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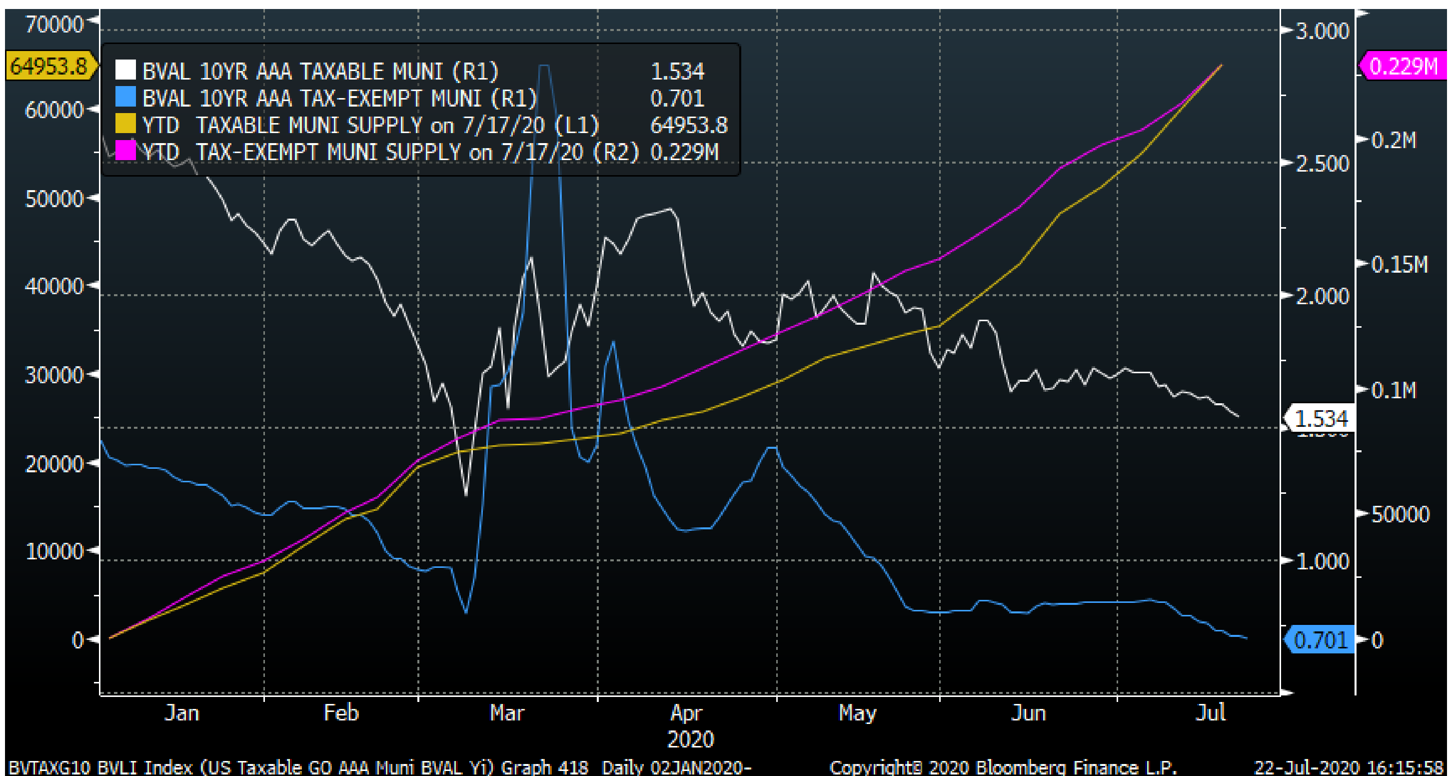
MUNICIPAL WEEKLY

FUNDAMENTALS

Overall market tone is consistent with an active reinvestment period and what was a smaller month-end finish for syndicate business. July saw an impressive yield run, as every 10 basis-point rally since May has seemed like the market would eventually meet resistance. Instead, the curve plods lower in yield to where just the very short end--at the risk of going below 0%--can't push further gains. Much like in prior years when the curve slope exceeded 300 basis points for a valuable extension trade at much higher yields, ultra-low rates are creating a need for extension for many constituents just to reach a yield where return vs. fees are justified. One of the more telling examples of current conditions was seen in a second-round pricing of $461 million tax-exempt Dallas-Fort Worth Airports (A1/A non-AMT). The 10-year maturity was finalized at +56/AAA, or 6 basis points tighter than the issuer's first series priced the week of July 13; the 4s of 2035 in the second round came 4 basis points tighter than the prior series *and* with more par value. Secondary flows at month-end didn't change that much from the first half of the month—MSRB data showed a consistent 75% share for maturities past 2026, with three-fourths of that total being bonds due past 2033. More than 70 basis points of slope past 10 years to the end of the curve is the simple reason why.

The strength in generic tax-exempt curves becomes obvious when looking at the breakdown of supply in July. Taxable volume exceeded $18 billion (up about 25% from June) while Bank Qualified and Tax-Exempt volume didn't reach the same levels from June. The graph below shows daily MSRB volume (including all sectors) this year with the respective 10-year AAA BVAL track. Note the red trendline between January and June where daily volume averaged above $14 billion. That figure for July has fallen to $11.8 billion, mainly due to lower secondary flows. The 10-year rate traded around 1.25% before March but has since rallied to under 0.75% on less tax-exempt float.



Source: MSRB; Bloomberg BVAL

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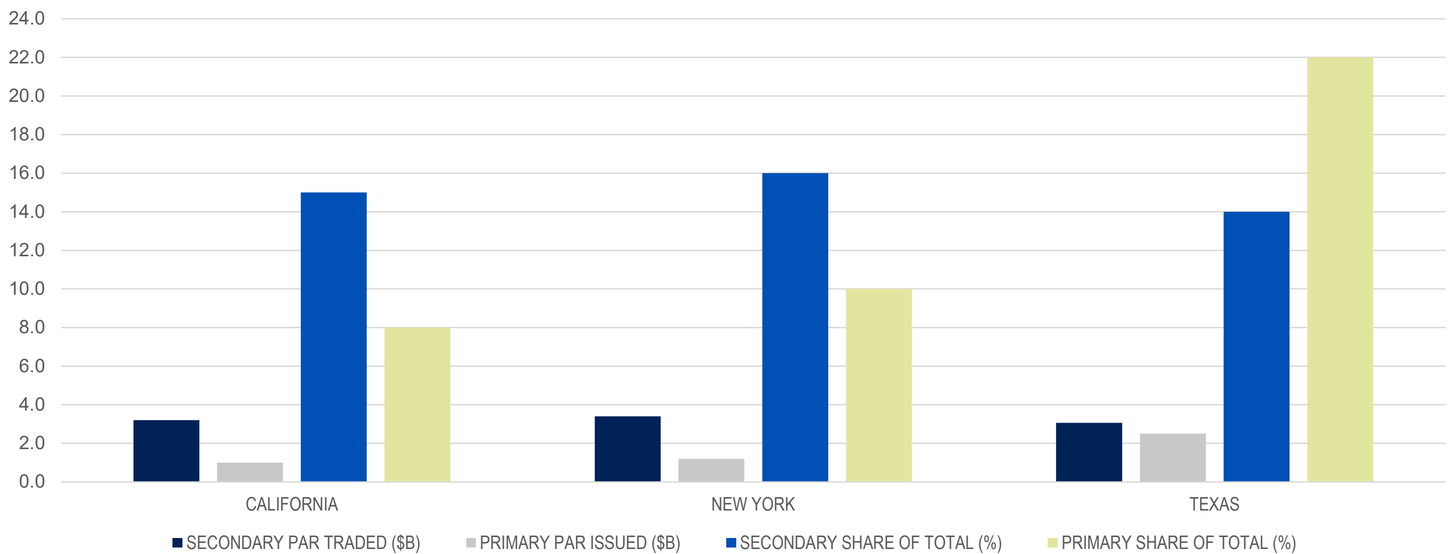
The effects of tax sheltering are having outsized influences in certain states. Greater demand for California paper is being reinforced by recent issuance and secondary trading volumes. The graph below contrasts current activity with New York and Texas:

- Among the three most-active issuing states, California supply was the lowest at just $1.0 billion, or 40% that of Texas and just 8% of all volume during the week of July 20. Secondary levels are more aligned with New York and Texas, where totals fell into the $3 billion range.
- The state issued $552 million Aa1/AAA California Department of Water Resources due out to 2035. Based on strong in-state demand and infrequent issuance, the 2035 maturity yielded a mere 1.00%, as compared to the 15-year maturity from a 2017 deal at 2.15% yield.
- More new issues within the state are trading *through* implied AAA spot levels, a condition now being mirrored in secondary bidsides. California supply is up just 10% from 2019, a much smaller increase than the entire market's 31% surge, adding to the strength of bidding. A Bloomberg Barclays California index has outperformed the broad market this year by 30 basis points.



Source: Bloomberg; MSRB

TECHNICALS

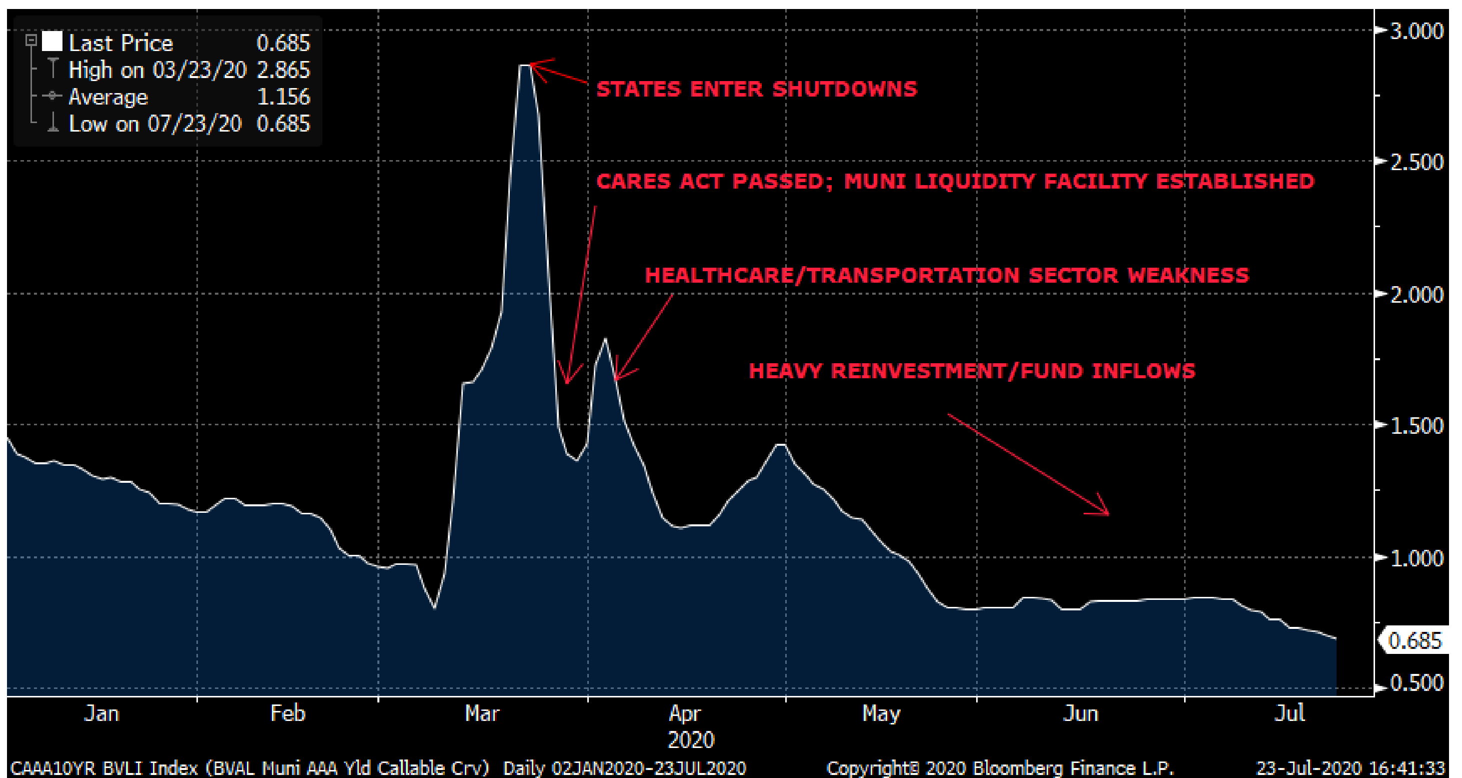
The market rolled into month-end comfortable enough with fundamentals that point to more implied demand than expected supply coming for August. The mismatch totals an approximate $28 billion, and doesn't include the amount of crossover activity the market has experienced in recent weeks from non-traditional muni buyers (only Greece and Iceland's 10-year bonds beat AAA munis right now). Final figures for July will point to wider-trading Revenue categories such as Lease bonds and Healthcare snagging the higher end of gains as ongoing yield compression and a 20 basis-point rally bear down on trading activity. There are still strong expectations that the next relief package will have enough funding for various sectors of the economy (including states, cities and transportation networks) so that revenue losses may be stemmed early in the new fiscal year. Add to that a commitment by the Fed to hold rates low and implement whatever means necessary to prevent further economic erosion and the case for current yields to remain steady or decline appears to be growing. Should business in August continues July's theme, the favorable slope from 10 years toward 30 years--holding at around 75 basis points—should offer reasonable alternatives for concession as well as keeping optionality in play for shorter-duration needs.

As Congress works toward another relief package, municipals sit in a precarious position of issuers realizing ideal financing conditions offset by existing and projected revenue challenges. The graph below shows this year's 10-year AAA BVAL range with pivotal turning points:

- Trading ranges offer some insight into what the second half of 2020 may bring. Between January 1st and March 10th this year, the yield averaged 1.17% but since May 1 the yield has traded at an average 0.89%. Looking back into the post-tax reform period, 2018's trading range was 80 basis points and 2019 saw a range of 105 basis points. For all of 2020, the trading range is 218 basis points, or more than double the two prior years.

- In late March when the impact of the CARES act and Muni Liquidity Facility began, yields came off their highs but then traded higher again into April as healthcare and transportation sector weakness surfaced. When June's reinvestment season began, the 10-year benchmark declined and has stayed well below 1% supported by heavy fund inflows.

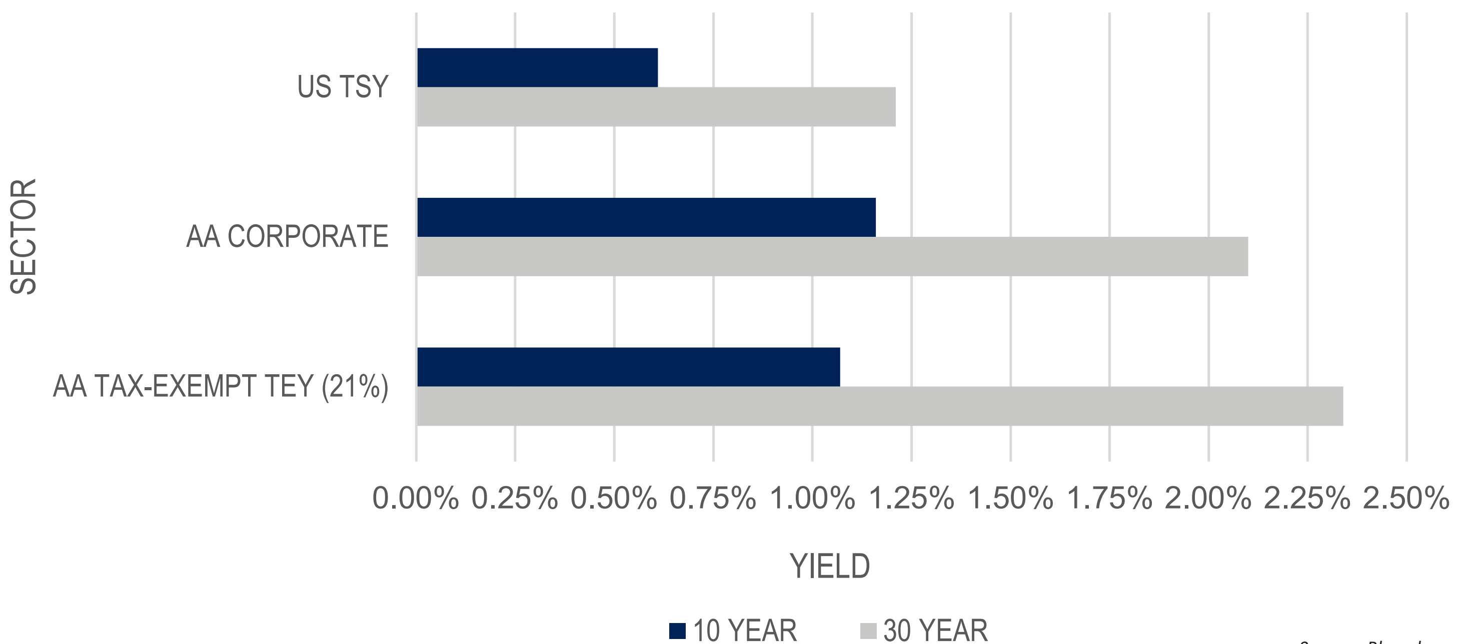
- Looking ahead to the post-summer period, reinvestments fall off in September just when supply is expected to rise pre-election. Since 2000, the September/October cycle has brought elevated volume ahead of federal elections. Supply ranged from a combined $36 billion (2000) to $93 billion (2016) according to Bond Buyer data. Market returns leading up to election cycles have been less predictable, where in 2004 gains approached 2% between September and October but 2008's Lehman bankruptcy/Recession saw losses exceed 6%. Most recently, the post-summer/pre-election period in 2016 saw broad market losses exceeding 1%.



Source: Bloomberg

What makes the current yield set seem so impressive is the rally from the March/April correction when shutdowns began. However dramatic the moves have been, implied muni yields *still* compare favorably to taxable sectors as shown in the following graph:

- For a buyer in the 21% corporate bracket, a 10-year AA muni nets a TEY of 1.07% against the UST 0.61%. Similarly-rated corporate bonds are in a comparable yield range at the lower tax bracket, but for an individual buyer at the top federal bracket the TEY in the muni grows to 1.35%.
- The current TEY becomes more compelling for commitments further out the curve. A 30-year AA muni nets a TEY of 2.34% for a corporate-rate buyer and for the individual buyer it increases to nearly 3.00%--interesting against long UST yields that are now back below 1.25%.
- Assuming UST rates hold steady, longer muni yields could rally another 20 basis points before reaching parity against long corporate bond yields (21% tax bracket).



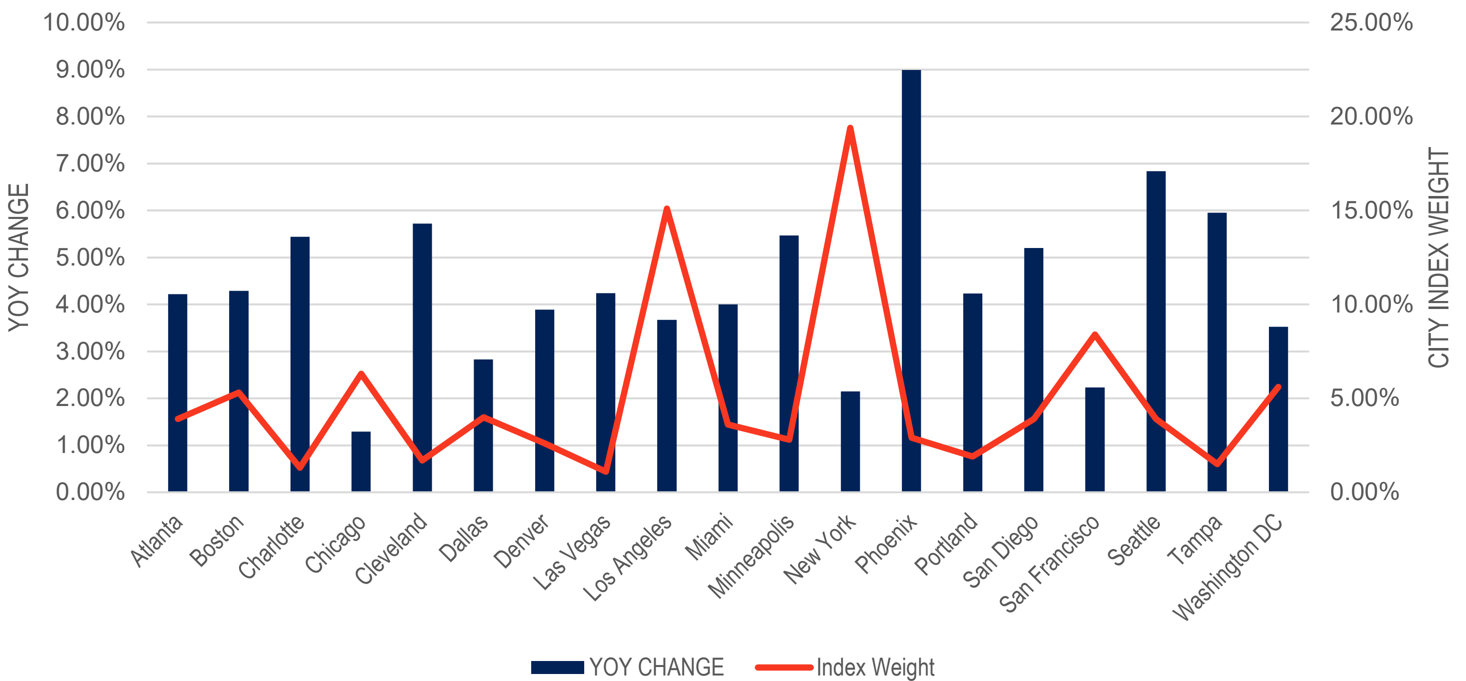
Source: Bloomberg

CREDIT

Areas that have larger negative 30-day supply projections—including CA, NY, TX and MA—can be expected to remain tightly bid, especially among the higher-tax states. For a state like Texas, lower float will weigh on general-market spreads and hold tax-exempt bidding to the lower end of historicals. In early May Texas PSF-backed 10-year spreads were wider than +30/AAA and 20-year PSF was trading +20/AAA. Those implied spreads narrowed to +12/AAA in both ranges during July. What were some of the widest-trading state names pre-selloff have also moved in on spread in intermediate maturities for similar reasons—such as Pennsylvania GOs (from +59/AAA to the current +34/AAA) and Connecticut GOs (+110/AAA to +53/AAA). Amidst the massive rally, bidding is reflecting the probability state GOs rebound from revenue downturns once pandemic treatments become available. For states like Connecticut, geography is playing in its favor with some actual and anecdotal evidence that New York residents are finding solace in the leafy suburbs. Whether the post-August period holds these relationships will be heavily influenced by where the political (presidential and congressional) and financial landscapes stand.

Recent housing data point to uneven results depending on the geography. The following graph compares year-over-year housing price moves for the cities in the S&P CoreLogic Case-Shiller Housing Index:

- The average national YOY housing price gain was 3.69% with several cities registering much higher prices. Charlotte, Cleveland, Minneapolis, Phoenix, San Diego, Seattle and Tampa recorded home price gains of more than 5%. Phoenix, in particular, saw housing gain 9% between 2019 and 2020. The common theme among this group is a combination of having low/no income taxes or being located away from major city centers.
- Cities that lagged the national average were Chicago, Dallas, New York City and San Francisco. Chicago's home prices gained a mere 1.29% YOY.
- Most cities fall in the top half of state volume where market presence is high. The coming year's data will be telling for what migration looks like with work-from-home conditions becoming entrenched—essentially giving workers more freedom to domicile where lifestyle and financial factors are more favorable. Another consideration is that low mortgage rates will encourage more ownership.
- Issuance within the Housing sector is 20% below 2019 and year-to-date gains of 3.08% lag the broad market by 45 basis points.



Source: spglobal.com; Bloomberg

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