Investment Insights

Addressing Municipal Market Volatility

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Highlights

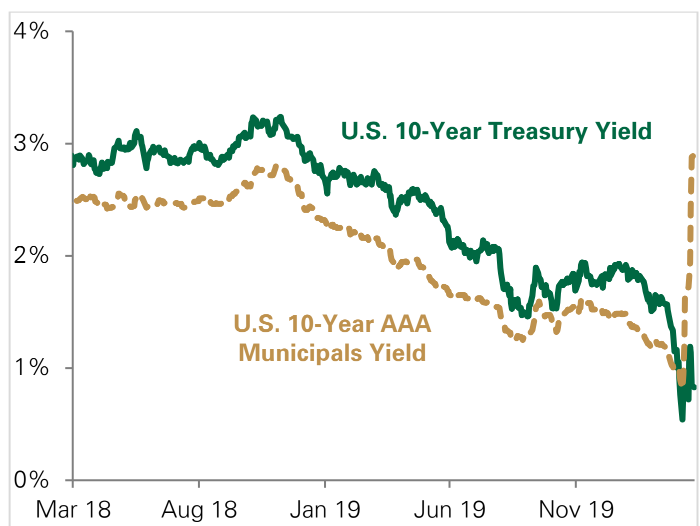
- Similar to the previous week, last week's municipal bond volatility remained heightened, and the asset class sold off.
- The leverage squeeze from the week before sparked more forced selling throughout the week.
- This coincided with normal seasonality in resets, pushing funding costs up significantly.
- We continue to believe that this dislocation will prove to be temporary, not structural.
- Bessemer's high-quality muni bias and Treasury position helped to mitigate the volatility.
- As the volatility subsides, Bessemer will look to capitalize on attractive muni valuations.

Last Week's Volatility

The heightened volatility throughout domestic markets continued unabated last week, and municipal bonds were no exception. The municipal bond asset class started to come under pressure on March 9 as levered municipal bond funds began to experience margin calls and were forced to sell into the market in order to cover margin (Exhibit 1).

Unfortunately, from a market pricing perspective, the selling pressure was met with two other exogenous events during the week: (1) a significant increase in the SIFMA funding rate (the SIFMA rate is a seven day high-grade market index comprised of tax-exempt variable rate demand obligations/resets), and (2) broader governmental intervention to halt the spread of COVID-19 (and the implications for muni credit) The increase in the SIFMA funding rate was especially shocking to investors and was driven by two influences: (1) normal seasonality that sees investors sell their resets in order to raise cash for tax payments, and (2) further leverage unwinds. In a normal year, tax-related selling tends to send the SIFMA rate up to approximately 1.5% to 2%. This year, however, that trend was exacerbated as mutual funds (that used short-term securities to lever up positions within their portfolios) were forced to unwind those leveraged positions as the economics of the trade were no longer viable. As a result, the SIFMA rate for weekly resets increased from 1.28% to 5.20% in a week, a level not seen since October 2008 (when SIFMA reached 7.96%).

Exhibit 1: Spike in Municipal Bond Yields



As of March 23, 2020.
Source: Bloomberg

Notably, despite the volatility and consternation among market participants, market liquidity did not disappear. Granted, the depth of the bidding was not as robust as normal, and levels often deviated significantly from the prior day's marks, but the muni team was able to execute all of the sale requests that came in. Further, as the week progressed and valuations swung to extremely cheap levels, a wide variety of buyers emerged in the marketplace, including banks, insurers, and even some retail.

Outlook

Market. While significant in magnitude and certainly unsettling to investors, the municipal market correction should prove to be temporary in nature. From the fundamental perspective, issuer balance sheets remain in good shape (having benefitted from conservative fiscal policy and the broader economic expansion since the great recession), and absent any change in fiscal policy (reintroduction of the advanced refunding or a change to the SALT cap, neither of which seems likely), the favorable supply/demand imbalance within municipal markets is likely to persist for the foreseeable future. Federal government stimulus to offset the onerous effects of COVID-19 should help stabilize those municipal sectors most affected, specifically state/local governments, hospitals, and transportation systems. Given this backdrop and extremely attractive valuations, the current environment should provide attractive opportunities to add municipal bond exposure and trim Treasury exposure as volatility subsides.

Resets. Similar to the market outlook above, the current dislocation in the front end of the market should prove to be a temporary dislocation (an exogenous shock and not a structural issue). Further, the Fed's actions at the end of last week should help to stabilize the market in the near future. As described above, the SIFMA rate increased significantly last week to 5.2% for weeklies. Notably, this last occurred in October 2008, when the rate increased to 7.96%. That event proved to be short-lived, however, and the rate normalized shortly thereafter. Despite the significant volatility last week, liquidity and market function in this part of the curve seemed to be unaffected, a sign that this may again prove to be a short-lived technical dislocation driven by exogenous factors (and not structural issues).

Often, clients tend to associate resets with Auction Rate Securities (ARS). It is important to note that they are indeed two different vehicles differentiated by several key factors, including (but not limited to) the following: (1) Unlike resets, ARS do not have a put feature and can only be sold via auction, and (2) resets have contractual liquidity support, typically in the form of a letter of credit (LOC) or standby bond purchase agreement (SBPA), which ARS do not have. Further, Bessemer has a very rigorous process for reviewing, approving, and monitoring resets —including credit quality of the issuer, the bank providing liquidity/credit support (if any), and legal provisions (including the formula for setting rates/the maximum rate). However, in an abundance of caution, it could make sense to hold, for the most part, resets that benefit from the additional support provided by bank liquidity agreements or bank letters-of-credit, which secure debt service as well as the purchase price of the bonds.

Credit. Given the unprecedented nature and breadth of the COVID-19 outbreak in the U.S., concerns about municipal credit and default are understandable. That said, our current view is that the municipal market will not see widespread defaults.

This thesis is predicated upon (though certainly not limited to) the following factors:

(1) As witnessed in prior crises, the federal government tends to step in to help state and local governments (this happened after Hurricane Katrina and the Great Recession). Given the breadth of shutdowns and the potential implications for unemployment, this is likely to occur during this crisis as well. Timing is key – state and local governments should have time to adjust to an anticipated decline in revenues and plan accordingly. Still, the breadth and likely length of the shutdown and the associated rapid rise in unemployment do pose uncertainty. On both the state and local levels, revenues are generally expected to fall and expenditures to rise as governments address the effects of the virus on their communities. Mitigating these risks, to an extent, is the fiscal prudence that a number of state and local governments have demonstrated following the Great Recession. Many have bolstered their balance sheets and increased rainy day funds —which translates into time to adjust to the effects of a weakening U.S. economy and to plan accordingly.

(2) Airports, on average, have roughly 600 days cash on hand to help buffer economic headwinds and are also likely to be beneficiaries of federal government support.

(3) Hospitals have already seen aid from the federal government, and this is likely to continue going forward. Specifically, HR 6201 contained two key components for hospitals: a 10% increase in Medicaid reimbursement and a $1 billion contribution to the National Disaster Medical System to help cover uninsured patients.

In terms of bonds purchased for client accounts, we focus on well-managed governmental/essential enterprise issuers with diverse economies and solid management. Furthermore, many of these issuers tend to be larger/economically significant, which should allow a greater voice in shaping public policy —including the Covid-19 response. Finally, Bessemer's analytical staff will be continually monitoring our holdings in this rapidly evolving environment —importantly, developments on the federal level. Appropriately targeted federal aid to state/local governments will be key as these governments navigate the downturn and provide services to residents.

Past Market Dynamics

Throughout the course of 2019, municipal bond markets experienced one of the most favorable supply/demand environments in many years, as supply underwhelmed expectations (lower issuance with a favorable composition) and demand soared to levels not seen in decades. Surprisingly, the environment experienced last year was largely driven by policy changes stemming from the Tax Cuts and Jobs Act (TCJA) of 2017.

As it pertained to municipal bond supply, one of the key tenets of the TCJA was the removal of the advanced refunding option for municipal bond issuers, an important refinancing option used by issuers to lower financing costs that accounted for roughly 20% to 25% of total annual supply. As a result, tax exempt issuance was somewhat inhibited in the first half. However, beginning in August, issuers and underwriters began to recognize that, with continually declining yields, the economics of advanced refunding tax exempt debt into the taxable muni market became extremely compelling, and from August 2019 to the end of the year, taxable muni issuance increased approximately fourfold. This resulted in a highly favorable supply mix for the market that perfectly complemented an ever-evolving demand environment.

The demand side of the municipal market was also extraordinarily strong throughout 2019, attributable to two main factors: (1) a steep decline in global sovereign rates, and (2) another key component of the TCJA. As global yields continued to decline throughout the year, the taxable muni market became a compelling option for overseas investors, particularly those in the U.K. and Japan. Cross-currency adjusted taxable muni spreads were very attractive for those investors, and the structural aspects of the market (low volatility, low defaults, etc.) satisfied Solvency II requirements (a directive in European Union law) very well, enticing significant overseas demand that complemented the uptick in taxable muni issuance.

At the same time, U.S. retail investor interest reached levels not seen in decades, largely driven by the SALT cap deduction within the TCJA (essentially, a tax hike for wealthy individuals). Given the implied tax hike, investors sought out the value of the exemption within muni markets, and inflows into the asset class exceeded $92 billion (for reference, the previous inflow peak occurred in 2009 at around $72 billion).

As one would expect from this high-demand/low-supply environment, municipal bond valuations spiked (trading anywhere from one to four standard deviations, rich to historical levels), and spreads tightened throughout the course of the year. For reference, the 10-year municipal index yield fell to an all-time low under 80 bps, and valuations tightened down to almost 70% of Treasuries (again, a level not seen in decades).

For more information on the recent market developments, we encourage you to read our March 12 *Investment Insights,* "Market Sell-Off Continues Despite Fed Actions"; March 9 *Investment Insights,* "Latest Thoughts on Market Turmoil"; February 28

Investment Insights, "Taking a Long-Term View During Volatile Times"; and our February 25 *Investment Insights*, "Portfolio Positioning Amid Recent Market Moves."

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