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Municipal Market Update.

The initial Covid-19 outbreak and subsequent government-imposed lockdowns confronted states, cities, and counties with unprecedented fiscal challenge. Additionally, the ongoing pandemic has weighed heavily on economic activity as investors face the shortest and most severe recession in the post-WWII era. The municipal bond market was not immune. Panic-induced selling drove muni bond prices to historically cheap levels in March. This selloff was commensurate with the increase in outflows by institutional investors. The resulting liquidity-crunch precipitated interest rate increases at an unprecedented pace. Tax-exempt rates decoupled from their Treasury counterparts, dislocating to an extent not seen since the Great Recession.

With support from the Federal Reserve, the flow of credit has eased over the past quarter, restoring liquidity to many areas of the fixed income market. Although the Federal Reserve has not purchased municipal securities directly as part of their traditional bond purchasing programs, they have established a program called the Municipal Liquidity Facility (MLF). The Municipal Liquidity Facility will offer up to $500 billion in lending allowing states and municipalities to tap into the facility to help manage the financial shortfalls caused by the pandemic. The facility will purchase up to $500 billion of short-term notes directly from U.S. states, the District of Columbia, U.S. counties with a population of at least 500,000 residents, and U.S. cities with a population of at least 250,000 residents.

The MLF is designed to operate as a liquidity provider to state and local governments, assisting those unable to obtain adequate funding under the current conditions. This $500 billion commitment from the Fed has helped return stability to the municipal bond market and conditions have improved since reaching the March low-water mark. Evidence of this return to stability can be shown by investors adding almost $3 billion to municipal bond funds in May, marking the first month of net inflows since February (Refinitiv Lipper data). However, performance across the muni market remains bifurcated with the highest rated municipals positive year-to-date while lower quality issuers remain below pre-pandemic levels.

AAA-rated municipals have shown a +3.38% year-to-date total return through May. This is due to a combination of low interest rates, muted inflation pressure, and liquidity from the Fed returning to the credit market. This sharp recovery within high quality muni bonds exemplifies the power of public policy. High yield (below investment grade) municipals have been hit particularly hard by recent outflows, with the broad index down 6.35% year-to-date through May.

Although rates have come down from their highs, this market continues to offer an attractive income advantage above AAA-rated municipals and taxable asset classes. As of June 23rd, the high yield municipal index was yielding 4.9% or around 8.3% on a tax equivalent basis. Current yield levels reflect a 190-basis point (1.90%) advantage over high yield corporate notes, which have historically been subject to higher defaults and lower recovery rates. The slower recovery within lower quality issuers is attributed to concerns of potential defaults in the marketplace. This concern may ease as we enter the summer months, driven by recent defensive action from the Fed coupled with optimism around states and cities beginning to re-open. It is also important to remember the Global Financial

Crisis in 2009 and 2010 when state governments similarly relied on federal support to whether the storm.

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