LYMAN
DIRECTOR OF MUNICIPAL FIXED INCOME RESEARCH

As we start the year, the Neuberger Berman Municipal Research team has been busy answering queries from clients regarding the effect of the presidential election on municipal credit trends. I thought that this would be a good time to share our views with a wider audience as to 2020 impacts.

I always cringe at the thought of writing articles that make predictions: Like most people, I hate to be proven wrong. However, in this case, I am quite confident in our team's perspective, given the reliable characteristics of municipal credit. To be clear, the views here focus on credit risk fundamentals, not bond prices or portfolio performance. Those are often affected by a range of non-fundamental technical factors, such as interest rates and new issue supply.

Before getting to our outlook, let's briefly look at behaviors of municipal credits that may affect their reactions to political events. First, changes to the credit quality of traditional municipal credits—tax-backed, essential-service revenue bonds issued by governmental entities—are usually glacial, and much slower than for corporates, often taking a year or more to evolve. (An exception is state issuers with economically sensitive revenue streams and social safety net expenditures.) Also, aside from natural disasters, municipals do not have the same level of event risk as corporates. Although specialty sectors such as health care, charter schools and land-secured issuers tend to be relatively volatile, most of the municipal market, given its ongoing income streams, is pretty stable from a financial perspective. Finally, municipal credits have a lower level of correlation among issuers; it's not uncommon to see two neighboring issuers with very different credit profiles due to their unique tax bases and/or governance. This means they will not be equally affected by broader trends.

From Taxes to Income Inequality

With that in mind, here are our thoughts on the impact of the election and current political issues on next year's environment.

First, we do not believe that the vastly different economic, social and tax policies proposed by the various candidates will have a material impact on overall municipal credit in the near term.

Consider taxes. The 2017 Tax Cuts and Jobs Act's reduction of certain tax breaks had a disproportionately negative impact on residents of higher-tax and high-property-value states. Some observers believed that real estate markets would be severely affected, and that population loss would be experienced in those states; however, we have seen only moderate impacts, none of which have flowed through to material changes in credit quality. Over time, the effects may be more severe, but active credit monitoring should catch them early. By the same token, if we were to see a change in power that reversed the 2017 tax law, it would be unlikely that there would be a rapid improvement in the credit quality of high-tax states. Again, the operative word is glacial.

Then there's infrastructure spending, which was a hot topic in the 2016 campaign. Our view back then was that it would have little impact on the municipal market given the complexities of municipal finance and the fact that federal policy cannot easily dictate actions by the local governments that would typically initiate infrastructure projects. This time out, infrastructure is barely on the radar screen for most candidates (with the exception of Michael Bloomberg, who recently announced an ambitious plan).

In contrast, income inequality has become major topic of discussion by the Democrats, and is significant enough to be considered when assessing municipal credit trends. Again, the impacts of the chasm between the wealthy and middle-to-lower classes is likely to find its way from the macro economy to municipal credit at a very slow pace. In the long run, we believe growing income inequality will be a negative, because it reduces the purchasing power and disposable income of most U.S. citizens, resulting indirectly in, at best, subdued growth in property values, but potentially declines in those values and, eventually, lower property-tax receipts. This dynamic could also result in compression of excise tax and fee revenues used to fund government services. Unlike corporations, governments cannot generally maintain financial margins by cutting costs, since the majority of governmental expenditures are tied to labor; both union contracts and a reluctance to cut essential services make it hard to trim these expenses. Additionally, there is limited ability to implement "game-changing" technology that will increase efficiency and reduce the costs of government services.

Health care and higher education are two areas of focus in the Democratic primary race. Although the various plans discussed would face significant opposition, in the unlikely event they were approved, they could have a major credit impact in those sectors of the municipal market. However, given the many impediments and unknowns, and the unlikelihood of success of these initiatives, I won't go into details here. Suffice to say, if some of the proposed changes were to occur, credit quality would not be directly affected in 2020, or 2021 for that matter, but could see an evolving impact in future years.

The year ahead is likely to be busy and chaotic. There is much at stake, and a change in the executive branch and/or the Senate could lead to some significant policy shifts. Still, readers can be comforted in the knowledge that the credit quality of municipal portfolios is unlikely to share the same near-term volatility.

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