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Quarterly Market Commentary

Municipal Fixed Income

4Q | 2019

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Supply is in demand

Municipal fixed income returns for 2019 were strong in the fourth quarter and among the best of the decade for the full year. The S&P Municipal Bond Index, which comprises over 200,000 individual securities with a total market value of nearly $2.5 trillion, ended 2019 an impressive 7.3% higher compared to the 1.4% increase seen in 2018. Although returns were strongest the first six months of 2019, every month but September contributed to the favorable results. Driving returns were strong market technicals, lower rates, and a stable credit environment.

Both investment-grade and high-yield municipal returns were strong in 2019. The S&P Municipal Bond Investment Grade Index returned a robust 7.0% for the year compared to just 1.1% in 2018. Meanwhile, the S&P Municipal Bond High Yield Index returned a strong 10.8% compared to 5.2% in 2018.

Returns across the curve were favorable with the S&P Municipal Bond Investment Grade Short, Short Intermediate, and Intermediate indices at 3.1%, 4.7%, and 6.9%, respectively. Likewise, the S&P Municipal Bond California and New York indices generated robust returns for the year of 7.4% and 7.0%, respectively.

Demand outpaces supply

Both supply and demand surprised to the upside in 2019. Municipal fund flows supported municipal valuations, turning positive the last week of 2018 and remaining positive for 52 consecutive weeks in 2019. Funds flow (Investment Company Institute) for the year of $92 billion set a calendar year high and came in 19% over the previous high in 2009.

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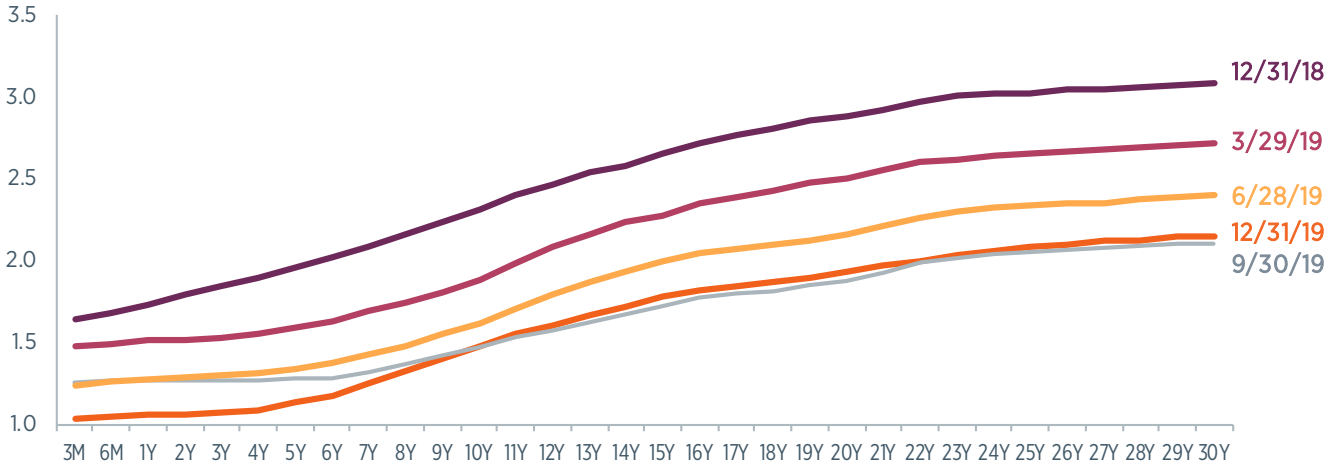
Figure 1
BVAL AAA municipal yield curve: recent trends (period ending December 31, 2019)

Maturity	4Q	3Q	2Q	1Q	prior year end	Change for the period (bps)				
	12/31/19	9/30/19	6/30/19	3/31/19	12/31/18	Δ 1Q	Δ 2Q	Δ 3Q	Δ 4Q	1 Yr
6 month	1.05	1.27	1.26	1.49	1.69	–19	–23	1	–22	–63
1 year	1.06	1.27	1.28	1.51	1.74	–22	–23	–1	–22	–68
2 year	1.06	1.27	1.29	1.52	1.80	–28	–23	–2	–21	–74
3 year	1.07	1.27	1.30	1.53	1.85	–32	–23	–3	–20	–78
4 year	1.09	1.28	1.32	1.55	1.90	–35	–23	–4	–19	–81
5 year	1.14	1.28	1.34	1.59	1.96	–36	–25	–6	–14	–82
6 year	1.18	1.29	1.38	1.63	2.02	–39	–25	–9	–11	–84
7 year	1.25	1.32	1.43	1.69	2.09	–40	–26	–11	–7	–84
8 year	1.32	1.37	1.48	1.74	2.16	–42	–26	–11	–5	–84
9 year	1.40	1.43	1.55	1.81	2.24	–43	–27	–12	–3	–84
10 year	1.48	1.47	1.62	1.89	2.32	–43	–26	–15	1	–84
15 year	1.78	1.73	1.99	2.28	2.65	–37	–29	–26	5	–87
30 year	2.15	2.11	2.40	2.72	3.09	–37	–32	–29	4	–94

Source: Bloomberg.

Figure 2
AAA municipal yield curve



Source: Bloomberg.

Meanwhile, muted supply in the first half of 2019 lagged demand, supporting strong municipal performance. Supply picked up in the second half of the year, exceeding volume expectations and introducing sizable taxable issuance to the municipal mix. Overall issuance for the year was up 21.8% from 2018, to a robust $421.9 billion. Contributing to the increase was unusually robust taxable issuance that reached $67.27 billion, up from $29.95 billion the prior year. Taxable issuance has averaged just $20–$30 million since 2011. Notably, fourth-quarter volume was up 54.1% from 2018. Not unexpectedly, the largest issuance for the year came from California at $60.2 billion, followed by New York and Texas at $45.5 billion and $43.7 billion, respectively.

Yield curve

Municipal curves flattened during the year with long-bond indices exhibiting the best performance. Overall, yields reached record lows in late August for maturities 10 years and longer.

U.S.-China trade tensions and slowing global growth factored into lower Treasury yields, which fell 65–95 basis points, or bps, (0.65%–0.95%) across the curve, followed by municipal yields (see Figure 2). The BVAL AAA municipal yield curve fell 68bps at the 1-year spot and 82bps and 84bps at the 5- and 10-year maturities, respectively.

Continued

Figure 3
BVAL AAA-municipal-to-Treasury ratio (period ending December 31, 2018)

	12/31/2019			11/29/2019			9/30/2019			12/31/2018		
	AAA	Treasury	Ratio (%)	AAA	Treasury	Ratio (%)	AAA	Treasury	Ratio (%)	AAA	Treasury	Ratio (%)
2 year	1.04	1.57	66.07	1.08	1.61	66.67	1.25	1.62	77.09	1.78	2.49	71.49
5 year	1.11	1.69	65.54	1.14	1.63	70.31	1.25	1.55	81.04	1.94	2.51	77.03
10 year	1.47	1.92	76.45	1.48	1.78	83.29	1.46	1.67	87.45	2.30	2.69	85.59
30 year	2.10	2.39	87.70	2.08	2.21	94.15	2.03	2.11	96.02	3.03	3.02	100.50

Source: Bloomberg.

Municipals outperformed Treasuries on a relative basis. MMD/Treasury ratios ended 2019 at 65.5% and 76.5% for the 5-year and 10-year, respectively. This is far lower than the 77.0% and 85.6% seen at year-end 2018.

Credit spreads tighten

A benign credit environment and a risk-on tone led credit spreads to tighten during 2019. Ten-year AA revenue bonds started the year at 25bps over the AAA scale and ended at just 17bps higher. Ten-year A revenue bonds tightened 14bps, starting at 51bps higher than AAA, and ending just 37bps over. Given this tightening, investors saw less benefit from moving down the credit spectrum. There appear to be few headwinds to drive credit spreads wider in the near term. However, although municipal credit fundamentals appear healthy, we believe growing fixed costs as a percentage of revenue in municipal budgets provides ample reason for careful credit selection.

Core narrative

Many of the dynamics that drove the municipal market in 2019—strong demand, low rates, and moderate tax-exempt supply—remain in place in early 2020. Nonetheless, it will be difficult to replicate last year's performance. Although geopolitical risks and the November elections provide potential volatility, global risks are currently showing signs of moderating. Armed with this information, Wilmington Trust has moved to a modest overweight on risk assets, but continues to view investment-grade tax-exempt municipals favorably as an asset class. Within the municipal space, we continue to see value in the government-backed housing sector.

Robert Tice
Research Analyst

Municipal Issuers Flock to the Taxable Market

A late-year surge in taxable municipal bond issuance drove municipal supply in 2019 well above expectations. And issuance of taxable municipal debt for the year was more than double that of the prior year with many first-time participants in the taxable market. Drivers for new participants were low rates and the loss of their ability to refund in advance any outstanding tax-exempt debt, a result of The Tax Cuts and Jobs Act (TCJA) of 2017. Three-quarters of taxable municipal debt issuance in 2019 came from taxable debt that was used to refund outstanding tax-exempt debt. As a result tax-exempt supply is reduced; much of this debt would typically be refunded at its call date. The rush to the taxable market may also have shifted a small percentage of new money issuance away from the traditional tax-exempt market, particularly in the health care and higher education sectors. Reduced tax-exempt supply in the face of strong demand drives yields lower.

TCJA eliminated popular mechanism

Prior to the TCJA provision, most municipal bonds could be refunded in advance, and occurred when issuers refinanced outstanding tax-exempt debt more than 90 days before the bond's first call date. A municipality would issue new bonds at a market rate lower than that of their existing bonds, then use the proceeds from the new bond to fund an escrow structured to repay the existing bonds at the first call date. However, the TCJA eliminated this frequently used refinancing tool.

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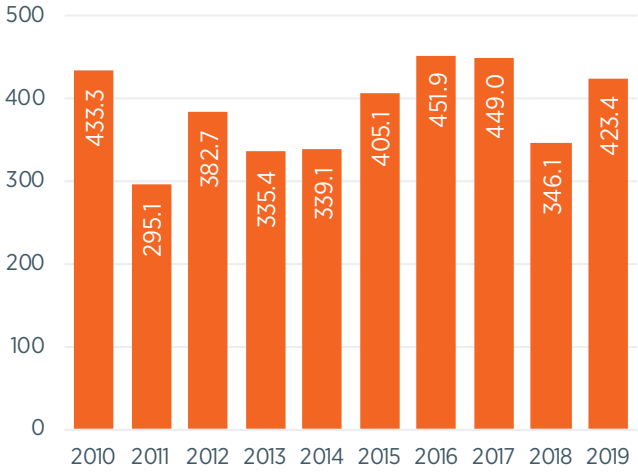
Consequently, issuers have increasingly elected to use taxable municipal bonds for this purpose. Given current rates, issuers still reduce their interest costs, but with less savings than would be generated from a tax-exempt refunding.

Municipal issuers opting for the taxable market benefit from the increased attention that comes from investors, including nontraditional buyers, such as international investors and pension funds that are attracted by incremental yield and the opportunity to diversify portfolio credit risk. Additionally, issuers benefit from an unconstrained use of proceeds and improved liquidity.

Historical drivers of taxable municipal debt

The development of the taxable municipal market was fueled by the passage of the Federal Tax Reform Act of 1986. The legislation established more stringent rules for state and local debt to qualify for tax exemption, and issuers were tasked with rigorous recordkeeping to maintain tax-exempt status. The legislation prohibited several types of tax-exempt financings that forced municipalities to issue bonds in the taxable market when they could not meet the new requirements.

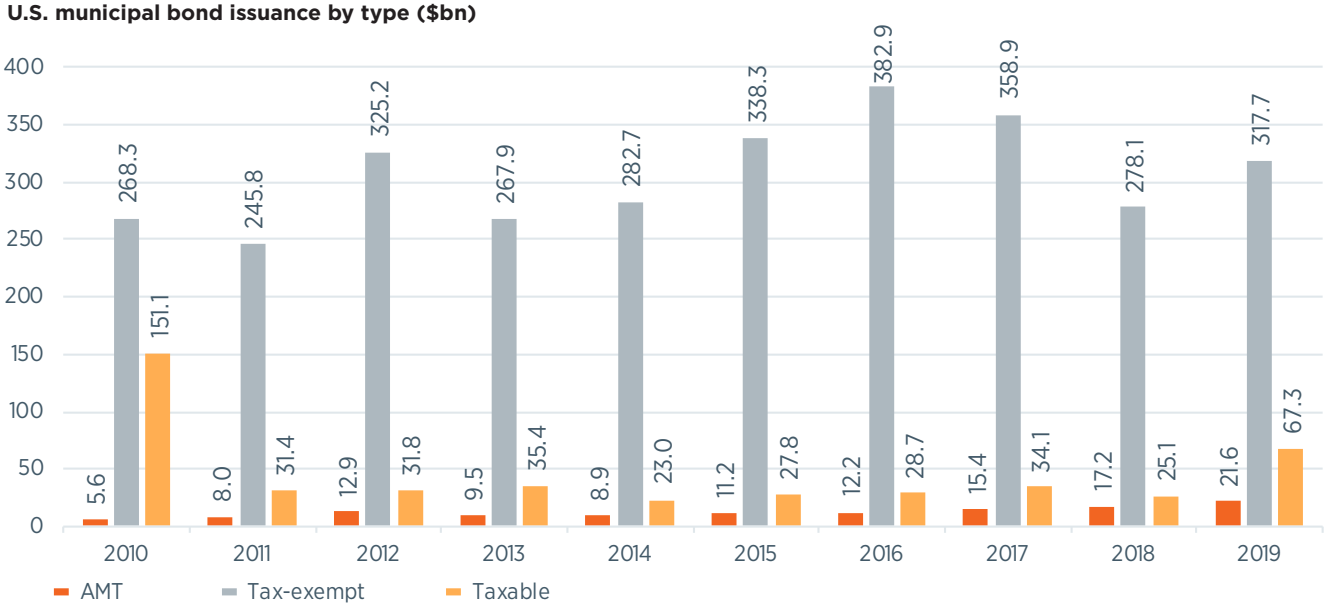
Figure 4
U.S. municipal bond issuance ($bn)



Source: SIFMA.

Investors were first exposed to a significant volume of taxable municipal bonds when the American Recovery and Reinvestment Act of 2009 created subsidized Build America Bonds (BABs) for a two-year period. Issuance of BABs hit a record $151.1 billion in 2010. Once the window for BABs issuance closed, taxable issuance averaged between $20 billion and $30 billion through 2018. Taxable issuance jumped from $25.1 billion in 2018 to $67.3 billion in 2019, with a significant $38 billion occurring in the last three months of the

Figure 5
U.S. municipal bond issuance by type ($bn)



Source: SIFMA.

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year. Health care, higher education, and airport issuers were notably active in their use of taxable issuance in 2019.

Taxable issuance will remain attractive to municipal debt issuers as long as interest rates stay near or below current levels. However, much of this taxable issuance cannibalizes future tax-exempt supply, potentially pressuring future yields. Currently, the widening gap between the amount of cash to be invested in the tax-exempt market and the number of new securities sold is driving municipal market returns to new heights and yields to new lows. With many favorable characteristics in the asset class, the supply of traditional tax-exempt bonds will continue to be easily absorbed by retail investor demand, though tax-exempt issuance may be at a historically lower percentage of the $3.8 trillion municipal market. Given the prevailing rate environment, this change in issuer behavior is likely to continue in 2020.

DISCLOSURES

The BVAL AAA Municipal Curves are constructed using trades from the Municipal Securities Rulemaking Board (MSRB) and contributed data. Constituents eligible for the curve must have a rating of AAA, minimum maturity and issuance sizes of $2mm and $30mm respectively, minimum trade size of $500K for MSRB Dealer trades and $1mm for all other MSRB trades and contributed quotes. All observations are normalized for differences in credit, optionality and coupon size.

The S&P Municipal Bond Index is a broad, market-value-weighted index that seeks to measure the performance of the U.S. municipal bond market. It tracks fixed-rate bonds exempt from federal income tax, though they may be subject to the alternative minimum tax (AMT), with par outstanding of at least $2 million. The index includes bonds of all quality ratings—from AAA to non-rated, including defaulted bonds—and from all sectors of the bond market. The S&P Municipal Bond Index constituents undergo a monthly review and rebalancing.

The S&P Municipal Bond Investment Grade Index consists of bonds in the S&P Municipal Bond Index that are rated at least BBB- by Standard & Poor's, Baa3 by Moody's, or BBB- by Fitch Ratings. For the avoidance of doubt, the lowest rating is used in determining if a bond is eligible for the Index. S&P Dow Jones Indices looks at the long-term rating, either insured or uninsured, and the underlying rating for index inclusion. All bonds must also have a minimum maturity of three years and a maximum maturity of up to, but not including, 15 years, as measured from the rebalancing date.

The S&P Municipal Bond Intermediate Index consists of bonds in the S&P Municipal Bond Index with a minimum maturity of three years and a maximum maturity of up to, but not including, 15 years, as measured from the rebalancing date.

The S&P Municipal Bond Investment Grade Intermediate Index consists of bonds in the S&P Municipal Bond Index that are rated at least BBB- by Standard & Poor's, Baa3 by Moody's or BBB- by Fitch Ratings. All bonds must also have a minimum maturity of three years and a maximum maturity of up to, but not including, fifteen years as measured from the rebalancing date.

The S&P Municipal Bond Short Intermediate Index consists of bonds in the S&P Municipal Bond Index with a minimum maturity of one year and a maximum maturity of up to, but not including, eight years, as measured from the rebalancing date.

The S&P Municipal Bond Investment Grade Short Intermediate Index consists of bonds in the S&P Municipal Bond Index that are rated at least BBB- by Standard & Poor's, Baa3 by Moody's or BBB- by Fitch Ratings. All bonds must also have a minimum maturity of one year and a maximum maturity of up to, but not including, eight years as measured from the rebalancing date.

The S&P Municipal Bond Short Index consists of bonds in the S&P Municipal Bond Index with a minimum maturity of six months and a maximum maturity of up to, but not including, four years, as measured from the rebalancing date.

The S&P Municipal Bond Investment Grade Short Index consists of bonds in the S&P Municipal Bond Index that are rated at least BBB- by Standard & Poor's, Baa3 by Moody's or BBB- by Fitch Ratings. All bonds must also have a minimum maturity of six months and a maximum maturity of up to, but not including, four years as measured from the rebalancing date.

The S&P Municipal Bond High-Yield Index consists of bonds in the S&P Municipal Bond Index that are not rated or whose ratings are less than or equal to BB+ by Standard & Poor's, Ba1 by Moody's, or BB+ by Fitch Ratings. Bonds that are prerefunded or escrowed to maturity are not included in this index. The lowest long-term underlying rating, either insured or uninsured, is used in determining if a bond is eligible for the Index.

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Selected S&P Municipal Bond Index totals and averages

	AS OF DECEMBER 31, 2019								
	Number of holdings	Market value (in $ billions)	Coupon	Yield-to-worst	Maturity	Maturity (in yrs.)	Priced-to-date	Priced-to-date (in yrs.)	Effective duration
Municipal Bond	202,928	2,481.75	4.34	1.83	06/03/2032	12.43	06/09/2025	5.45	5.54
Investment Grade (IG)	193,812	2,321.71	4.44	1.71	11/23/2031	11.90	05/03/2025	5.34	5.44
Intermediate	115,615	1,182.18	4.49	1.60	06/25/2028	8.49	04/23/2025	5.31	4.88
IG Intermediate	111,887	1,132.81	4.49	1.54	06/21/2028	8.47	04/29/2025	5.33	4.91
Short Intermediate	82,983	835.64	4.54	1.29	03/01/2024	4.17	08/02/2023	3.59	3.26
IG Short Intermediate	79,646	796.25	4.53	1.25	03/11/2024	4.20	08/17/2023	3.63	3.30
Short	48,625	483.74	4.55	1.16	01/25/2022	2.07	01/08/2022	2.02	1.87
IG Short	46,212	454.98	4.53	1.14	01/30/2022	2.09	01/14/2022	2.04	1.88
High Yield	9,116	160.04	3.42	3.60	01/28/2040	20.10	12/02/2026	6.92	6.92
High Yield Ex-Puerto Rico	8,938	137.89	3.76	3.61	08/05/2039	19.61	09/06/2026	6.68	6.41
California	28,301	394.77	4.09	1.67	06/24/2033	13.48	08/25/2025	5.66	5.84
New York	12,987	291.77	4.50	1.69	01/05/2033	13.01	04/09/2025	5.28	5.33
Puerto Rico	230	24.68	2.15	3.42	11/22/2041	21.94	05/07/2028	8.39	9.65

Sources: Wilmington Trust Investment Advisors, Investortools, Inc., S&P Dow Jones Indices LLC, ICE Securities Evaluations, Inc.
Index calculations by Investortools, Inc. Custom Index Manager, the Federal Reserve System.

The S&P Municipal Bond High Yield Index Ex-Puerto Rico is designed to measure bonds in the S&P Municipal Bond Index that are not rated or are rated below investment grade, excluding Puerto Rico

The state level municipal bond sub-indices consists of bonds in the S&P Municipal Bond Index that have been issued by municipalities or municipal authorities within the respective states, the District of Columbia, Puerto Rico, Guam, and the U.S. Virgin Islands. States and municipalities may have issues across the duration and quality spectrums or may be more concentrated to certain sub-indices, such as in the S&P Investment Grade or High Yield bond indices.

The S&P Municipal Bond Puerto Rico Index consists of bonds in the S&P Municipal Bond Index issued by the Commonwealth of Puerto Rico, and municipalities and municipal authorities within the Commonwealth. Individually these entities may have issues across the duration and quality spectra; however, as a general matter they have been increasingly concentrated in the S&P High Yield Bond Index.

Indices are not available for direct investment. Investment in a security or strategy designed to replicate the performance of an index will incur expenses, such as management fees and transaction costs, which would reduce returns.

Quality ratings are used to evaluate the likelihood of default by a bond issuer. Independent rating agencies, such as Standard & Poor's and Moody's Investors Service, analyze the financial strength of each bond's issuer. Moody's ratings range from Aaa (highest quality) to C (lowest quality). Bonds rated Baa3 and better are considered "Investment Grade." Bonds rated Ba1 and below are "Below Investment Grade" (also "High Yield" or "Speculative"). Similarly, Standard & Poor's ratings range from AAA to D. Bonds rated BBB– and better are considered "Investment Grade" and bonds rated BB+ and below are "Below Investment Grade."

All investments carry some degree of risk. Investors should develop a thorough understanding of the risks of any investment prior to committing funds.

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Selected S&P Municipal Bond Index total returns

	AS OF DECEMBER 31, 2019			CALENDAR
	MTD	QTD	YTD	2018
Municipal Bond	+0.33%	+0.65%	+7.26%	+1.36%
Investment Grade (IG)	+0.31%	+0.62%	+7.03%	+1.13%
Intermediate	+0.37%	+0.71%	+6.92%	+1.55%
IG Intermediate	+0.36%	+0.69%	+6.87%	+1.39%
Short Intermediate	+0.29%	+0.80%	+4.73%	+1.78%
IG Short Intermediate	+0.29%	+0.79%	+4.72%	+1.68%
Short	+0.21%	+0.67%	+3.11%	+1.78%
IG Short	+0.20%	+0.66%	+3.08%	+1.72%
High Yield	+0.57%	+1.09%	+10.76%	+5.23%
High Yield Ex-Puerto Rico	+0.51%	+1.05%	+9.89%	+3.26%
California	+0.33%	+0.65%	+7.40%	+1.08%
New York	+0.31%	+0.54%	+6.99%	+0.92%
Puerto Rico	+0.92%	+1.35%	+16.32%	+23.70%

Sources: Wilmington Trust Investment Advisors, Investortools, Inc., S&P Dow Jones Indices LLC, ICE Securities Evaluations, Inc. Index calculations by Investortools, Inc. Custom Index Manager.