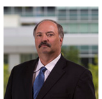
MUNICIPAL FIXED INCOME
COMMENTARY 4Q 2020

Municipal Fixed Income is a separately managed account investment strategy



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Now Looking Ahead

As noted in the last quarterly commentary, the Municipal Fixed Income SMA program is working to provide readers with both insight into the reasons behind historical events, and some visibility into possible future events impacting the strategy.

Municipal bonds began 2020 at very pricey levels, but the outbreak of COVID-19 halted the rally and brought prices down rapidly in March and April, creating a remarkable opportunity for value. We took full advantage of the short-lived sale on munis - using cash and deposits to extend duration on the purchases. Simply put, we were buying heavily while others were selling.

Deficits Less Severe than Feared

Last spring, economists predicted the pandemic-related economic devastation would significantly reduce state and local government tax receipts, causing budget shortfalls of $300 billion to $400 billion over the next two years. Surprisingly, deficits in the year ended June 30 were only about $30 billion above pre-pandemic projections, and deficits in the current year are likely to be in the same range, according to a Dec. 14 report by Capital Economics Senior U.S. Economist Andrew Hunter. While state expenses (like Medicaid) have risen, overall budget shortfalls look to be manageable in light of working vaccines.

California said the state budget was poised to gain a windfall of roughly $26 billion, while New York and Connecticut revealed tax revenue was still strong, thanks in part to the booming stock market. While many states and cities are still facing large deficits, they are just not as big as initially feared. Of course, the spike in COVID-19 cases could trigger more shutdowns, potentially reversing the nascent recovery that local governments have seen so far. Most of California ended 2020 back under a stay-at-home order, and New York could be headed toward a shutdown. Because of the lag in collecting taxes, states historically struggle with big deficits well after recessions end, or in the current environment, after the COVID surge is over.

Be Careful What You Wish For - PM Comments

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- Watch Volatility (which could spike)

Concerns ranging from election results, COVID-19, high unemployment, and revenue/earnings surprises could convince retail muni investors to initially buy in anticipation of higher taxation, then sell if tax changes do not materialize. Also, increasing commodity prices (from a falling dollar) and declining state/local credit ratings could boost interest rates even as the Fed holds short-term rates low.

- Bid/Ask Spreads Could Narrow but Then Widen Again

Increasing supply issued into strong near-term demand (on fears of higher taxation) could maintain bids while ask prices increase. If demand levels off and interest rates begin to climb on credit rating downgrades, spreads could widen later in the year.

- Duration Could Be Forced Longer

Even with short-term rates bottoming near historical lows, and the Fed committed to keeping these rates near zero, municipalities could extend duration to take advantage, adding to investor risk.

- New Issuance Could Exceed Demand

New 2021 issuance may exceed 2020 volume. With interest rates so low, underwriters are feverishly pushing states and municipalities to sell as much debt as possible to lock in these rates long-term. Taxable municipal bond issuance should also continue to increase, especially if the incoming administration reverses the advance refunding disallowance.

- Credit Downgrades Could Exceed Upgrades

The trend of negative watch for credit rating downgrades (since March 2020) could accelerate along with actual downgrades. The next round of downgrades will likely impact localities and states the most until revenues rebound. Investors may have forgotten there has been nearly a decade of more upgrades than downgrades as municipalities improved their financials.

Credit deterioration likely will vary by sector, with transportation, tourist 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.

- Individual municipal bond mutual funds or exchange-traded fund owners could sell

The news flow could cause investors to rethink their exposure, possibly selling their positions and adding to supply in secondary markets. Individual muni mutual fund shareholders tend to be momentum-driven, so when prices rise they create positive inflows but when prices decline they tend to liquidate.

- There May Be Opportunities to Purchase High Quality Bonds at a Discount

The recent election, volatility, supply/demand, credit rating changes and a host of other potential disruptive news could result in a dislocation of the municipal bond sector from other fixed income sectors (similar to what was witnessed in March 2020). If this occurs, the event may not be as severe as what happened last spring. We will be watching for these opportunities and plan to take advantage and extend duration with high quality municipal bonds.

Opportunity Still Exists

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

Our Firm

Crossmark Global Investments is a faith-based boutique investment management firm that provides a full suite of investment strategies to institutional investors, financial advisors, and the clients they serve. For over 30 years we have delivered uniquely constructed products based on our proprietary, disciplined, and repeatable process. We are especially known for helping our clients align their investments with their values by creating socially conscious, responsible investment strategies. Founded in 1987, we are headquartered in Houston, Texas.

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