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Quarterly Market Commentary

Municipal Fixed Income

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Bent but Not Broken: Munis Still Strong Overall

In the first quarter of 2020, the municipal market experienced a decade of turbulence. January and February experienced traditional municipal returns and new inflows from investors looking to take advantage of the high level of credit quality and after-tax income and returns that municipals provide, while March experienced pressure. It's been a wild ride.

For the 14-month period ending February 2020, total municipal bond inflows were a record $120 billion in new monies. Through the end of February, the return on the S&P Municipal Bond Index—which includes an average maturity of 12 years, as well as both investment-grade (IG) and high-yield (HY), or below IG, bonds—was 2.9%, and the yield to worst was 1.34%. In contrast, the yield on 5- to 30-year AAA municipals reached their all-time lowest point in history in early March (0.49% in 5 years and 1.38% in 30 years).

During the first quarter, as COVID-19 began to creep up on the equity and Treasury markets, the municipal market began to experience selling pressure. Shareholders began to redeem shares in IG and HY mutual funds and exchange traded funds (ETFs) on March 11 and it continued through the end of the quarter, reaching $30 billion in total outflows, according to Lipper.

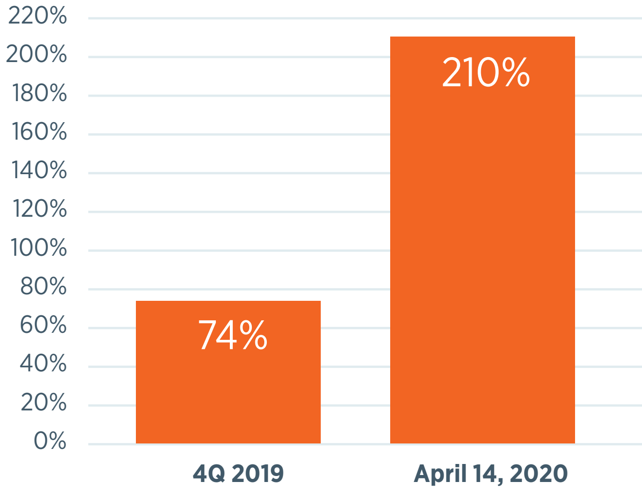
By the end of March, the S&P Municipal Index returned –3.3% for the month and –0.58% year to date with the yield rising 0.73%. The $30 billion in outflows over this three-week period was the quickest and most sudden in municipal history. Typically, outflow cycles are longer (36 weeks on average) and the outflow dollar total is more spread out.

Continued

Figure 1

Municipal bonds yielding a historic premium to Treasuries

Yield ratio of the 5-year AAA municipal to 5-year UST expressed as a percentage



Source: Bloomberg. Data as of April 14, 2020. Five-year AAA yield vs. five-year UST.

These outflow cycles, as they are called in the municipal market, all have several things in common: They are preceded by huge inflows. The cycle begins when the selling starts. This causes net asset value to recede, creating a negative feedback loop. Additional selling causes bond prices across all maturities and credit quality to decline and the negative loop continues. In the last 12 years, there have been four outflow cycles: 2008 (financial crisis), 2010 (a selloff ensued after financial analyst Meredith Whitney predicted "hundreds of billions" of dollars in muni defaults in a *60 Minutes* interview), 2013 (taper tantrum), and 2016 (President Trump's election).

As is true in all outflow cycles, the value of municipals increases as yields rise rapidly and bond prices decline. One market-wide measure of valuation is to compare the yield on a AAA municipal for a particular maturity to the yield available on a Treasury maturing in the same timeframe. Generally, tax-exempt municipal yields trade at a discount to U.S. Treasuries due to the preferential tax treatment. As Figure 1 shows, on April 14 the five-year AAA municipal bond yielded 74% compared to the five-year U.S. Treasury. Market volatility and the global flight to quality brought U.S. Treasuries much lower at the end of March. The yield on the same five-year AAA bond was 300% on March 31 (the five-year AAA municipal yield was 1.15% compared to the five-year U.S. Treasury, which yielded 0.38%).

Every credit sector across municipal issuers was affected by COVID-19 as it ravaged the Northeast region, especially New York State and New York City. The effects were seen throughout the economy and, in particular, credits such as hospitals and transportation systems (airports, ports, turnpikes, toll road, railroads, and subways). Governors across the country instituted various forms of social distancing and lockdowns to restrain the spread of the virus. Generally, municipal credits went into the crisis in the best fiscal shape in history after having emerged from the 2008 financial crisis with record amounts of revenue, strong cash reserves, and reduced fixed expenditures—including headcount.

Municipal credit: Resilient and time-tested

Expected fallout from the COVID-19 outbreak led the three major rating agencies to place negative outlooks on most sectors within U.S. public finance as the pandemic wreaks havoc on the economy. While few borrower downgrades have occurred to date, a spate of downgrades should be expected once financial disclosures confirm the challenges of this period. What should not be expected is a rash of IG defaults. Yes, there is likely to be an increase in defaults, but the majority of these will be in the riskier part of the rating spectrum; exactly what one would expect.

Unique credit characteristics of municipals

Municipal credits benefit from important credit characteristics that non-municipal issuers do not. Benefits differ by sector and may include tax-raising ability (state and local governments), high essentiality (airports and hospitals), regional monopolies (public power and water/sewer), and large philanthropic bases (universities). Of course, not every credit within the health care sector is essential, and not every university has a strong donor base. These differences highlight the importance of careful credit selection.

Continued

Figure 2

Municipal defaults are historically low compared to corporates

Rating category	Municipal	Global corporates
Aaa	0.00%	0.00%
Aa	0.04%	0.63%
A	0.27%	0.96%
Baa	1.57%	1.69%
Investment-grade	0.18%	1.20%
Below investment-grade	12.35%	22.06%
All grades	0.29%	8.84%

Figures represent the average 10-year default rate since 2009.
Source: Moody's Investors Service.
See the Disclosures section for information on Quality Rating Categories.

Exceptional track record

Historically, the municipal market has experienced extraordinarily low default rates compared to global corporates. Moody's reports the average cumulative default rates from 1970 to 2018 at just 0.10% for IG municipal credits compared to 2.28% for IG corporates. Data since 2009 illustrate a similar pattern (Figure 2). Global corporate credits during this period defaulted at a rate 30.5x that of municipals. Within the IG category, the figure falls to a still-impressive 6.7x.

Supportive stimulus—CARES Act and MLF

Municipal credits benefit from strong public support without which we would not be seeing federal stimulus at unprecedented levels. Through the Coronavirus Aid, Relief and Economic Security (CARES) Act, municipal sectors will be supported with over $300 billion in federal stimulus dollars. Grants are providing much-needed support for states,[1] tribal governments and territories, transit agencies and airports, universities, and hospitals. Additional stimulus to hospitals and state and local governments is expected.

Additionally, the Federal Reserve is providing liquidity support for the municipal market. Through its Municipal Liquidity Facility (MLF), the Federal Reserve will purchase through September 30, 2020, up to $500 billion of short-term notes (utilizing a special purpose vehicle or SPV) to U.S. states,[2] counties with at least two million residents, and cities with at least one million residents. State-level[3] issuers can use the proceeds to support[4] additional counties and cities, although some states may have legal or constitutional prohibitions from serving as a conduit. Borrowing capacity of the MLF is more than 10 times the total amount of municipal notes ($46 billion) issued last year.

Core narrative

There is no doubt these will be challenging times for municipal issuers just as they are for corporations and individuals. But if history is a guide, and we believe it is, municipal defaults will occur primarily among those borrowers that entered 2020 with the weakest financial positions and more speculative prospects. While there could be outliers, we believe a vast majority of investment-grade municipal credits can be expected to weather the current storm while consistently honoring their financial obligations to bondholders.

[1] Another $75 million of stimulus was added for hospitals subsequent to March 31, 2020.

[2] Subsequently changed to December 31, 2020.

[3] Subsequently lowered to 500,000.

[4] Subsequently lowered to 250,000.

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Selected S&P Municipal Bond Index totals and averages

	AS OF MARCH 31, 2020								
	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	204,787	2,476.33	4.33	2.07	08/03/2032	12.21	02/01/2026	5.83	5.50
Investment Grade (IG)	195,598	2,326.22	4.42	1.89	02/04/2032	11.73	08/07/2025	5.36	5.32
Intermediate	115,932	1,181.77	4.48	1.83	09/07/2028	8.44	07/25/2025	5.31	4.80
IG Intermediate	112,247	1,134.80	4.48	1.73	09/07/2028	8.42	07/09/2025	5.27	4.79
Short Intermediate	84,151	851.44	4.52	1.53	05/16/2024	4.11	10/29/2023	3.57	3.21
IG Short Intermediate	80,873	811.96	4.52	1.48	05/28/2024	4.14	10/23/2023	3.56	3.24
Short	48,212	481.48	4.53	1.38	05/12/2022	2.11	05/18/2022	2.13	1.90
IG Short	45,824	453.26	4.52	1.34	05/18/2022	2.13	04/28/2022	2.07	1.92
High Yield	9,189	150.11	3.41	4.95	10/15/2039	19.90	12/05/2033	13.20	8.51
High Yield Ex-Puerto Rico	9,011	129.50	3.75	5.01	03/12/2039	19.44	01/05/2033	12.24	8.05
California	28,550	391.71	4.09	1.93	07/16/2033	13.14	01/08/2026	5.78	5.71
New York	13,129	292.48	4.48	2.00	06/11/2033	13.05	10/15/2025	5.54	5.42
Puerto Rico	230	23.03	2.15	4.51	03/30/2042	21.46	04/21/2038	18.08	10.70

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, the Federal Reserve System.

DISCLOSURES

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.

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Selected S&P Municipal Bond Index total returns

	AS OF MARCH 31, 2020			CALENDAR
	MTD	QTD	YTD	2019
Municipal Bond	–3.34%	–0.58%	–0.58%	7.26%
Investment Grade (IG)	–2.94%	–0.24%	–0.24%	7.03%
Intermediate	–3.00%	–0.47%	–0.47%	6.92%
IG Intermediate	–2.85%	–0.32%	–0.32%	6.87%
Short Intermediate	–1.95%	–0.49%	–0.49%	4.73%
IG Short Intermediate	–1.91%	–0.45%	–0.45%	4.72%
Short	–0.93%	–0.16%	–0.16%	3.11%
IG Short	–0.91%	–0.15%	–0.15%	3.08%
High Yield	–9.11%	–5.55%	–5.55%	10.76%
High Yield Ex-Puerto Rico	–8.71%	–5.51%	–5.51%	9.89%
California	–3.47%	–0.60%	–0.60%	7.40%
New York	–3.49%	–0.79%	–0.79%	6.99%
Puerto Rico	–10.79%	–5.52%	–5.52%	16.32%

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 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.

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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