JUNE 29, 2020

MUNICIPAL WEEKLY

FUNDAMENTALS

A surge of issuance could take the June tally above January's $32 billion figure and move the month to the most active for 2020. Of course, there was a lull in volume from mid-March through most of April, but to some extent current activity is catchup from that period. All is not lost for issuers, though, as rates are lower by 90-100 basis points from early April and fund flows, combined with a large reinvestment cycle, have rebounded to impressive levels to create a demand-meeting-supply force. For buyers it's a case of weeding through credits and structures and finding the best-yielding alternatives given an uncertain revenue picture across many sectors. Some weakness has crept into the 10-year range as yields fight their way back to 1%, but overall performance can be pegged to the immense cash haul scheduled for July and fund flows that are holding strong. One definitive supporting factor is the diversity of new issue credits, including Texas PSF-backed schools, local California names, AA-rated local GOs/utilities and single-A universities and airports. With no one sector dominating, the credit curve is smoothing out and giving inquiry a range of issues from which to choose. Spreads show the market's bias—NR/AA+ Western CA Water Revenues were negatively spread to AAAs through 10 years while A3/NR (BAM insured) Birmingham AL Airports were finalized +103/AAA BVAL in the 2030 maturity. Looking beyond the end of the quarter likely brings much of the same theme *with the caveats that state and local revenue begins to show rebounds with businesses reopening and the fund-flow component holds steady.* A breakdown in either metric could cause a yield pullback. Looking back to the prior election cycle and in the ensuing years, the first half of 2016, 2018 and 2019 saw greater results accrue as compared to the second half. This year has the asterisk of March/April with COVID-19 related effects.

Following tax reform in 2017, new issue optionality began to change as buyers responded to new dictates. The graph below highlights issuance this year with a breakdown of call structures:

- In 2019, 65% of deals were issued with a 10-year option but that had moved to 75% through the end of April 2020. The ensuing stimulative efforts by the Fed have taken inflation off the table for the foreseeable future and created a need for duration.
- Of deals issued with calls (86% of all volume) so far this year, 65% were priced with a 10-year option as inquiry moves out the curve. A combined 27% has been issued with 8- and 9-year options. Less common is a <5 year and 6-year structure, but 5-year callable bonds appear to have some traction with 8% of all callable volume. A lower prevalence of shorter-call options this year could be a function of absolute yields having rallied down from 1% and inquiry reaching into longer stated final maturities for more yield pickup.

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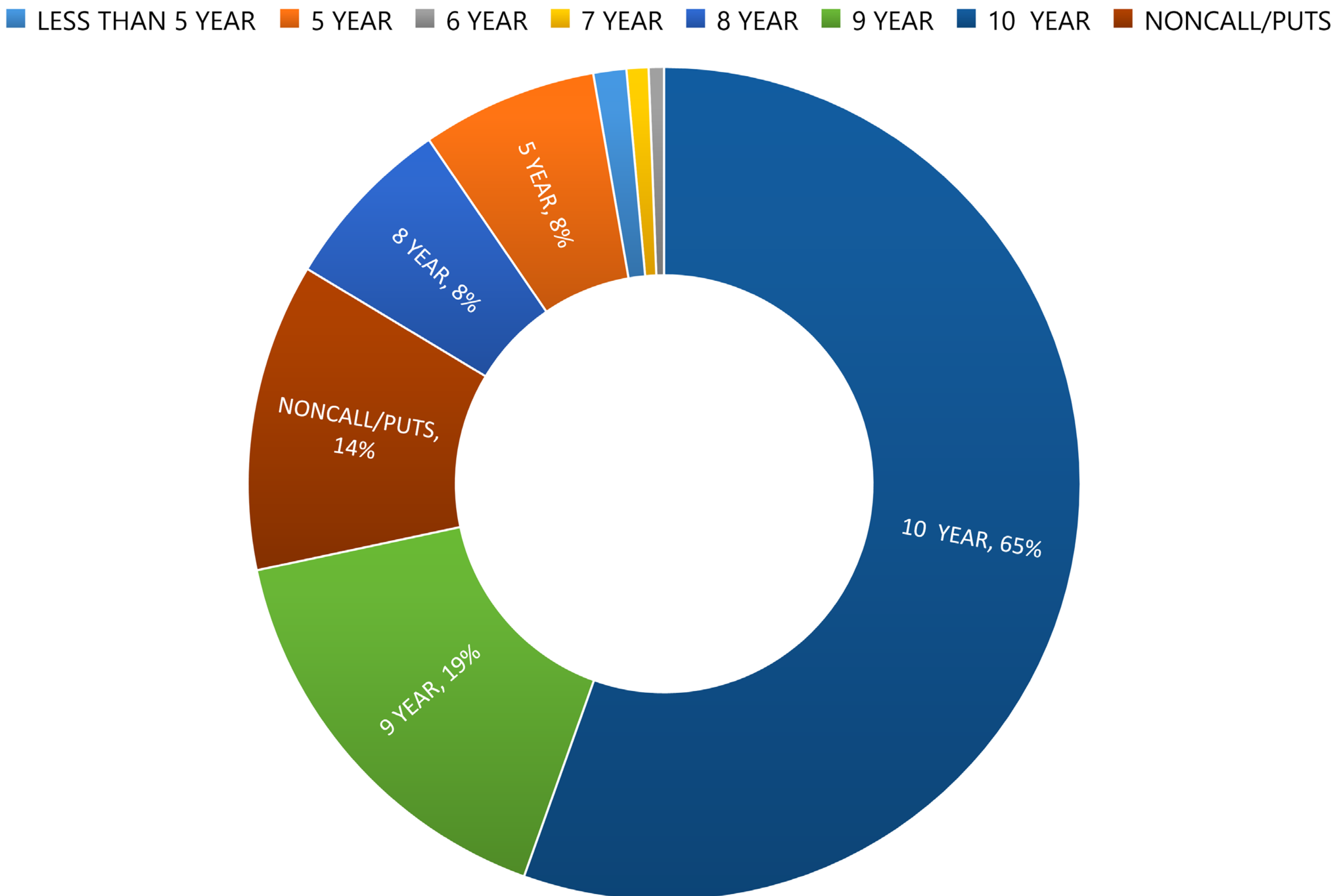
2020 NEW ISSUE OPTIONALITY STUDY
(Long-term $25 million+ issue size/non-AMTthrough 06/19/20)



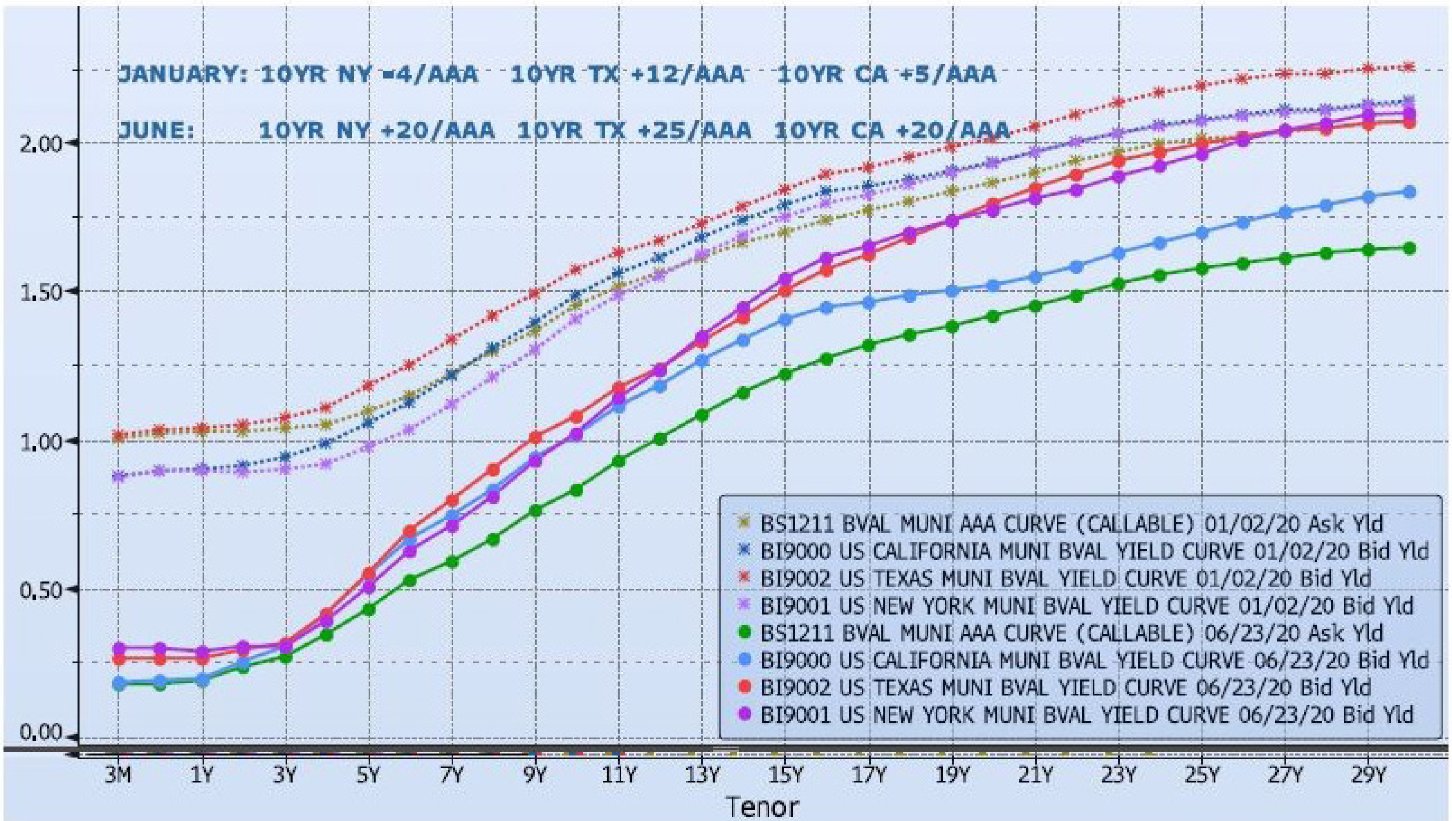
Source: Bloomberg

TECHNICALS

The primary market is front and center as the quarter comes to a close but at some expense to secondary volumes. Once again *just enough* activity is taking place away from new issue that generic benchmark curves are virtually unchanged from the start of the month. Some structures are finding fewer willing takers at published prices—namely high grades with minimal spread to AAA spots as yield fatigue becomes more apparent. Both the 10- and 30-year spot have traded below 1% and 2%, respectively, since early May—forcing a more patient inquiry approach. Among current issues, certain sectors stand out for wider opportunities—Texas PSF (two deals offered 10-year maturities +20/AAA) and Michigan School Building Loan Fund-backed credits (a Pontiac School issue with the state's school guaranty rated Aa1 but with no underlying rating priced the 10-year maturity at +76/AAA). Several smaller sales of local California names offered negative spreads to implied AAAs inside 10 years—likely a function of the state's $8 billion negative net supply projection over the next 30 days. One interesting feature that has developed this month as yields remain low and supply has increased is the growth of sub-3% coupons in competitively-bid sales than in negotiated pricings. Of tax-exempt issues this month $100 million or greater (non-AMT), 85% of competitive sales implemented a 2%-range coupon in at least one maturity, as compared to just 22% of negotiated issues. The disparity speaks to the different approaches between the two processes but also to buyers' knocking down coupons for additional concession.

June's yield performance has been nothing if not steady with a narrowly-traded market. However, the three largest issuers have seen their spread relationships undergo changes from the start of the year, as shown in the graph below:

- In January, intermediate spreads in the New York benchmark traded -4/AAAs, Texas was spread +12/AAA and California's spread was +5/AAA.
- Based on actual and expected budget challenges following the selloff, each state has seen spread widening to their AAA benchmark. Current indicative BVAL spreads in the 10-year spot are +20 in New York, +25 in Texas and +20 in California. Past scenarios where similar changes occurred proved to be reliable entry points as credit strength has remained in the upper investment grade ranges. Proposals to enhance federal funding programs for states' benefit would smooth out upcoming fiscal year challenges as well.



Source: Bloomberg BVAL

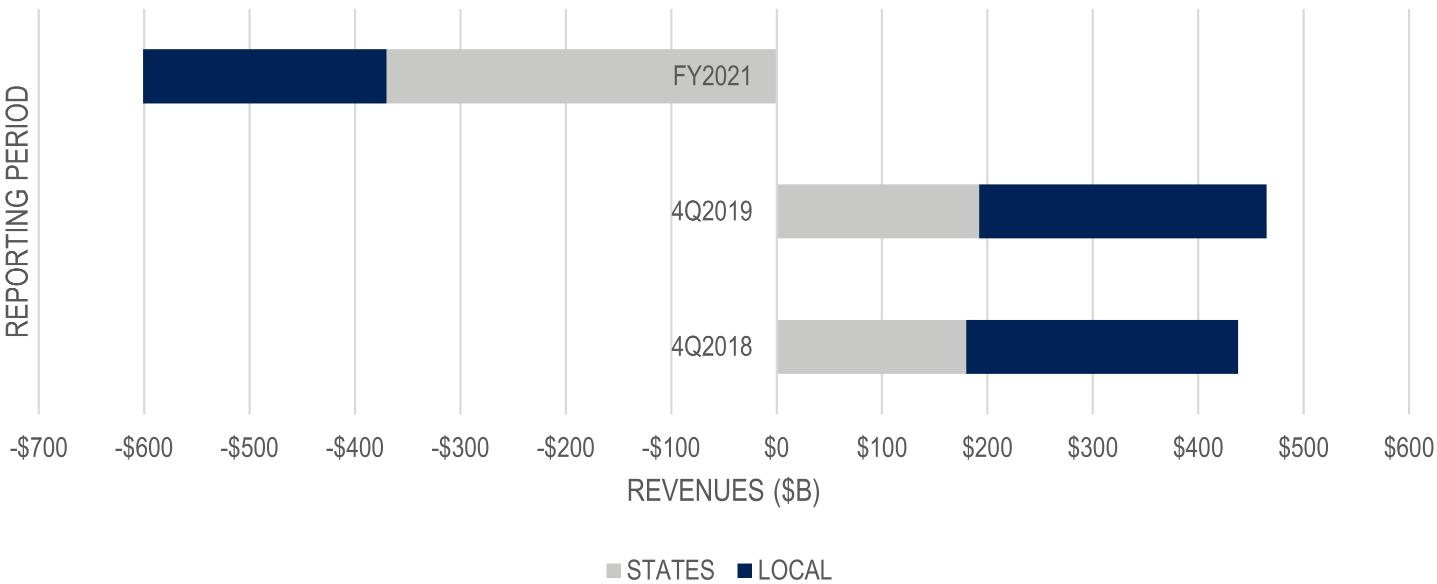
CREDIT

Revenue challenges at the state and local level are obvious given the hits to income, sales and miscellaneous/tourism tax collections. A deeper dive into state and local finances provides some perspective on what to expect in the coming fiscal year, as shown in the graph below:

- As reported by *The Bond Buyer* using Kroll Bond Rating figures, revenue losses across seven categories are estimated at $690 billion through June 2021. Specific to states, the figure is placed at $370 billion, or about two quarters worth of revenue (The Urban Institute calculated 4Q18 and 4Q19 state intake at $372 billion). At the city/county level, Kroll estimates losses to be $231 billion, or less than the revenue that was collected in 4Q19.
- Credit histories of all states and active city and county issuers are relevant, particularly when taken in the context of the Great Recession period. Pew Trust research indicates some states took as little as a year to as much as 12 years for full pre-Recession recovery. COVID-19 effects are expected to be more short-lived due to the non-systemic nature of the business downturn.

- In terms of ratings strength, of the states that issue GOs, 34 have mid-AA or higher ratings by at least one agency (11 states don't have GO debt). Since the crisis began in March, 13 states have issued some form of GO debt with successful distribution as buyers recognize the long-standing recovery nature of temporary revenue losses.

STATE AND LOCAL REVENUE PROFILES
2018-2019 (Actual)
2021 (Estimated)



Source: Bond Buyer; Kroll; Urban Institute