MUNICIPAL FIXED INCOME: Q1 2021 SECTOR UPDATE

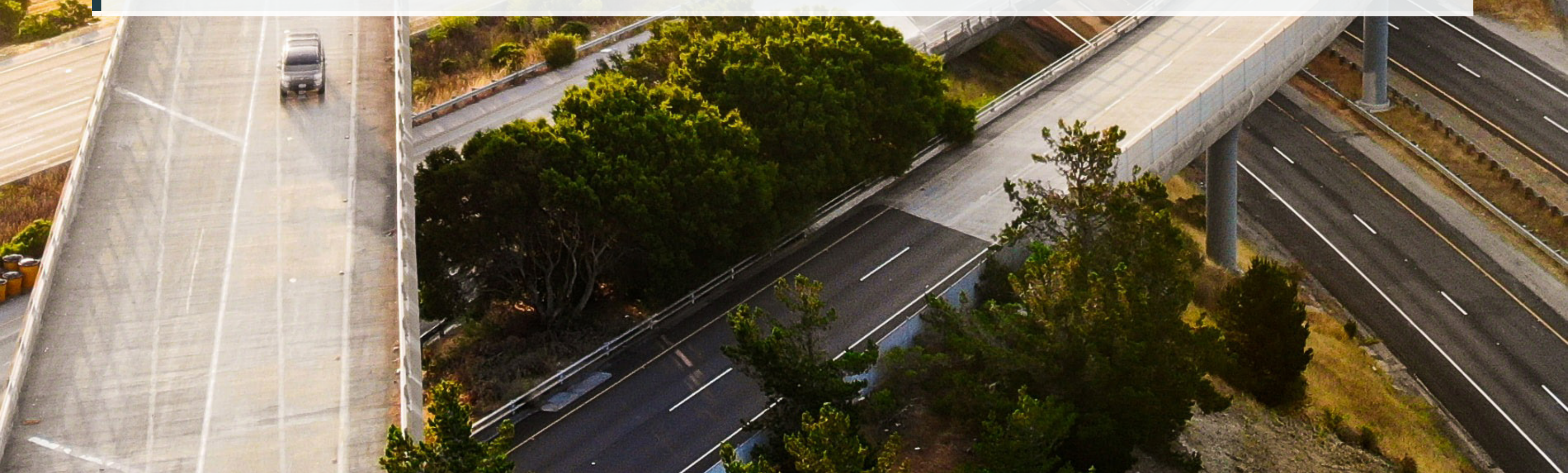
Our quarterly municipal bond commentary provides you with information on the strategy and model performance for the past quarter. However, in light of recent events, we want to give our readers a deeper dive into the municipal market. Potential tax changes loom, and municipal bonds have reacted differently than other fixed income sectors over the past year. We hope you enjoy our extended commentary for the quarter, and feel free to reach out with any questions you may have.

Changing Behavior - Municipal Bonds vs. Treasuries

The municipal bond yield to Treasury yield ratio decoupled again in the first quarter. U.S. Treasury yields rose along most of the yield curve while investment-grade municipal bonds remained stubbornly close to their year-end yields. Historically, municipal bond yields average 85 percent of Treasury yields, but the decoupling between 10-year municipal bonds and 10-year Treasuries began in January 2021. This movement accelerated through mid-February when the ratio hit a historical low of 58 percent. At the close of the first quarter, the ratio had risen to a still-low 64 percent. While there was a rebound in municipal bond prices in March, the benchmark remains in negative territory yet is outperforming other fixed income sectors.

New Municipal Bond Issuance

New municipal bond issuance was down 15 percent in January and 17 percent in February as compared to the year-ago periods. However, it is no surprise that new March issuance was nearly triple (up 179 percent) year over year. The depressed issuance in early 2020 was a direct result of the growing pandemic.



The Municipal-Friendly Infrastructure Bill

President Biden unveiled a $2.25 trillion infrastructure plan, with the investments to be implemented over an eight-year period. This plan would be paid for over 15 years through a rise in the corporate tax rate (from 21% to 28%) along with the introduction of a minimum tax on global corporate earnings. While the President's plan does feature traditional road, bridge, and airport projects, the package also includes items like high-speed broadband, electrical grid enhancements, lead pipe replacement in homes and schools, and the retrofitting/weatherizing of commercial buildings.

Besides surface transportation, broadband, and the electrical grid, the proposed plan will also have funding for elder care, renewable energy, combating climate change, housing and manufacturing.

Some of the municipality specific spending priorities include the following:

- $621 billion for roads, bridges, rail, ports, waterways, airports, public transportation, and electric vehicles - some of these funds would be allocated as follows:*
    - $174 billion for the research and promotion of electric vehicles and charging stations
    - $115 billion for modernizing 20,000 miles of highways, roads, and main streets that are "in most critical need of repair," as well as repairing the most "economically significant large bridges" and roughly 10,000 smaller bridges
    - $85 billion for public transportation
    - $80 billion for Amtrak
    - $25 billion for airports
    - $20 billion for a new program that would "connect neighborhoods"
    - $17 billion for inland waterways, ports, and ferries
- $400 billion to help care for the aging and those with disabilities
- $300 billion to boost the manufacturing industry
- $213 billion to construct and rehabilitate affordable housing
- $111 billion for modernizing water delivery systems
- $100 billion to expand broadband access
- $100 billion for the electrical grid
- $100 billion to build new public schools and upgrade existing buildings with better ventilation systems and indoor air quality
- $12 billion for community colleges

* Source: The White House

2021 Municipal Outlook

While we cannot predict the future, our analysis suggests some potential shifts that could occur in the municipal bond market throughout the rest of 2021. Listed below are some of my thoughts on the most likely developments.

Volatility could increase in the second quarter – We know the market doesn't like uncertainty, but we see the potential for increased volatility this year based on however these issues are resolved: inflation caused by stimulus and possible infrastructure spending, proposed tax changes that include the corporate tax rate moving from 21% to 28%, a weakening of the U.S. dollar causing a rise in commodity prices, and a deterioration in credit ratings leading to higher interest rates even as the FOMC holds short-term rates low and allows the economy to run "hot."

Municipal bond spreads could initially widen then narrow in the second quarter – Net new municipal bond supply could increase in April and May (more new issuance than total calls and maturities). If demand begins to level off and interest rates climb on credit rating downgrades, we could see spreads widen through the second quarter. There is the belief that new 2021 issuance could exceed the 2020 total. With interest rates low, underwriters are feverishly pushing states and municipalities to sell as much debt as possible to lock in the cheap, long-term funding. However, taxable municipal bond issuance could slow as rising interest rates on taxable fixed income have served as a near-term drag on performance for that sector.

Duration could continue to be forced longer – The Federal Open Market Committee is committed to keeping short-term interest rates low until inflation is sustainably over its 2% target. Based on recent interviews with members of the Fed and recent press conferences from Chairman Powell, it appears the FOMC is very willing to remain patient while awaiting signs of sustainable inflation and broad-based growth in the labor market.

Downgrades of credit ratings could exceed upgrades – Since March 2020, we have seen a trend of increasing downgrades for municipalities along with an increase in municipalities being put on negative watch. Look for the next round of downgrades to impact localities and states, at least until revenues return to pre-pandemic levels. Investors tend to forget there has been a near-decade of more upgrades than downgrades as municipalities had been diligently improving their financials. Credit deterioration will likely vary by sector, with transportation, tourism, and sales tax-reliant credits seeing some of the greatest negative effects, followed by health-related services, smaller private higher-education, and certain general governments.

Changes in flows – Individual owners of municipal bond mutual funds or exchange traded funds could reverse the positive inflows seen lately to negative outflows, further adding to supply in the secondary markets. Individual municipal bond mutual fund shareholders tend to be more momentum-driven, so when prices rise, they create positive inflows, but when prices decline, they tend to liquidate.

Buying at a discount – Factors including the recent Federal stimulus, volatility, supply/demand issues, credit rating changes, and a host of other potentially disruptive news could result in a dislocation of the municipal bond sector from other fixed income sectors. We witnessed a similar phenomenon in March 2020 when the pandemic first affected the markets. If this occurs, the event's depth and length may not last as long as what was witnessed one year ago, but it would provide an opportunity to purchase high-quality bonds at a discount to current valuations.

Crossmark Global Investments continues to find value in the municipal secondary market. We focus on bonds rated A or better by Moody's or Standard & Poor's at time of purchase and are involved with essential services like water, sewer, power, streets, highways, public school education, and general obligations. Crossmark limits the maturities of its municipal strategy holdings to 20 years. The ideal maturities on the yield curve currently have moved to the 8-year to 20-year range with a call option between 2024 and 2027. The Crossmark Global Investments municipal strategy continues to position the model with a shorter duration than the Barclay's Quality Intermediate Municipal Index, focusing on higher quality municipalities and opportunistically using municipal bond market volatility to manage the portfolios entrusted to us.

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