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Tax-Exempt Municipal Bond Market State of the Union

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Snapshot

- Uncertainty breeds volatility, and the muni market has been no exception.
- Bonds issued by New York, New Jersey and the Metropolitan Transportation Authority have experienced credit rating downgrades.
- We believe the worst is behind us, and we will continue to hold these bonds in our portfolios.

Financial markets at large have witnessed a tremendous amount of volatility in 2020, and the typically sleepy municipal bond market has been no exception. The emergence of the COVID-19 virus and the U.S. presidential election have been the two primary market narratives yielding the greatest impact on the municipal bond market over the course of this year. Although the virus will continue to cause short-term disruption, vaccine distribution has already begun and holds the potential key to fully reopening the economy. With the elections in the rearview mirror, there is added reason for optimism.

The Current Environment

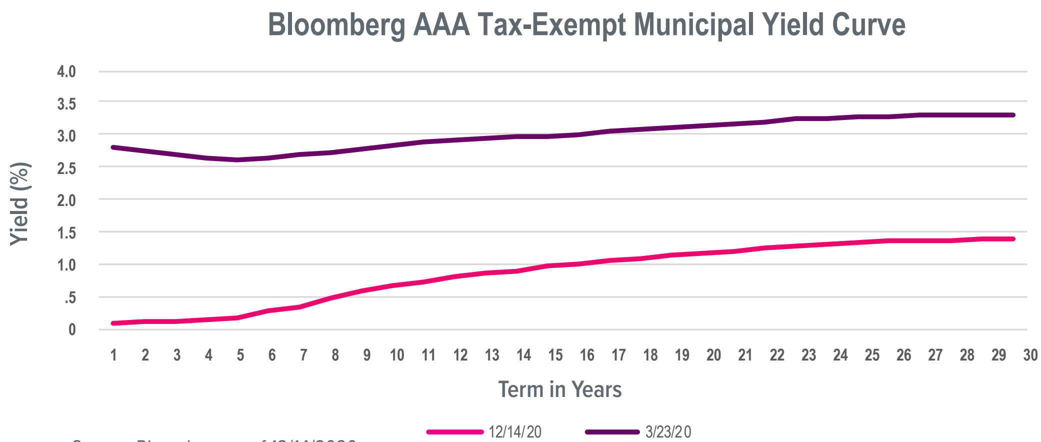
While the current uptick in positive COVID-19 cases is expected to get worse before it gets better and lockdowns have started to reemerge, vaccine distribution is a light at the end of the tunnel.

Similarly, the uncertainty surround the outcome of the U.S. presidential election has come and gone—barring the unlikely event of unprecedented judicial intervention. Some unfinished business does remain in the U.S. Senate, as the state of Georgia did not have any clear winners in the election. If one or both seats that are up for grabs in Georgia are claimed by Republican candidates, then control of the Senate will remain with the Republicans. However, if Democrats win both seats, the Senate would be split evenly between Republicans and Democrats, and Vice President Kamala Harris would hold the tie-breaking vote beginning on January 20, 2021. Following November's elections, Democrats maintain control of the House of Representatives; thus, a Senate victory would change the playing field. Still, even with this possibility, we believe the level of political uncertainty is considerably dampened.

Muni Market Impact

The broad municipal bond market has performed well since the COVID-19 led market sell-off. Municipal bond prices bottomed in March. Since that time, yields have declined in excess of 175 basis points through mid-November across the curve.

Exhibit 1: Yields are Down, Prices are Up



Source: Bloomberg as of 12/14/2020

The rally in tax-exempt municipal bonds has been impressive; however, as has been the case in every financial market, not all sectors and geographies within the muni market have performed equally. The Northeast region of the U.S, which was hit particularly hard by the pandemic early, illustrates this point.

COVID-Induced Downgrades

New York was one of the first and hardest-hit states by the COVID-19 pandemic, which forced major metropolitan areas (including New York City) to shut down. The objective of those lockdowns was to stop the spread of the virus. Unfortunately, turning off the economy did not come without consequences in the form of deteriorating credit metrics as sales and income-tax revenues plummeted. On October 1, 2020, Moody's downgraded New York and New York City general obligation bonds by one notch to Aa2 from Aa1.

New Jersey was also hit early and hard by the pandemic. On November 6, 2020, S&P downgraded New Jersey general obligation debt to BBB+ from A-. S&P has a stable outlook on the credit rating, but notes that they "expect New Jersey will continue to have a significant structural deficit that will be difficult to close in the coming years because of decreased revenues associated with the COVID-19 pandemic, combined with high and increasing debt, pension and other post-employment benefit liabilities."

The Metropolitan Transportation Authority (MTA), which manages public transit, bridges and tunnels in New York City and surrounding areas, may have been hit hardest by the shutdowns. As the pandemic gripped the region, the MTA witnessed subway ridership declines of as much as 90% at their peak. While some improvement has been seen, ridership declines are still pronounced. As of the week ended November 6, Long

Island Rail Road (LIRR) and Metro-North train line ridership were down by 74% and 79%, respectively, on a year-over-year basis. The MTA recently released its proposed 2021 budget, which is currently under review by the MTA board. The budget is expected to be voted on sometime this month. The MTA warned of up to a 40% cut in subway and bus service and a 50% cut for commuter-rail lines, while also raising fares and tolls for existing services. In addition, the MTA announced it would be eliminating over 9,300 jobs if the agency does not receive additional federal assistance. As a result, MTA transportation revenue bonds have been downgraded by both Moody's and Fitch recently to A3 and A-, respectively. S&P rates the bonds BBB+.

Our Portfolios

As we look ahead to 2021, we take an optimistic view towards the tax-exempt municipal bond market. That said, we recognize that not all municipal bond issuers are created equal. Certain sectors and geographies will continue to face asymmetric financial pressures in the short term. No two recessions are the same, and we are still emerging from one of the sharpest and deepest economic downturns in modern history.

The municipal credit cycle is now playing catch-up to the economic cycle. The recent ratings downgrades to New York, New York City, New Jersey and the MTA are just a few examples of many downgrades that have already taken place. We anticipate ratings downgrades to continue across the municipal spectrum for the foreseeable future as the impact of the decline in economic activity continues to weigh on the financials of state and local governments.

This stage of the economic cycle is perfectly normal, and we regularly consider it when constructing our low-turnover fixed-income strategies. The primary objective of these strategies is to provide investors with a stable, steady stream of income throughout the economic cycle while also seeking to preserve capital. Against that backdrop, our portfolios are conservative in nature and are constructed using high-quality investment-grade tax-exempt municipal bonds. We remain confident in the ability of our strategies to continue delivering on their primary objectives for our investors. We are comfortable holding debt issued by New York, New York City, New Jersey and the MTA at this time, and are not making any changes to our strategies.