RIVERBEND
Capital Advisors

Municipal Comment

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Paradigm Shift

To say that 2019 was not the year most expected for the municipal bond market is an understatement, to put it mildly. Dramatically increased issuance, astonishing fund inflows, voracious demand, declining ratios to US Treasuries, surging taxable new issue volume and strong market performance were among the surprises.

Flows and Demand

Municipal bond mutual funds experienced $94 billion in inflows in 2019, surpassing the prior record of $80 billion in 2009. The uninterrupted positive inflow streak has now extended for more than a year, as funds have taken in another $7 billion so far in 2020. Aftershocks of The Tax Cuts and Jobs Act of 2017 continue to impact the muni market, as many taxpayers have felt the effects of the $10,000 cap on state and local tax (SALT) deductions. Increased tax burdens turned many investors, particularly those in high-tax states such as California and New York, to the municipal bond market. With few options to receive tax-exempt income, investors have flocked to munis.

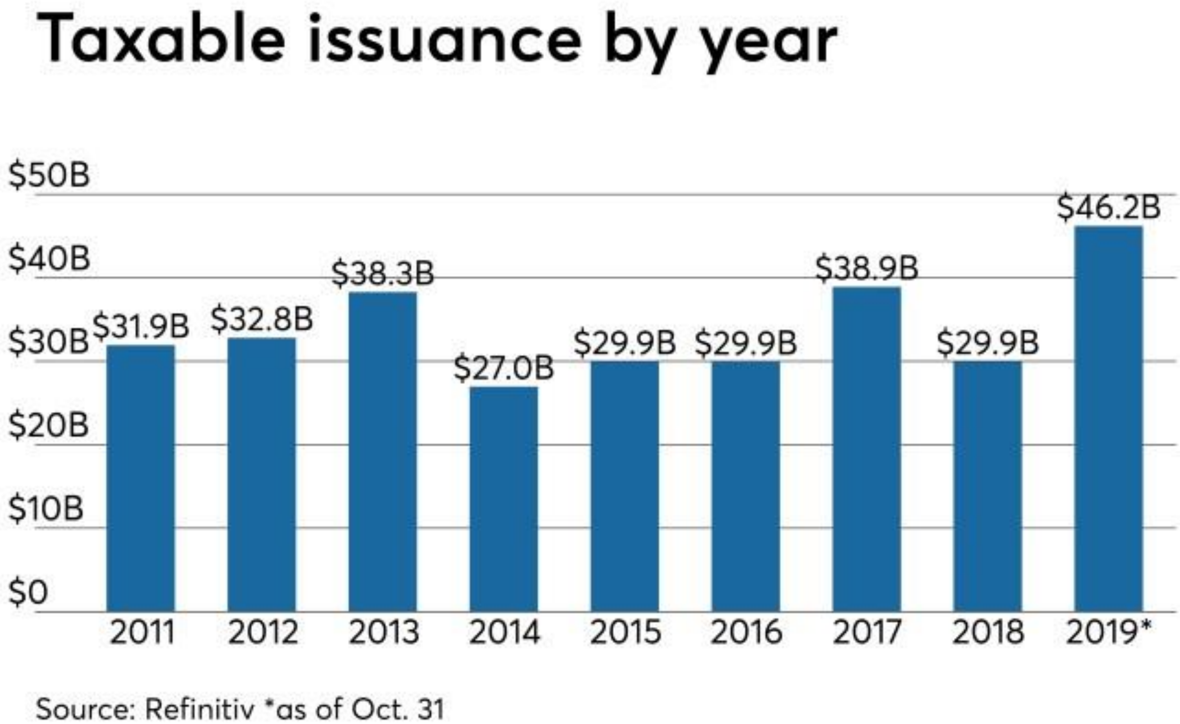
Results

Municipal market returns were solid in 2019, with Bloomberg Barclays Municipal Index up 7.54%. Muni curves flattened over the year, driven primarily by intermediate and long bonds as inflation fears subsided and investors extended duration seeking yield. The drop in muni/Treasury yield ratios was impressive, with the 10-year yield ratio moving from 84% to 76% and 30-year muni ratio moving from 100% to 88%.

Issuance and the Taxable Surge

Combined taxable and tax-exempt new issue supply was up 27% in 2019, to approximately $416 billion. So far, the $18 billion in 2020 new muni issuance is the lowest in six years. Nearly one third has been taxable. According to Bloomberg, approximately $25 billion in outstanding munis will be redeemed over the next month and investors will receive an additional $13 billion in interest payments.

In an interesting development, issuers used the taxable bond market to advance refund $70 billion of older higher-coupon tax-exempt debt in 2019. The 2017 tax reform law took away the ability of state and local issuers to engage in tax-exempt advance refundings. But with last year's decline in rates, many municipalities could issue taxable bonds to refund tax-exempt bonds that might have had 4.00%+ original yields and a few years left to call dates. Cost savings more than made up for the negative interest rate differential between taxable and tax-exempt muni yields.



Taxable municipal bond issuance in 4Q2019 increased approximately seven times vs. 4Q2018, according to Bloomberg data. Most forecasts for 2020 call for a 6-10% increase in muni supply but with tax-exempt issuance fairly steady and most of the growth in taxable.

Gross and Net Estimate of 2020 Supply

Estimated net issuance breakdown	Tax-exempt (billions)	Taxable (billions)	Total (billions)
Total gross issuance	**$345**	**$95**	**$440**
Total maturing bonds	**$161**	**$18**	**$179**
Total calls due to refundings	**$173**	**$29**	**$202**
Calls due to prior advance refundings	*$68*	*$8*	*$76*
Calls due to current refundings	*$105*	*$21*	*$126*
Grand total redemptions	**$334**	**$47**	**$381**
Net issuance	**+$11**	**+$48**	**+$59**

Source: Citi

Taxable municipal bonds offer high-quality, excess yield, long duration, and, in some cases, state and local tax exemption. The taxable municipal bond market originated in the 1980s when the 1986 Tax Reform Act restricted the ability of state and local governments to issue tax-exempt bonds for purposes that did not meet public use criteria. The market experienced a surge of more than $200 billion of issuance with the passage of the American Recovery and Reinvestment Act in 2009. The Act created the Build America Bond (BAB) program to stimulate the economy and create jobs and provided federal subsidies to issuers of taxable bonds. The program expired in 2010 and no BABs have been issued since.

Why Munis?

For many investors, the objectives of a municipal bond allocation include capital preservation, generation of tax-free income, and balance of risk with more aggressive investments. Municipal bonds tend to not experience the same degree of price fluctuation as US Treasuries, non-U.S. sovereign debt and corporate fixed income, and are generally not correlated with equities. Default rates are low. Income is predicable.

Riverbend Capital Advisors

We are a boutique fixed income manager focused in the municipal bond market. Our approach is proactive and tactical as we seek to capitalize on market inefficiencies for the benefit of our clients. We customize portfolios according to each client's tax status, risk profile and investment objective, and can accommodate state-specific, taxable, and high-yield mandates.

In the current environment, we prefer callable bonds with short to intermediate duration, investment-grade credit quality and premium coupon as we believe this structure is defensive yet offers more attractive taxable equivalent yields and higher muni ratios to UST's than bullet maturity issues.

Please feel free to contact us anytime if you'd like to discuss the topics cited in this update, or any others related to the municipal bond market.

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