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Thoughts on the Municipal Bond Market

April 18, 2021

What a difference a year makes. In April 2020 the world was near the peak of unknowns surrounding the Coronavirus Pandemic and we were forced into a position to make several tough investment calls. A big one was on the outlook for Municipal bonds because they had corrected in price and the economic shutdown that had just begun represented enormous uncertainty about what would happen next. Under normal circumstances, our biggest concern when evaluating the attractiveness of long term Municipal bonds is the outlook for interest rates and inflation. However, a year ago the dominant narrative coming out of Wall Street was focused on the *safety* of Municipal bonds. The concern was that the shutdown would cause a substantial shortfall in revenues to state and local governments while increasing their spending burden. The risks were widely embraced among investors. Concerns about default risk were front and center in the financial press. At the time, our assessment that these popular perceptions were unjustified turned out to be the right call.

Our belief was that a big increase in default risk was unlikely to be a serious issue. It was based on a thorough and thoughtful understanding of the actual facts surrounding the source of municipal revenues and the reality of the rules governing municipal spending and budgeting. We also had an accurate understanding of how debt service on municipal bonds fit into the overall spending priorities that municipal governments have. In addition, we understood the how and why of the federal government (Treasury) transfers of funds to state governments, particularly in response to recessionary pressures. As a result, we concluded that concerns over elevated default risk were way overblown and the Pandemic-induced price correction was more of a buying opportunity than a reason to become less bullish on the outlook for Municipal bond price performance going forward. Municipal bonds have since recovered in price, exceeding pre-Pandemic levels. Earlier this month, David Rosenberg commented extensively on what the impact on state government finances were during 2019 and up to the present:

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"Early on in the pandemic, there were growing concerns about state and local government revenue shortfalls and increased spending burdens. However, with the initial $150 billion allocated to states through the CARES Act and now President Biden's $350 billion spending plan for state and local governments in the American Rescue Plan, these fears have been abated. Indeed, with lower impacts on revenues than anticipated, these fiscal transfers far outweigh the holes created by the pandemic." [1]

The outlook for Municipal bonds *and* Treasury bonds are uncertain in the months ahead for a variety of reasons. The purpose of this Commentary is to shed some light on the factors that are in play that will be impacting the performance of these bonds as we make our way out of the Pandemic and into whatever "back to normal" looks like.

The Economic Recovery

The United States is in the process of making startling progress toward "herd immunity". This is due to a combination of 1) millions of people acquiring immunity via contraction of the virus and 2) the spectacular success in delivering vaccines to the American people. Many experts believe that herd immunity could be achieved this year and the expectation is that social distancing protocol will be dramatically eased by mid-summer. That would be great for the economy and is very likely, provided that the virus does not mutate in such a way that these efforts lose their effectiveness. However, under reasonable circumstances, the return to normal in the United States does not necessarily suggest that we should expect the booming economy that the pundits are espousing and the stock market is suggesting. There are several reasons why "pent-up demand" among consumers will not result in a powerful growth trajectory once the initial reopening takes place. That is because the pent-up demand is largely for services that were not available due to social distancing protocol like travel, entertainment, eating out and going to the gym or hairdresser. These items of consumption really do not lend themselves to playing catch-

[1] "Breakfast with Dave" April 5, 2021

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up. In economist lingo, there is no “multiplier effect”. Who is really going to Italy twice this fall because they got shut out last year? (Actually, global tourism reached 10% of global GDP pre-Pandemic and it will probably be the last victim of social distancing to get back to normal.)[2] Will people go out to eat more or less often in the future? Conversely, during the shutdown, consumers spent very heavily on big-ticket durable goods like appliances and other home improvement items in an effort to adapt to a “shelter at home” lifestyle. Durable goods spending is where the biggest hit typically occurs during recessions and it is usually the source of the pent up demand that powers the recovery and the next business cycle. This time however, durable goods spending actually *increased* during the recession so it will most likely suffer a hangover in the recovery. Perhaps the biggest headwind to returning to normal and establishing a strong economic expansion is the challenge of reemploying the millions of people who lost their jobs and have not yet returned to work (or have done so at reduced wages).

Rather than speculate on how the reopening will go with all its variables, I am focused most on how the whole shutdown is likely to have long-term economic consequences, long after the virus is gone. Because the global shutdown was such a traumatic and far-reaching event, many emerging consumer economic trends were thrust into the present that otherwise would have occurred much more gradually. Telecommuting comes to mind. What will working in the office or jumping on a plane to meet with a client look like in the future? Just imagine what ZOOM will become from a technology perspective now that virtual meetings are universally accessible and accepted. It can only get much better. But the economic impact of less office occupancy and reduced travel is negative for growth. How many brick and mortar retail establishments will thrive going forward? The lockdown resulted in a dramatic reduction in service sector and retail spending, but from a variety of perspectives, there is a bright side. American Express bills cut in half was nice. Fewer shopping trips and dinners out are not that hard to get used to either. Society was reintroduced to some of the benefits of frugality and they may decide they like it. In order for the recovery to go beyond just regaining much of what was lost,

[2] Belle Haven Investments *Market Insights* Q1 2021

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consumer spending behavior will have to expand dramatically from where it was pre-Pandemic. There is very little likelihood of that happening until the job market is fully recovered. That could take several years, even in the most optimistic analysis.

Intermission

The First Quarter saw much higher interest rates on Treasuries, but Municipal bonds outperformed. Here are some representative Q1 performance figures: [3]

- S&P 500 6.17%
- NASDAQ 2.81%
- 30 year Treasury STRIPs -15.66%
- S&P Nat'l Muni Bond Total Ret. Index -0.405%
- National Leveraged Closed-end Muni Funds 1.85%
- Gold -8.95%
- Oil 22.51%
- Bitcoin 103.34%

The Prospects for Inflation

Without a robust economic expansion that transcends all of the long-term damage to the economy, inflation is unlikely to accelerate beyond the initial bottlenecks that should be corrected this summer. For that reason, the reversal in Treasury bond rates in recent weeks from up to down (see chart) could reflect the likelihood that the economic impact of the recently passed American Rescue Plan (ARP) and its accompanying mass issuance of $1400 checks to households earning less than $150,000 was already discounted in the market.

Fed Chairman Powell has expressed the opinion of the Federal Reserve Board that any inflationary impact from the combination of reopening the

[3] Thomson One

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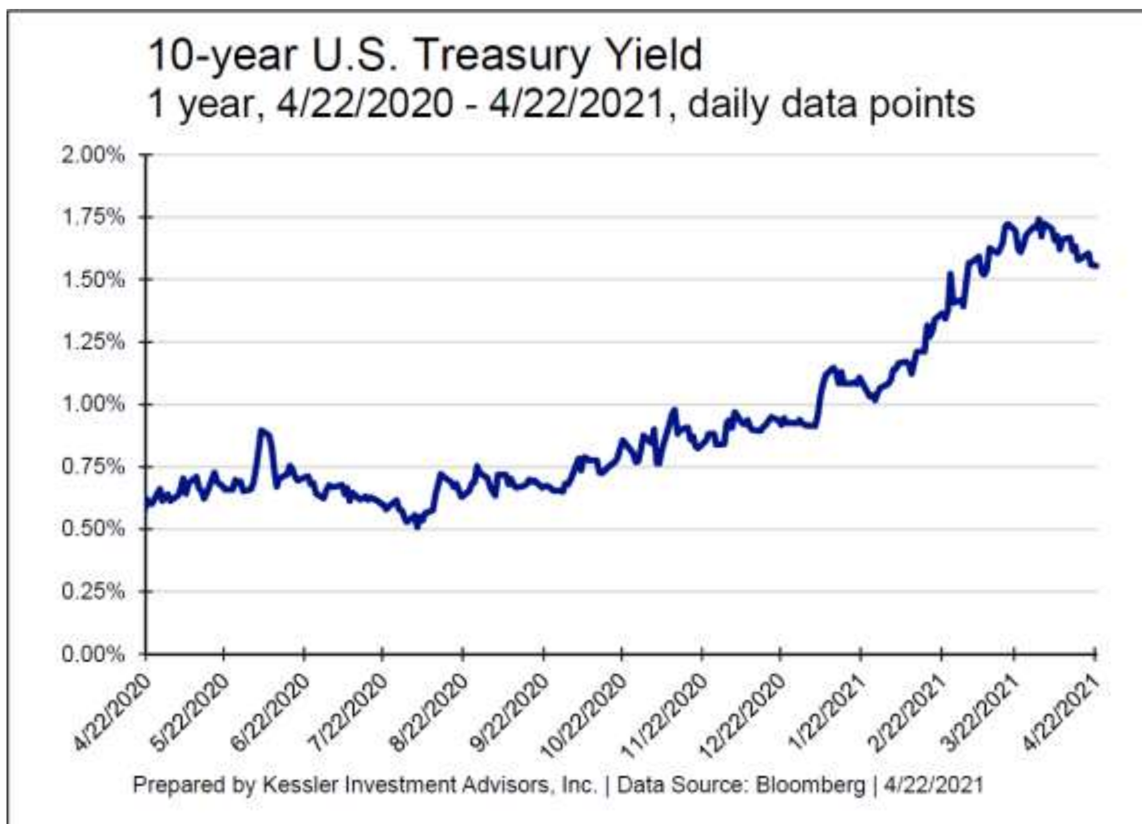
economy and the accompanying fiscal stimulus from the federal government will be "transitory". This is an objective and informed opinion at the highest level and stands in contrast to the ingrained hope for higher inflation that is a constant fixture on Wall Street. Because an economic expansion is typically associated with rising interest rates and higher inflation, higher prices are enthusiastically embraced as part of a bullish narrative.



Increased Demand for Municipal Bonds

For the last 6 months, the financial markets have been driven largely by the outcome of the national elections, the arrival of extraordinarily effective vaccines and the unprecedented stimulus packages passed by Congress. As part of the political changing of the guard, the national agenda has shifted from the tax cuts that were implemented by the Trump

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Administration to proposed tax increases on corporations and wealthy households by the newly elected Biden Administration. Because municipal bonds are generally exempt from federal income tax *and* the 3.8% Affordable Care Act levy on investment income for high-income households, they become far more attractive than taxable bonds as tax increases become law.[4] For example, when corporate tax rates were cut from 35% down to 21% under the Trump Administration, insurance companies and other corporations that have investment portfolios liquidated municipal bonds because the "taxable equivalent yield" or the after-tax advantage of municipal bonds was dramatically reduced. The current proposal to raise corporate taxes back up to 25-28% has the opposite effect of making municipal bonds more attractive, increasing demand. These same dynamics are also true for wealthy households that experienced tax cuts under the prior administration but are facing potentially significant tax increases in the near future. The Biden Administration has proposed raising the top marginal tax bracket for households earning over $400,000 and eliminating the 20% deduction afforded small businessmen and women who structure their business as "pass-through" entities for tax purposes. In addition, the current administration has floated changes in capital gains rates for the wealthiest households.

Limited Supply of New Municipal Bonds

In addition to the increase in demand caused by higher tax rates, the hundreds of billions of dollars recently granted to state governments via stimulus packages have dramatically reduced the need for municipalities to issue new bonds in the next couple of years or longer, particularly if the multi-trillion dollar infrastructure bills proposed by the Biden Administration are passed. Infrastructure spending by the federal government is accomplished primarily with municipal shovels. The federal funds used to build and repair roads, bridges, and government facilities such as schools are a direct reduction in the fiscal burden on municipalities. From David Rosenberg:

[4] Belle Haven Investments, ibid.

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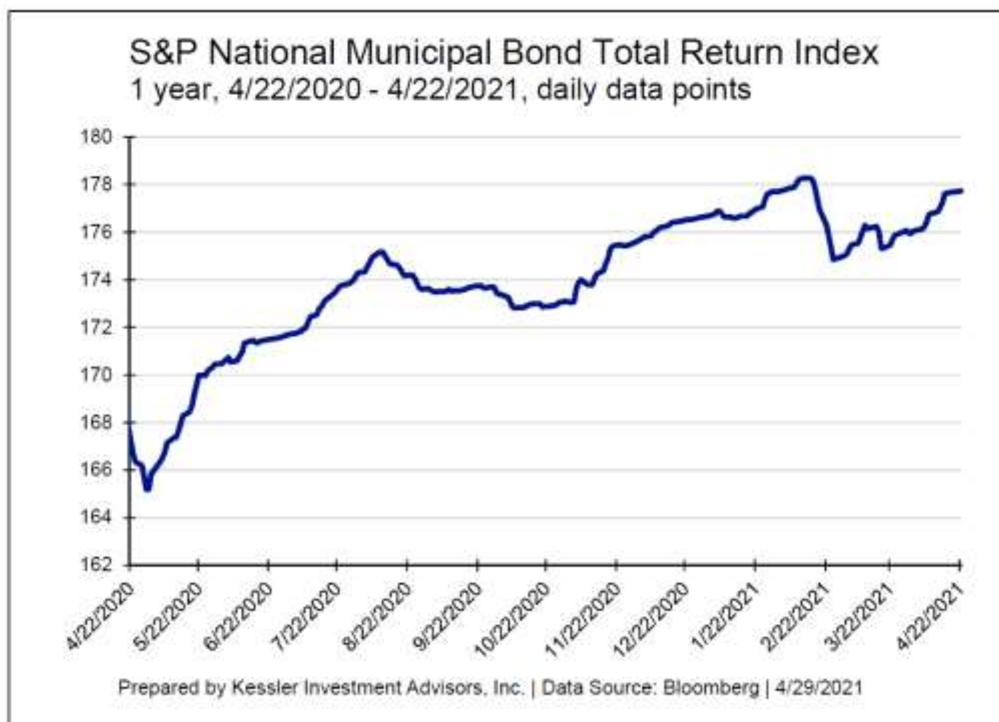
"Needless to say, the assistance is so over-the-top given what is needed at the state and local level that one can reasonably expect a dearth of new supply ahead as the federal government is forced to continuously boost the size of the Treasury auctions. All this points to even tighter spreads and decent returns for muni investors." [5]

Municipal bonds have performed favorably, particularly since the election and munis have generally been appreciating since the early stages of the shutdown last spring. Fiscal stimulus benefitting state budgets and the likelihood of higher marginal tax rates will continue to favorably impact the supply/demand equation for municipal bonds.



Quality concerns stemming from the Pandemic appear to have been

[5] David Rosenberg, ibid.

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relieved by the smaller than expected impact on revenues and the massive transfer of funds from the federal government to state and local coffers embodied in the stimulus packages from Congress.

Looking forward to the year-end 2021 and into 2022, we believe municipal bond performance remains dependent on the performance of the economy and the behavior of inflation. But because of all the uncertainties surrounding the nature of the recovery, municipal bonds are attractive based on their conservative fixed income characteristics. In addition, the positive fundamental tailwinds of increased demand as new supply dries up, should make a positive contribution to overall performance.

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Interest on municipal bonds is generally exempt from federal income tax. However, some bonds may be subject to the alternative minimum tax (AMT). Typically, state tax-exemption applies if securities are issued within one's state of residence and, local tax-exemption typically applies if securities are issued within one's city of residence. The tax exempt status of municipal securities may be changed by legislative process, which could affect their value and marketability.

Bonds are affected by a number of risks, including fluctuations in interest rates, credit risk and prepayment risk. In general, as prevailing interest rates rise, fixed income securities prices will fall. Bonds face credit risk if a decline in an issuer's credit rating, or creditworthiness, causes a bond's price to decline. Finally, bonds can be subject to prepayment risk. When interest rates fall, an issuer may choose to borrow money at a lower interest rate, while paying off its previously issued bonds. As a consequence, underlying bonds will lose the interest payments from the investment and will be forced to reinvest in a market where prevailing interest rates are lower than when the initial investment was made. NOTE: High yield bonds are subject to additional risks such as increased risk of default and greater volatility because of the lower credit quality of the issues.

A taxable equivalent yield is only one of many factors that should be considered when making an investment decision. Morgan Stanley and its Financial Advisors do not provide tax or legal advice. Individuals should consult with their tax/legal advisors before making any tax/legal-related investment decisions.

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