RIVERBEND
Capital Advisors

Municipal Comment

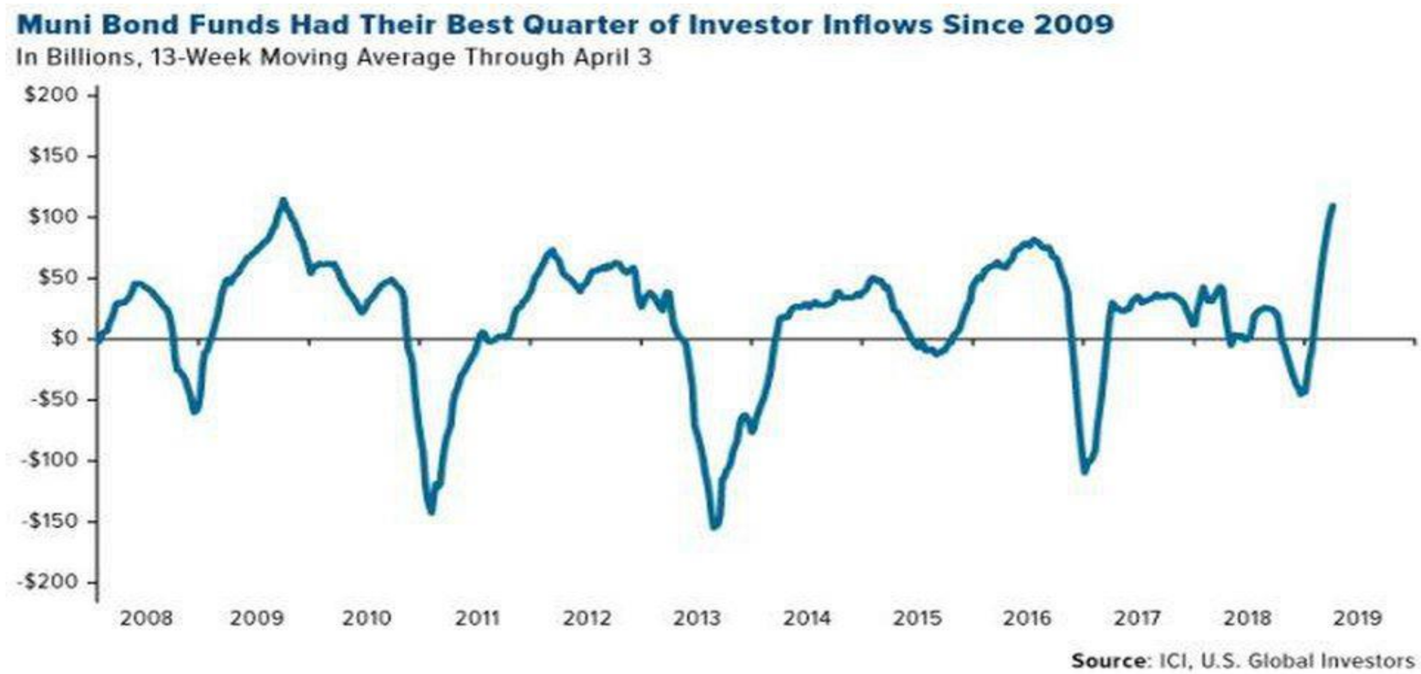
June 2019

Everything's Coming Up Munis

The downward trajectory of US Treasury rates this year has certainly provided a boost to municipal bond performance, with the market through May up 4.91%, according to the Bloomberg Barclays Municipal Index. However, several other important factors are contributing to the municipal bond market rally.

New issuance has been light in 2019. The absence of advanced refundings, which were eliminated by the Tax Cuts and Jobs Act of 2017, has kept a lid on supply. A general reluctance by state and local governments to issue debt is also driving market technicals. On the demand side, The midyear rollover is underway. Bond maturities, call dates, and coupon payments tend to be clustered in June-August. Proceeds are generally reinvested in the muni market. As this plays out in an environment of diminished supply, it is likely to support continued positive performance.

Tax reform resulted in an increased tax burden for many high-income earners. Limits on state and local tax deductions are driving demand, as investors seek tax-advantaged assets. As a result, flows into municipal bond mutual funds and ETFs through May were up more than 400% from last year. Demand should remain consistent through 3Q/4Q 2019, outstripping the diminished supply of bonds.



Credit fundamentals are solid, with a small circle of notable exceptions. Tax receipts are stronger than expected in many states. Spending is reasonable and state rainy-day funds have been replenished to the tune of approximately $70 billion. On average, this represents 7.5% of annual state budgets, according to the National Association of State Budget Officers. Moody's upgrades have outpaced downgrades for the last four years.

Hot Spots

Connecticut passed its FY20 budget, closing a $3.7 billion gap without an income tax increase. Among other things, the budget maintains a hospital tax, expands the sales tax to other services, and cuts employee healthcare costs. While lawmakers rejected the governor's proposal to shift a quarter of teachers' pension costs to municipalities, state and public employee unions are still negotiating the governor's proposal to tie cost-of-living increases for retirees to pension performance.

Illinois Governor J.B. Pritzker

Illinois recently passed a $40 billion budget for Fiscal Year 2020. Moody's affirmed its Baa3 rating on the state's general obligation bonds, noting that the state avoided material deterioration of its credit vulnerabilities and marginally built on strengths. They added that pension contribution requirements continue to outpace organic revenue growth and will subject the state to persistent fiscal pressure. S&P expressed similar sentiment, stating the budget "holds the line" and places the state on a more stable near-term credit trajectory. They attributed the stability to an unexpected increase in income taxes and the governor's decision not to extend the pension plans' amortization period or issue pension bonds. The rating agency also cautioned that the state has yet to demonstrate whether it will realize the FY20 revenue assumptions or receive voter approval for the graduated income tax amendment.

Shining Star

The Texas Permanent School Fund is a AAA-rated school endowment agency that backs $79 billion of debt from more than 800 school districts statewide. It is one the most secure credits in the municipal market with more than $45 billion in assets. Its ratio of guaranteed debt to assets is less than 2 to 1. Fund holdings consist primarily of financial investments, although its wealth largely originated from mineral rights. Returns have averaged 6.90% for the last ten years.

No school district backed by the fund has defaulted since its inception 36 years ago. The amount of debt that the school fund can guarantee is capped at $120 billion. Bonds backed by the fund yield about 15 basis points higher than other AAA municipal issues due to the lack of in state demand, as Texas has no income tax.

Looking Ahead

High yield, lower-rated bonds have led the market this year and spreads have tightened. With the uncertainty created by unresolved trade disputes, their potential to slow the economy, and the possibility of the slowdown negatively impacting tax receipts, we gravitate toward higher quality credits. Given that we may be at the later stages of the economic cycle, this doesn't seem like the appropriate time to reach for additional yield by dropping down in quality. Spreads are very tight relative to historical relationships. We continue to favor higher coupon, callable bonds for their incremental additional yield and defensive characteristics.

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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