FHN FINANCIAL

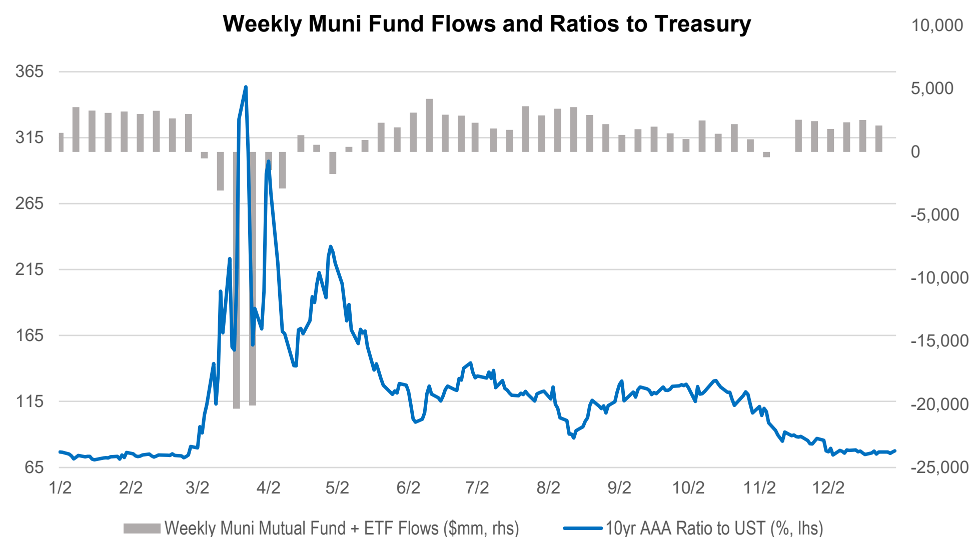
JANUARY 8, 2021

2021 MUNICIPAL OUTLOOK

Back to the New Normal

The carnage of volatility, uncertainty, and disappearing liquidity in March 2020 left municipal investors staring at near double-digit losses in the course of just two weeks. As communities around the globe seized up in fear of a rapidly spreading and deadly virus, the panic was justified.

But then the Fed stepped in and Congress wrapped a bow on a historic package of economic stimulus to deliver relief to the economy. Banks that were flush with cash from a flood of deposits were quick to recognize the opportunity in municipal valuations that were completely out of whack from normal relationships to falling Treasury yields. Other investors followed their lead to pour money back into an asset class that now had implicit support from the central bank.



Source: ICI, MMD

The rally that followed the Fed's intervention in the state and local debt markets was nothing short of remarkable. After all, AAA ratios to Treasuries have sunk from a whopping 350% at the height of the crisis to less than 80% today, exactly where they entered the year and 10 points below their five-year average. Benchmark 10yr municipals hit a new all-time low of 0.58% in August, as did the iconic Bond Buyer 20 GO index, whose August post of 2.02% was the lowest back to 1961.

But relative to corporates and taxable munis that posted gangbuster price gains despite record issuance in both sectors, the performance in tax-exempts looks lukewarm at best. This has less to do with poor investor sponsorship than the incredibly rich valuations in the tax-exempt sector to start the year, which left less room for spread compression relative to Treasury benchmarks in the summer rally.

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	2020	2019	2018	2017	2016	2015	2014	2013	2012	2011	2010	2009	2008
Total US Agg	7.51	8.72	0.01	3.54	2.65	0.55	5.97	-2.02	4.22	7.84	6.54	5.93	5.24
Intermediate	5.60	6.67	0.92	2.27	1.97	1.21	4.12	-1.02	3.56	5.97	6.15	6.46	4.86
Treasuries	8.00	6.86	0.86	2.31	1.04	0.84	5.05	-2.75	1.99	9.81	5.87	-3.57	13.74
Mortgages	3.87	6.35	0.99	2.48	1.67	1.51	6.15	-1.45	2.60	6.32	5.50	5.75	8.52
Corporates	9.89	14.54	-2.51	6.42	6.11	-0.68	7.46	-1.53	9.82	8.15	9.00	18.68	-4.94
Agencies	5.48	5.89	1.34	2.06	1.39	1.01	3.58	-1.38	2.16	4.82	4.36	1.53	9.26
Taxable Muni	12.11	14.32	-1.39	10.84	5.26	-0.01	18.79	-6.11	12.50	23.81	6.90	4.89	-4.11
Tax-Exempt Muni	5.21	7.54	1.28	5.45	0.25	3.30	9.05	-2.55	6.78	10.70	2.38	12.91	-2.47

Source: Bloomberg Barclays

Within the municipal sector, highest grade bonds were the runaway winners, benefitting from a flight to quality trade as the pandemic brought new story lines by the week and the election posed no shortage of drama. Investors hesitated to dip their toe in the murkier municipal segments while pandemic questions remained unresolved. Interestingly, "murky" in 2020 did not always fall along rating lines — even the highest grade airports and hotel tax bonds struggled to find a bid through the worst of the shutdowns. Thankfully, new stimulus and the first round of vaccinations have renewed investor faith in travel and leisure sectors that could bounce back by 2022. Spreads have been responding in kind.

Tenor	Return
1y	1.76
3y	2.97
5y	4.29
7y	5.11
10y	5.62
15y	6.32
20y	6.19
22y+	6.25

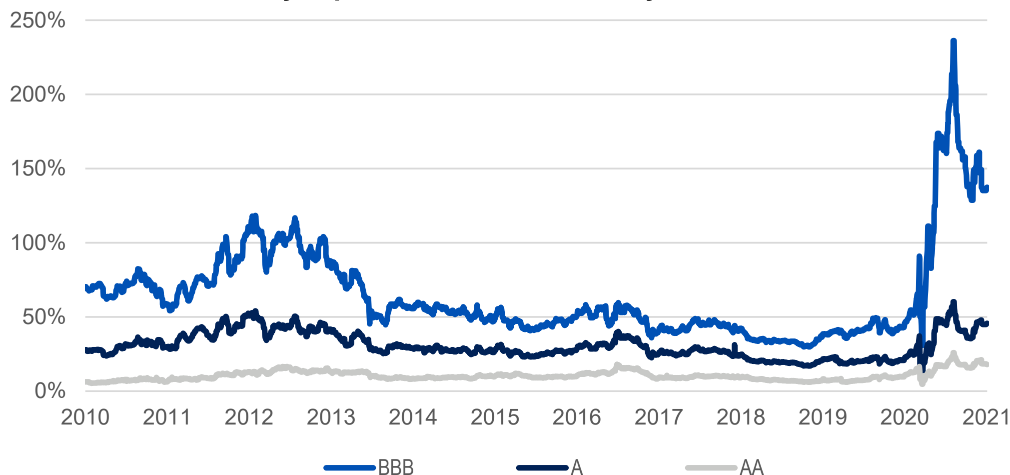
Rating	Return
AAA	5.51
AA	5.24
A	5.27
BBB	4.55
HY	4.89

Sector	Return 2020	Return 2020H1	Return 2020H2	YTW	Mod. Dur.
Housing	4.47	1.84	2.59	2.05	5.54
Special Tax	4.73	1.67	3.01	1.06	5.03
Leasing	5.04	0.15	4.89	1.21	5.26
State GO	5.12	2.83	2.23	0.77	4.41
Transportation	5.16	1.04	4.08	1.35	5.09
Education	5.39	2.58	2.73	1.14	5.40
Electric	5.40	2.80	2.54	0.90	4.47
Hospital	5.70	1.12	4.53	1.56	5.17
Local GO	5.86	3.13	2.65	0.97	5.18
Water/Sewer	5.86	3.35	2.42	0.85	4.85
Tobacco	6.60	1.52	5.00	1.47	5.24

Source: Bloomberg Barclays

In 2021, we see little room for further spread compression in high grades, which are already trading near their tightest ratios to Treasuries in over a decade. Much better opportunities exist in the single-A and triple-B categories, which are still at wide spreads to high grades and offer more room for spread compression if vaccines reach most of the population by the third quarter.

10yr Spread to AAA as % of 10yr AAA



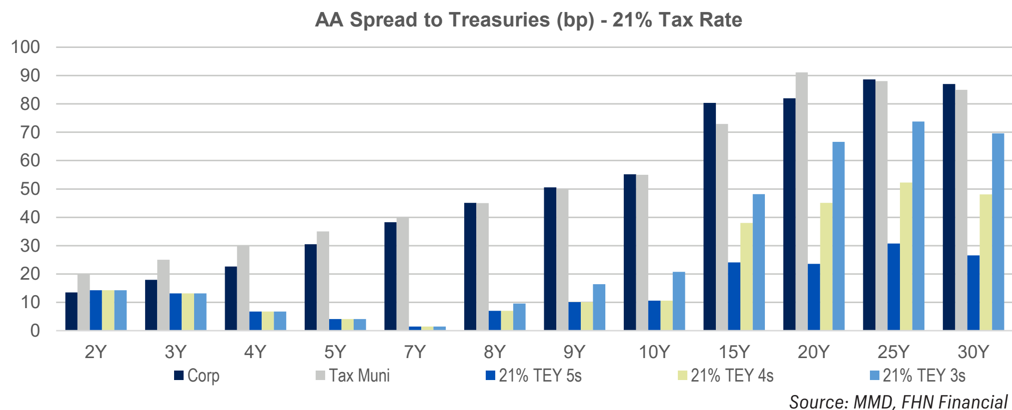
Source: MMD

The days of municipals trading as a rates market may be behind us. COVID has exposed abundant risks and opportunities in what has become a vast and diverse credit market, and investors would be wise to abandon old theories about how municipal spreads might react to each new development the next decade may bring.

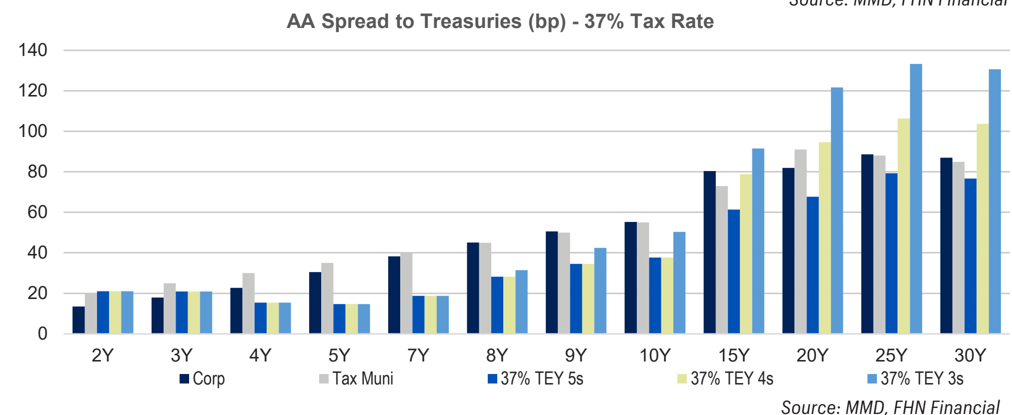
2021 Playbook

#1 Consider taxable munis. As we reflect on 2020, taxable municipals probably aren't on the first page of the highlight reel. But in the history of municipal finance, they had a major moment. The $145bn in taxable municipal supply in 2020 just barely missed the record posted in the second year of the Build America Bond program and was enough to offer some seriously compelling relative value across the yield curve for buyers in all tax brackets. **Taxable municipals should continue to offer plenty of options for all duration needs with a heavy calendar this year.**

#2 In tax-exempts, target 15-20yr maturities, where feasible. Although 3% coupons will offer 20bp+ in yield over 5s in 15 year maturities and 35bp+ in maturities of 20 years of longer, we expect more Sub-S and individual buyers may gravitate to 4s to protect against new inflation threats. Currently rich tax-exempt valuations argue for a stronger C-corp allocation to taxable municipals, but it's worth revisiting these comparisons frequently, especially as the "January effect" wears off and even more so if talk of tax increases picks up.



Source: MMD, FHN Financial



Source: MMD, FHN Financial

#3 Make selective allocations in single-A and triple-B rated credits.

#4 Cherry pick sectors based on risk tolerance and expectations for vaccines and the economy.

- The most conservative sectors will include utilities, MUDs, property tax-backed entities like park districts, HFAs, and other governments that get most of their operating dollars from the housing market.
- We also support bolder calls in sales, income, or even hotel tax bonds with adequate coverage, multi-state hospital systems that will rebound with a stabilization in cases and continued resumption of elective surgeries, toll roads as traffic picks up, ports supported by a global economic recovery and robust online sales volumes, and community colleges and flagship public universities that are poised to benefit from a long-term shift toward lower cost education options.

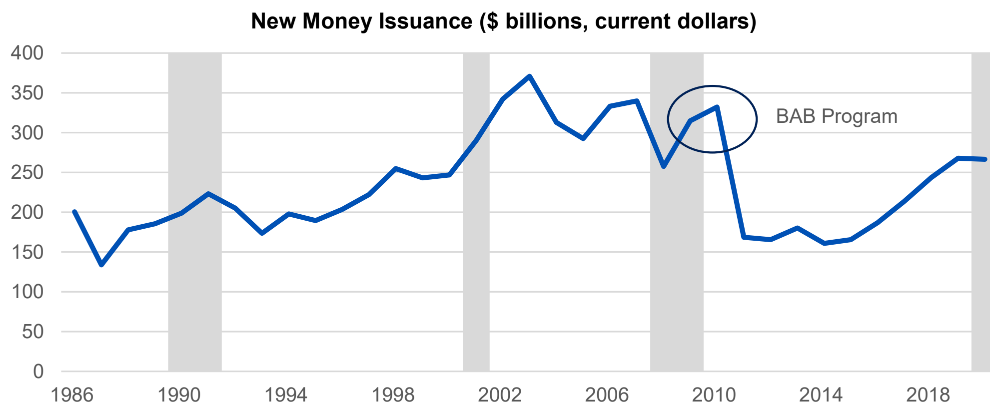
2021 Supply Outlook – More of the Same

The supply outlook for 2021 shouldn't rock the boat from new ranges established last year. We project $485bn in total supply for the year, just 2% higher than 2020's record issuance and consisting of a similar mix of taxables and tax-frees. The surge in advance refunding volumes will continue to drive issuance in the taxable municipal market, underpinned by low interest rates and expectations that Congress won't reinstate tax-exempt pre-refundings.

$ Billions	2021	2020	5yr Avg
Total	**485**	**474**	**425**
Tax-Exempt	335	329	362
Taxable	150	145	63
Taxable %	31%	31%	15%
New Money	285	267	227
Refunding	200	207	198
Refunding %	41%	44%	47%

**Combined purposes counted as refundings*
***Tax-exempt includes ~$10bn in AMT*
Source: FHN Financial, Bloomberg, Bond Buyer

Even though total supply could near the half a trillion mark, *net supply,* which measures the difference in total supply and outstanding bond redemptions, is still expected to be negative. A key roadblock to higher net supply this year may be government reluctance to fund new projects, which is always a byproduct of recessions and the reason investors keep flocking to municipal governments that prioritize budget balance over capital needs.



Source: Bond Buyer, FHN Financial

New money supply fell following each of the past three downturns and, after adjusting for inflation, still hasn't recovered from the peak hit in the early 2000s. Our outlook for 7% new money growth in 2021 breaks from this trend, owing to the allure of extraordinarily low interest rates and better-than-expected revenue performance for the majority of governments. However, risks to this forecast skew negative, in our view. As one sign of government reluctance to take on new debt, just $45bn in bond measures were put on state and local ballots in November, the lowest in a presidential election since 2012. For what it's worth, it's not taxpayers who are revolting against new spending in the pandemic — they approved all but $4.5bn.

Government stimulus in the form of interest subsidies on Build America Bonds (BABs) helped spur infrastructure investment in the last recession, and infrastructure appears to have the same priority on the new administration's agenda. Biden's $2tn spending package may have too many climate provisions to win support when both parties have narrow bases in Congress, but his broader goal to invest in US

infrastructure networks is one topic that could have bipartisan sponsorship this year. If infrastructure makes the 2021 agenda, we expect it could come in the form of a BAB-like subsidy program on state and local government investments. If that's the case, expect an even greater shift in the supply mix toward taxables this year.

Another wildcard in the supply outlook could be broader adoption of pension obligation bonds (POBs). POBs have historically been frowned upon by government accounting and finance associations as a risky arbitrage play on market rates. Returns in pension plans must beat the financing costs on the bonds for the strategy to succeed. POBs also replace a flexible cost on discretionary pension contributions with a hard cost on bond debt service, which could limit government flexibility. Some would argue that's a bad thing, but we tend to believe a budget commitment works better for politicians that can be quick to kick a flexible cost to future generations or blame current problems on past administrations.

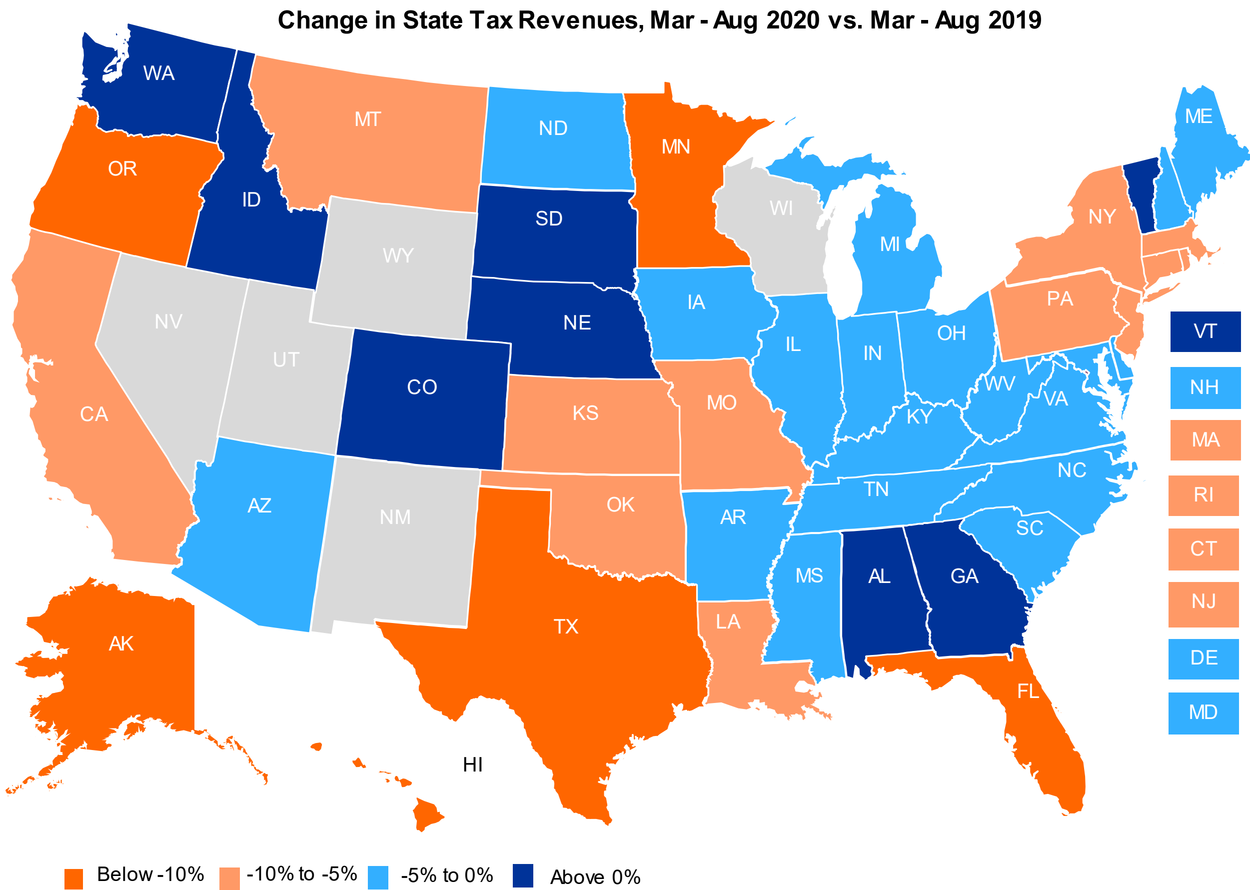
In general, the use of POBs in such a low rate environment heading into another potentially long expansion doesn't seem like a bad bet, and we expect more governments could exploit this opportunity with taxable POBs this year.

Credit Outlook: A Tale of Two Cities

When the virus first broke out, municipal investors were naturally uneasy about how state and local governments would be able to function with no end in sight to the terrifying rise in caseloads. Then the federal government stormed in with a record package of stimulus for individuals, the unemployed, and small businesses, and the future started to look a little brighter. Municipal governments also got checks, but the $150bn in CARES Act funding was only to reimburse pandemic expenses, not the plunge in revenues government budget officers feared as they blindly took to writing budget plans while cases were still raging.

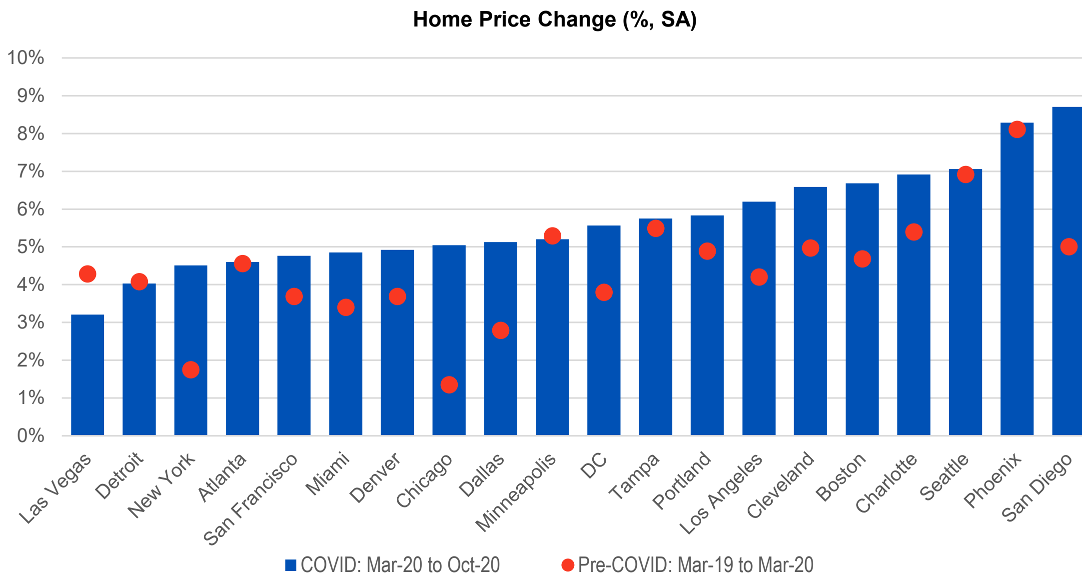
But then came an interesting realization. Yes, the pandemic was ravaging the economy, but the people it was impacting were not the ones funding most government budgets. The pandemic recession was unlike any other in that it was disproportionately impacting certain service industries and low wage workers that don't pay a lot in taxes. Meanwhile, the rich were doing just fine, and some were getting richer, and the revenues they poured into the economy meant governments got to put their red pens away for a few months and deliver pleasant, albeit cautious, reports of revenues surprising higher than planned. Even New York City, at the epicenter of the pandemic and the subject of rampant speculation of resident flight, has gotten to revise revenues higher each month, thanks in part to a banner year on Wall Street.

From March through August, the median state saw revenues drop just 3.6% from the same period a year prior. Some even saw revenue growth. But the average revenue loss, at 6.4%, tells a much bleaker story for selected governments. States like Hawaii, Florida, and Alaska, with dependence on tourism and energy, are seeing revenue holes in the double-digit percentages, and their timeline for recovery will be much longer.



Source: Urban Institute

At the local government level, disparities may be even more pronounced. In aggregate, local governments get three-quarters of their tax revenue from property taxes, leaving just a quarter to the most sensitive receipts such as sales, income, and hospitality taxes. And here's where another pleasant anomaly of the Great Lockdown Recession comes in — it's not having a destructive effect on housing. In fact, most regions of the country are seeing house price *appreciation* through the pandemic, most at higher rates than pre-crisis. Delinquencies are showing up, but the worst of them were avoided by forbearance programs that put property tax responsibilities on servicers.



Source: CoreLogic

Even if housing markets start to soften, the lag in tax assessments and collections relative to market value changes means the weaker prices would not show up in tax rolls for at least two years. Many parts of the country have much longer reassessment cycles that put property tax effects out three or more years or smooths them over housing cycles. Needless to say, governments that depend on the property tax base for most of their revenues are doing just fine.

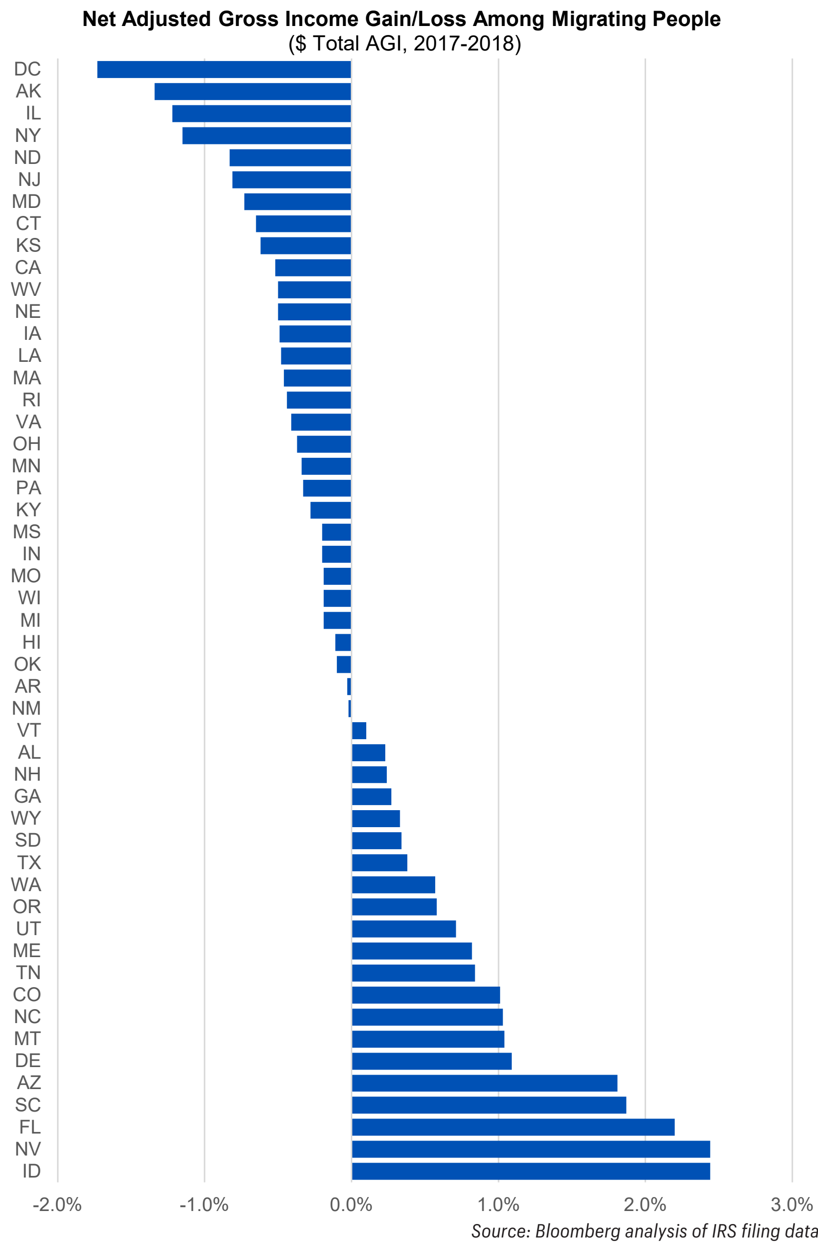
Local governments funded to a greater degree by sales and income taxes are benefitting from the same outperformance in those receipts that states are enjoying. Those revenues may be falling, but in many places it's occurring to a manageable degree and the strongest governments entered the crisis with ample reserve balances that provide some cushion while revenues recover. It's the weaker governments, the ones that came into the recession with poor liquidity and a running deficit, that we have to worry about, but they appear to be few and far between.

Another headwind for some governments is pensions. After the stock market roared back following its beating in March, concerns for public pension fund investments have abated somewhat, but the depressed revenue environment that could be expected to last for years will leave similar scars.

Just look at Illinois. Its revenue loss has been consistent with the average state, but it still had to tap the Fed's Municipal Liquidity Facility twice for a total of $3.2bn in deficit financing. This is not because its revenue loss was so severe but because it had counted on revenue growth, above and beyond expansionary gains thanks to a progressive income tax it hoped would pass in November, to keep the budget balanced and make minimum payments to its pensions. As the saying goes, hope is not a strategy, and we are now in exactly the environment we warned could cripple a government like Illinois that counted on it.

Revenue loss, muted investment returns, and now, migration woes.

This is the real wildcard as we look forward into the next decade. What, exactly, will the new normal look like? We've all heard the reports by now of empty Manhattan streets and company after company talking about their plans for a new flexible workplace or permanent remote work accommodations. We don't have a crystal ball, but we've seen enough to guess that lifestyles will probably look quite different when the next decade comes around. Will New York City be deserted? Of course not. But the outmigration from high cost places that was already underway prior to the pandemic is likely to get worse. **From where we sit, this will be the number one data to watch over the next two years, a horizon which should give investors enough time to reverse trades that made the wrong bet.**



Stimulus Provides Some Indirect Relief to Municipalities While Some Wait for More

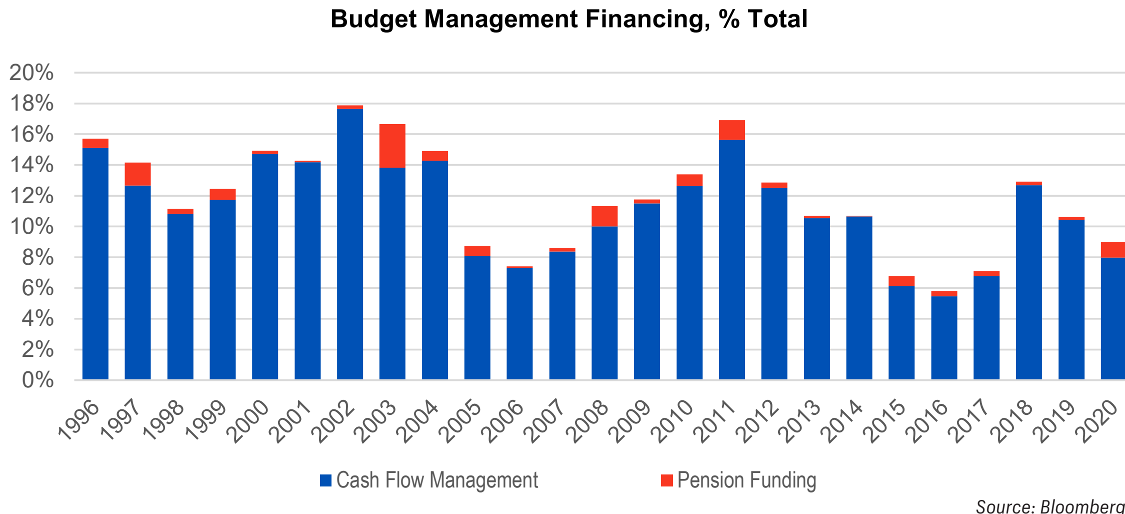
State and local governments didn't get the direct aid they had hoped in the federal stimulus deal struck last month, but they got the next best thing. The $900bn relief bill delivers $600 checks to individuals, an extension of unemployment benefits at $300 per week, more PPP funding, and targeted aid to airports, public transit systems, and schools and universities hit hardest by social distancing orders. The economic padding the bill provides in the midst of fresh shutdowns across the country should be enough for the average government to see adequate tax revenue to fund budgets.

Meanwhile, the have-nots that are bearing the brunt of the economic damage in this crisis are still hoping the stimulus package is just a down payment on further, targeted relief from the new President. **Their prayers may have been answered. Democrats have been itching to direct more federal relief to state and local governments, and now that they've gained control of the legislative agenda in Congress, governments may finally receive the blank checks they've been hoping for.**

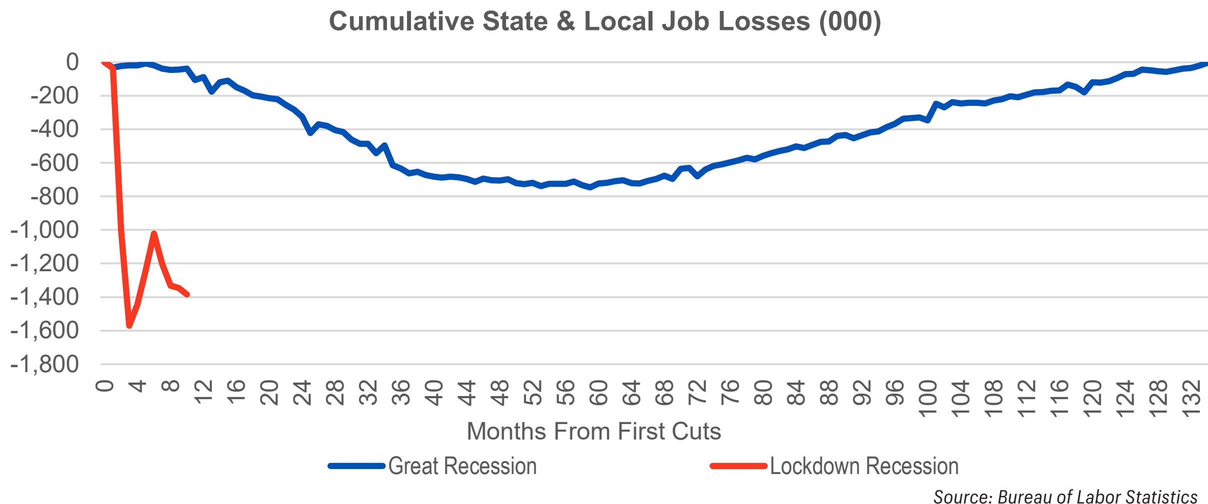
We present two reasons why direct stimulus to governments could support the municipal recovery.

1. Infrastructure and Jobs At Stake

States have balanced budget requirements. Many are constitutionally or otherwise prohibited from borrowing for deficits. In fact, this was a major obstacle in the design of the Municipal Liquidity Facility — even if governments wanted to borrow through the program and could get better financing through it, few had the statutory clearance to use it. As the chart below shows, cash flow management, even including the amounts borrowed by Illinois and the MTA through the MLF, was not a prominent feature of borrowing plans this year.



Instead, governments cut jobs. The carnage to public sector payrolls this spring was immediate and severe, not unlike the experience in the private sector but unusual relative to the slow and lagged response of governments in a typical recession. This recession is, of course, not typical, but the failure of jobs to rally nine months into the crisis suggests continued caution on the part of governments that could derail the national recovery.



Moody's Chief Economist suggests that every dollar spent on state and local governments will produce a return of $1.34 a year later, exactly because of the jobs they create. Until governments sense a turnaround in revenues, they'll be hesitant to rehire and spend money on the type of infrastructure projects that can produce serious dividends for the economy. Stimulus could help them get there.

2. Help for the Needy

In terms of actual government *needs* for stimulus, most governments could survive without it. We've already covered the remarkable performance in tax receipts at the national level, which has left an aggregate, cumulative budget deficit of $270bn for states from 2020-2022, hundreds of billions less than the last recession. After netting out the record reserves states carried into the Great Lockdown Recession and CARES Act funding already received, Moody's estimates the gap across both state and local governments will be roughly $200bn, assuming the delivery of new stimulus checks this month prevents a double dip. The $160bn allotment for municipalities that was struck from December's final stimulus package would have gone a long way.[1]

For the vast majority of governments, which are looking at revenue performance +/- 5% vs. pre-pandemic levels, failure to deliver additional stimulus hasn't been such a big deal. But for tourism-dependent governments, transit agencies, and certain universities that can't turn a profit at social distances, gaping budget holes make federal stimulus a more pressing matter. Compromise across the aisle may require a needs-based allocation that would deliver funding to those that need it the most, which may not cure the jobs or infrastructure picture, but would certainly generate some much needed relief to governments bearing the brunt of the pandemic's economic toll.

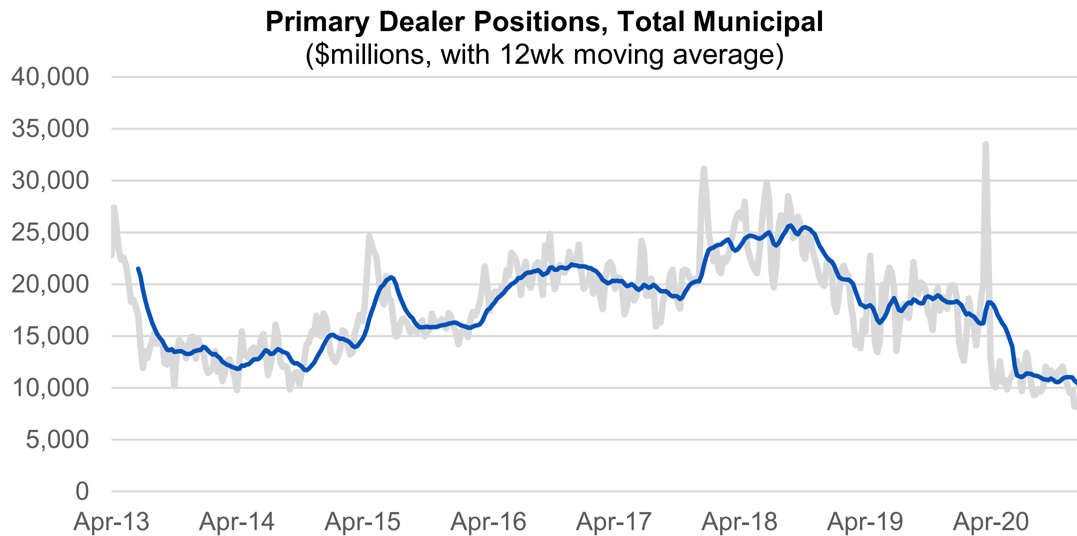
Municipal Liquidity Facility is Dead

The Federal Reserve threw the municipal market a lifeline in April when it took the unprecedented step of intervening in the state and local government debt markets. Its unease wading into the municipal trenches was palpable, marked both by a slow ramp up to opening and also restrictive criteria for participation that limited the program to states and just a handful of the largest cities and counties. The Fed gradually relaxed its terms and even its price schedule, but it was never accommodative enough to encourage broad participation as only two issuers — the state of Illinois and the New York Metropolitan Transportation Authority — borrowed through the program.

Of course, participation wasn't the point, and there are few governments that will complain about the financing opportunities the Fed's backstop afforded. Governments have been able to borrow through the public debt markets at near record low interest rates thanks to the Fed's broad support for fixed income markets. This allowed the most cash-crunched to borrow for deficits and governments more broadly to realize debt service relief through refinancing and extended principal payments. Even New Jersey and Suffolk County attracted big enough fan bases to get deals done at rates below pre-COVID levels.

Treasury Secretary Mnuchin stirred up some controversy, even from the normally cordial Chair Powell, when he ordered the Fed to return all unspent program funds and end the program at year end. Powell has been vocal about the fragile state of the recovery and the need for further intervention in the markets, but his warnings didn't deter the outbound Treasury head. Congress put the nail in the coffin with its December relief package, including a provision that would ensure the Fed cannot revive the expired liquidity facilities created and funded by the CARES Act. The Fed retains its lending authority, which could allow for the creation of a new program in an emergency, but only with the approval of Congress and not likely unless we reach code red conditions.

[1] This was Democrats' "skinny version" of relief. The HEROES Act would have directed $1tn to municipalities, including $915bn in flexible aid that could be spent for any purpose.



Just the promise of creating a new backstop in a pinch may be enough to contain investor fears about another sharp sell-off. A fresh batch of stimulus and new vaccines also help, as does the support of the new Treasury head. Tight dealer inventories of municipals suggests some fragility in prices should levels get tested again, but for now, we think investors will be comfortable knowing the Fed is ready on the sidelines to resuscitate the markets if necessary.

Election Round Up

Democrats' win in Georgia shifts the balance of power in Washington in the new President's favor. Although a razor thin Democratic majority makes it more likely some of Biden's policies move forward, the more controversial initiatives could still struggle to pass a narrowly divided Congress. Fortunately for governments, more stimulus spending, including direct payments to governments, may be at the top of the list of easy wins Democrats hope to tackle this quarter.

Category	Considerations
Taxes	An increase in tax rates will be one of the first things investors think about as they digest the outcome of the Georgia runoff. Democrats will certainly try to push through Biden's tax policy, which includes an increase in the corporate tax rate to 28% and a reversion of the top individual rate to 39.6%, but it's not a sure bet. As Trump learned when he inherited control of Congress in 2017, full party control does not give the President carte blanche to force their agenda. At the very least, we expect Democrats will postpone any discussion of tax changes until they gain some momentum on less controversial topics, so it may be later in Biden's term before it comes to a vote. But since it's an inevitable topic of discussion and likely source of uncertainty, here's a hit list of impacts to the municipal sector. An increase in the **corporate tax** rate to 28% from 21% would increase corporations' demand for tax-exempts. Today, obvious shifts in relative value would only occur in 15yr+ maturities, but that's been a sweet spot of bank barbells. More bank and corporation sponsorship of tax-exempts would have a tightening bias on spreads, but not to a significant degree given currently rich valuations and the potential for retail asset allocation shifts in an economic expansion. We wouldn't expect an increase in the top **individual tax rate** to 39.6% from 37% to move the needle on spreads. This would be especially true if legislation is accompanied by a reversion of **SALT deduction** caps. TCJA's limits on state and local tax deductions increased effective tax rates and caused investors in the highest tax states to put more money in the tax haven of municipals. A reversion of the cap on its own could modestly reduce demand from these investors, but when combined with federal tax increases, may be viewed as neutral. A restoration of the **AMT** provision to 2017 levels would result in wider AMT spreads. If Congress doesn't pass tax increases, many of the provisions from the TCJA will still sunset at the end of 2025. One exception is the reduction in the corporate tax rate, which was permanent.

Stimulus	The first round of checks have gone out, but Democrats claim their work is not done. Stimulus is a very likely focus of the new Congress, and if it looks anything like the HEROES Act, state and local governments will be a key beneficiary. Pages 8-10 have a full discussion on municipal stimulus needs, including our argument for why it could do the economy, and the neediest governments, a lot of good.
Infrastructure	Biden's pick for transportation secretary, former South Bend Mayor Pete Buttigieg, a champion of innovative economic development, shows a commitment to prioritizing US infrastructure. Although Biden's $2tn spending blueprint has some controversial provisions, namely on climate initiatives, the broader goal of investing in US roads and bridges should have bipartisan support. Key questions are when and who foots the bill. Washington likes to fall back on its state and local partners to champion these projects, and if that means federal subsidies on state and local bonds, taxables' share of the municipal market will grow even larger.
Education	Biden has pushed for free two-year public colleges. Although the idea has growing support from young people, even a majority of Republicans aged 18-29, this costly initiative could struggle to find support in narrowly divided Congress. However, the pandemic has no doubt laid bare the problem of pricey tuition in light of increasingly seamless venues for virtual or hybrid learning. The shift toward more affordable higher education will accelerate. We continue to favor flagship public universities, community colleges, and elite private schools with the resources to compete over small, niche private institutions or regional colleges that can't play ball at a lower price tag.
Energy	Energy policy is likely to shift more toward investments in renewables. We expect utilities with a high carbon footprint will face increased costs to reduce their mix of energy coming from fossil fuels.
Climate Risk	Similarly, expect more discussion on climate risks. Increasing frequency and intensity of hurricanes and wildfires over the past decade have brought their own attention in the media, but Biden is likely to stoke those headlines to support his climate agenda. This should also mean more federal FEMA funding to government victims of climate events as well as potential incentives for bonds funding climate risk mitigation or other ESG programs. **FHN Financial also offers a platform to screen for climate exposures in portfolios. This includes risks of sea level rise, wildfires, rising temperatures, as well as a number of other climate threats that could materialize over the next 50+ years.** Contact us for details.

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