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Municipal market dynamics bode well going forward

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The municipal bond market has proven resilient this year, despite the headwind of rising interest rates. This relative stability has been driven by favorable credit developments, attractive valuations and an improving technical backdrop. And investors appear to be understanding that the Tax Reform and Jobs Act has generally positive long-term implications for municipal bonds. With longer-term interest rates stabilizing in the second quarter, these tailwinds contributed to a rebound in municipal market performance.

KEY TAKEAWAYS

- Municipal bonds outperformed Treasuries, but municipal-to-Treasury ratios are mixed.
- High yield municipals returned attractive second quarter performance, driven by narrowing credit spreads and higher income.
- We see opportunity for credit spreads to narrow further, income to act as a main driver of returns and scarcity value to grow in selected areas.

THE U.S. ECONOMY IS STRENGTHENING

The current economic expansion is in its ninth year and is the second longest on record. Consumer spending and business investment have strengthened and home prices have broadly recovered in most regions, boosting home equity to all-time highs.

A strong labor market tends to be the linchpin of consumer spending, housing market activity and auto sales. On average, 194,000 net new jobs were created monthly in the second quarter, and initial plus continuing jobless claims are trending at record lows. The number of job openings exceeds the number of job seekers for the first time in nearly 20 years. While the unemployment rate ticked up slightly to 4.0% in June, this was due to more people entering the labor force.

Most of the economic improvements over the last nine years have been based on unprecedented monetary stimulus. The expansion's longevity bears watching now that the Federal Reserve (Fed) has been tightening monetary policy for nearly two years. However, interest rate increases have been normalizing from a near-zero level, and overall rates are not yet considered historically high or restrictive.

Growth

Second quarter gross domestic product (GDP) may reach a 3.9% annualized growth rate, up from the 2.2% annualized pace of the first quarter. The U.S. economy has only achieved higher than 3% growth in two quarters during the current expansion.

Inflation

Inflation continues to tick gradually higher. The Fed's preferred inflation gauge, the core PCE deflator, finally hit the Fed's stated target of 2% in May for the trailing 12 months. Recent momentum may carry core PCE slightly above 2% in the coming months, but we do not believe that would produce an overreaction in the financial markets.

Fed policy

The Fed increased the fed funds rate to a range of 1.75% to 2.00% at the June meeting. The accompanying statement implied two additional increases in 2018, three in 2019 and one in 2020. This is based on the median forecast of the Fed's board members, and should be viewed with numerous caveats. The Fed has a history of tightening policy rates until something in the economy breaks. Thus, this forecast is more hawkish than the bond markets would imply.

The Fed is also reducing the assets held on its balance sheet, both U.S. Treasuries and government agency-supported mortgage-backed securities (MBS). The Fed reduced its reinvestment program by $20 billion in the first quarter and $30 billion in the second quarter, and intends to reduce it by $90 billion more for the balance of the year.

The Fed's combination of rate increases and balance sheet reductions is considered hawkish compared to other major global central banks. As a result, the U.S. dollar has appreciated versus most major global currencies and the yield premium has increased for U.S. Treasuries over other developed market government bonds.

GLOBAL UPSWING BECOMES LESS SYNCHRONIZED

2018 began in the midst of a synchronized global economic upswing, but that trend may be ending. As U.S. GDP accelerates to a 4%+ growth rate, the second quarter growth forecast in the eurozone has pulled back to 0.5%, with Japan at 1.1% and China at 1.6%.

This less synchronized dynamic has affected currencies, relative yields and central banking policies. The Japanese and German 10-year government bonds recently yielded 0.03% and 0.34%, respectively. As the 10-year U.S. Treasury yield has stabilized around 2.85%, this represents an increase in the yield premium over other high quality sovereign debt.

Whether this can continue hinges on other central banks. The Bank of Japan recently recommitted to the yield curve control policy, which implies negative short-term interest rates, approximately 0% in the 10-year maturity and 0.70% longer term. The ECB also met in June and reiterated that it anticipates no significant policy tightening before summer or autumn 2019.

Just as Greece's economy and financial situation appeared to have stabilized, significant political volatility erupted in Italy. The Italian economy is in a moderate slowdown, and voters recently elected a new president with a more populist, anti-euro viewpoint. The probability that Italy would actually pull out of the euro in the near term is very low. But the country is more at the heart of the EU than the U.K., so it raises concerns. And Italy represents the third largest bond market in the world, behind the U.S. and Japan.

The trade war is another previously low probability event that is becoming reality. President Trump recently implemented new tariffs on imports from Europe, China and Canada. In early July, prospects grew that an additional $200 billion of Chinese goods will face a new 10% U.S. tariff. If this happens, the amount of Chinese goods facing new tariff policies would total 80% of all Chinese imports into the U.S.

It is difficult to predict how disruptive the situation might be to the U.S./Chinese trade relationship. In the near term, the turbulence has contributed to a flight-to-quality effect that has strengthened the demand for U.S. Treasuries and further flattened the yield curve.

THE TREASURY YIELD CURVE CONTINUES TO FLATTEN

The combination of strong economic data, controlled inflation and a hawkish Fed is causing the yield curve to flatten to new lows. The market is concerned that the Fed may go too far and trigger the next recession, and is starting to price in this possibility.

The 2-year Treasury yield sits at 2.61% versus the 10-year yield at 2.87%. This 26 basis point (bps) differential is being closely watched, as it is a new low for the cycle. Similarly, the mere 12 bps difference between the 10-year yield of 2.87% and the 30-year yield of 2.99% is also a new low.

If the Fed sticks to its median forecast of short-term rate increases, the yield curve would likely invert by year end. An inverted yield curve (when long-term bonds yield less than short-term bonds) has predicted each of the last seven recessions. Perhaps ironically, the recent economic data show an acceleration rather than a slowdown. The philosophy of “tighten until something breaks” should be monitored very carefully.

MUNICIPALS OUTPERFORM TREASURIES

The broad municipal bond indexes outperformed Treasuries, but municipal-to-Treasury ratios were mixed. The 10-year AAA municipal yield rose from 2.42% to 2.46%, while the 10-year Treasury yield increased from 2.74% to 2.86%. The 30-year AAA municipal yield decreased one bps, from 2.95% to 2.94%, while the 30-year Treasury yield increased one bps, from 2.98% to 2.99%.

Short-term municipal-to-Treasury ratios are relatively low at 60%, demonstrating the strength of short-term municipal bonds. 10-year ratios decreased slightly, from 88% to 86%. Long ratios remain relatively cheap, ranging from 95% to 100% during the quarter.

This pattern has been consistent through the first half of 2018, demonstrating that the municipal yield curve is steeper than the flattening Treasury curve. This means there is greater compensation for assuming duration risk in the municipal market versus taxables. This phenomenon is probably caused, at least in part, by individual investors’ overall preference for short-term bonds and the avoidance of longer duration in general.

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The municipal outperformance is generally not attributable to declines in municipal-to-Treasury ratios, which held steady during the second quarter. Higher coupons and credit spread contraction have been more important thus far in 2018. Looking forward, we see reasons for continued municipal credit spread narrowing, providing a buffer against potential interest rate volatility. In addition, long-term municipal ratios are attractive by historical standards, and we believe they have the potential to decline, which would provide additional enhancement to performance of longer-term municipal bonds.

TECHNICALS ARE INCREASINGLY SUPPORTIVE

Supply

Total issuance was 20% lower year over year during the first half of 2018, due to the 59% decline in advance refundings. Tax reform legislation prohibits municipalities from advance refunding bonds on a tax-exempt basis. Municipalities are still investing in infrastructure projects, as shown by the 22% increase in new money issuance during the first half of the year, somewhat offsetting the sharp decline in refinancing supply.

Total issuance was 20% lower year over year during the first half of 2018.

The total amount of municipal debt outstanding declined by $20 billion in the first quarter. This trend is likely to accelerate as maturities and bond calls exceed new issuance by a wider margin. We believe the negative net new issuance will become a greater factor in the second half of the year.

Demand

Investors have added approximately $10 billion to municipal bond funds year to date. Given the muted return environment, in addition to the Fed's hawkish stance, this is evidence of surprisingly strong demand. The value of the tax benefits of the asset class, in addition to stabilization and improvements in overall credit quality, have contributed to demand for municipals.

Credit spreads

Credit spreads have narrowed steadily over the first half of the year. Comparing the yield of the Bloomberg Barclays High Yield Municipal Index to the MMD AAA scale in 20 years, average credit spreads started the year at +272 bps and have contracted by 79 bps to +193 bps year to date. Fundamental as well as technical trends support this steady narrowing. Tax-exempt fund flows are strong, including high yield municipal flows. At the same time, issuance has been declining, even amid high levels of bond calls and maturities.

Defaults

Defaults remain very low, totaling $1.6 billion in the first half of 2018. Most were in the industrial development revenue bond sector and specifically related to electric power deregulation. We don't believe Puerto Rico's defaults should impact default data significantly going forward.

Upgrades have numbered 510, while downgrades totaled 470 over the trailing 12 months, according to Moody's Investor Service. Importantly, the upgrades were on $13.6 billion par in the first quarter, while the downgrades represented $5.7 billion in par.

State and local tax collections increased by 5.8% year over year during the first quarter. Personal income taxes and property tax collections are demonstrating robust growth. At the same time, governors' proposed spending increases average 3.2% for the coming fiscal year. This will be the ninth consecutive year of state increases in both revenue and spending.

MUNICIPAL CREDITS FOCUS ON BUDGET ISSUES

Janus vs. AFSCME has minimal immediate impact on municipals

Janus vs. AFSCME was brought before the U.S. Supreme Court to determine whether government employees who are represented by a union to which they do not belong can be required to pay a fee to cover the costs of collective bargaining. The plaintiff argued that having to pay the fees violates the First Amendment. The court ruled that nonunion employees cannot be compelled to pay "fair share" union dues.

A mid-1970s Supreme Court ruling previously established that fair share dues were legal, but could not be used to fund political activities. About half of U.S. states have laws requiring nonunion employees to pay union fees to support contract negotiation costs. Janus argued that fair share dues violate free speech rights because everything the union does is inherently political.

The decision has energized both union advocates and detractors. From a municipal investor perspective, the ruling is unlikely to have an immediate impact on credit quality, though some have suggested every state in the union just effectively became a right-to-work state. The reality is likely a bit more nuanced. While the decision serves to undermine the future influence of public sector unions, it will by no means eradicate union influence overnight or immediately improve the prospects for funding underfunded public pension plans. Rather, the ruling will reduce public-sector unions' political influence over time and eventually, public-sector employee labor costs. To the extent unions are weakened, this may have some favorable impact on the future of public pension funding in certain locations.

Sales tax decision provides state revenue

In South Dakota v. Wayfair, Inc., et el., the Supreme Court determined that states could require retailers to collect sales taxes on products that they sell via the Internet regardless of whether the retailer has a physical presence in the state. This decision overturned the rulings in the cases of Quill Corp. v. North Dakota and Bella Hess v. Department of Revenue of Ill. The Government Accountability Office has estimated that state and local governments would collect between $8 and $33 billion in additional sales tax revenue per year if they received sales tax receipts on all purchases made over the Internet.

The incremental revenue will not be uniformly realized by local governments, as seven states have no form of sales and use taxes and four more (as of their fiscal 2017 financial statements) categorize under 10% of their statewide revenue as being derived from such taxes. Twelve states report sales taxes representing between 20% and 34% of total revenues.

Illinois's unexpected budget offers near-term stability

Illinois enacted a budget on time for fiscal 2019, for the first time since fiscal 2015. Although the budget is far from structurally balanced, the end of self-defeating political gridlock should stabilize the state's financial operations and forestall rating agency downgrades for the near term.

The $38.5 billion General Fund spending plan represents a modest increase over the prior year. The plan did not require a revenue increase due to additional $4.5 million in income tax revenue derived from last year's permanent tax rate increase. Notable positives include additional funding for education at all levels and a partial restoration of funding cuts to local governments enacted in the prior year. The additional funding will provide some budgetary relief for downstream credits.

Unfortunately, the budget relies on questionable assumptions and does not begin to address longer-term challenges. These include considerable questionable savings from a proposed voluntary pension buy-out plan that has yet to be executed, decently sized inter-fund borrowing and proceeds from the sale of an office building in Chicago that may not actually materialize.

Just having a budget tightened yields on Illinois paper to +160 bps over MMD from +200 bps at the height of the budget standoff last year. Illinois still remains an outlier compared to other states facing similar pension funding challenges. Governor Rauner, who faces reelection this fall, has been unable to make meaningful progress on pensions, which remain a key issue for longer-term credit quality and the rating. If the next administration does not take on these issues, there is heightened risk that the rating agencies will eventually downgrade the state to below investment grade. For now, the rating and credit should remain stable.

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Chicago Board of Education returns to market with an improved credit story

Chicago Board of Education (CBOE) is perhaps the most improved credit in Illinois over the last two years, transitioning from the precipice of insolvency to a much firmer fiscal position.

The district was the primary beneficiary of the state-wide school funding reform legislation enacted in August 2017. CBOE expects to receive an estimated $450 million in new annual recurring revenues in addition to a recurring $250 million pension levy increase approved in fiscal 2017. New pension funding, both state and local, will now cover approximately 80% of the district's annual pension contribution.

The increased funding, combined with expenditure control measures, will bridge the budget deficit for fiscal 2018. Management now expects to end the year with a positive fund balance. Prior to the revenues approved over the last two years, the district faced an annual operating deficit of over $1 billion, about 20% of budget. The magnitude and recurring nature of the new state-authorized funding has stabilized the district's finances.

Despite the improved financial outlook, CBOE depends on short-term borrowing to maintain adequate cash flow, and has outsized long-term liabilities in the form of bonded debt and their unfunded pension liability. The district's cash flow was negative throughout fiscal 2018, making the district vulnerable to unanticipated disruptions.

The short-term challenge of managing cash flow, the heavier long-term challenge of keeping up with growing pension costs and the dependence on market access for liquidity all weigh down the rating, which remains below investment grade for Moody's, S&P and Fitch. The fiscal 2019 budget is expected to be adopted in the next few months, and the district plans to return to the market with another refunding and possibly new money offering later this year.

Puerto Rico's restructuring slowed by conflict

Puerto Rican bond prices continue to improve, driven by both positive reception of several inter-creditor negotiations and a better-than-expected economic recovery accompanied by strong revenue collections. It's too early to predict how these developments will impact creditor recoveries coming out of Puerto Rico's Title III restructuring process. Importantly, Puerto Rico's long-term economic trajectory has not necessarily improved, and the market still lacks clarity on their true capacity to service debt. Expect additional price volatility as the court case plays out and the board and government's plans for debt restructuring are advanced.

Next year's fiscal plan will likely be more relevant in pointing to creditor recoveries. The oversight board stated their intention to file Plans of Adjustment, which will propose specific treatment for unsecured and secured creditors, with the Title III court within the next year. The court certification process could take another six months after plans are filed. Creditor negotiations and the Title III court process are ongoing. Both are expected to be lengthy, and all initial court rulings will likely be appealed.

Fiscal and structural reforms and debt restructuring continue to move slowly, now beset by conflict between the elected government and the federally appointed Financial Oversight and Management Board. Both the governor and the local legislature have filed lawsuits against the board following conflict over the fiscal 2019 budget process. The fiscal 2019 budget enacted by the Puerto Rican legislature failed to include many labor reforms and other measures the board believes are essential for future economic growth. In response, the board amended the fiscal plan and certified their own fiscal 2019 budget, as authorized by PROMESA.

In early July, both the Puerto Rico government and legislature commenced adversarial proceedings against the board, alleging that the board has overstepped its authority provided by the 2016 PROMESA law, usurping Puerto Rico's right to home rule. Open political and legal conflict between the board and government, as well as other recent conflicting court rulings on creditor challenges to PROMESA all further complicate the restructuring and undermine the prospects for quick resolution of the Title III cases.

New Jersey reaches a budget compromise

New Jersey enacted a $37.4 billion budget for fiscal 2019. After months of disagreement, Governor Murphy and the legislature compromised on new revenue sources by raising the personal income tax rate on incomes over $5 million and implementing a four-year corporate tax surcharge. New revenues were needed to fund the new administration's priorities, including higher funding for education, transportation and pensions.

New Jersey's top marginal income tax rate rises to 10.75% on income of $5 million and above, making it the third-highest top marginal rate in the country. A temporary corporate business tax surcharge of 2.5% will be applied for two years before falling to 1.5% for the next two years on businesses earning more than $1 million. This brings New Jersey's top corporate business tax to 11.5% for 2019 and 2020, the second highest nationally.

The budget does not increase the sales tax rate, as Governor Murphy had initially proposed. While this theoretically leaves room to raise the sales tax or other revenue streams, the legislature has shown heightened political resistance to increasing taxes on residents. Furthermore, the corporate tax surcharge is set to phase out, creating a future mismatch between revenues and rising expenses.

The fiscal 2019 budget makes a $3.2 billion pension payment (including approximately $1 billion in funding from the lottery), up 28% from fiscal 2018 but equal to only 60% of the actuarially required contribution (ARC). This continues the ramp-up in funding by 10% of the ARC each year as outlined under the Christie administration. The state has yet to determine how it will generate an additional $3 billion that would be needed to fully fund the ARC by fiscal 2023. Closing future budget gaps will be more difficult as the state's tax burden is already among the highest in the nation.

OUTLOOK

We see opportunity for credit spreads to narrow further, income to act as a main driver of returns, and scarcity value to grow for the remainder of 2018. We believe municipal-to-Treasury ratios will stay within recent ranges, while long-term ratios still have the most room to decline, meaning municipals can outperform to a greater extent in the second half.

Potential for additional Fed rate hikes continues to be the primary performance headwind. Although rates have increased only gradually and from very low levels, the perception of rising rates remains, exacerbated by the Fed's hawkish rhetoric.

Outside of Fed policy itself, municipal-specific dynamics bode well for performance going forward. Positive technicals serve as a tailwind in an environment of low supply and steady demand. Tax reform has settled the tax treatment for municipal bonds, and made the exemption itself more valuable for many investors. At the same time, fundamentals continue to look solid.

These factors have the potential to narrow credit spreads over time and mitigate the asset class's sensitivity to the Fed and U.S. Treasury rates.

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Endnotes

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Definitions

The **Municipal Market Data AAA scales** are compilations of the previous day's actual trades for AAA-rated insured bonds.

The **personal consumption expenditures (PCE) deflator** indicates the average increase in prices for all domestic personal consumption.

One **basis point** equals .01%, or 100 basis points equal 1%.

The **Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA)** is a 2016 U.S. federal law that established an oversight board, a process for restructuring debt, and expedited procedures for approving critical infrastructure projects in order to combat the Puerto Rican government-debt crisis.

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