

Balance Sheet Insights

PIPER SANDLER FINANCIAL STRATEGIES

February 11, 2021

Waiting on Opportunities in the Municipal Bond Market

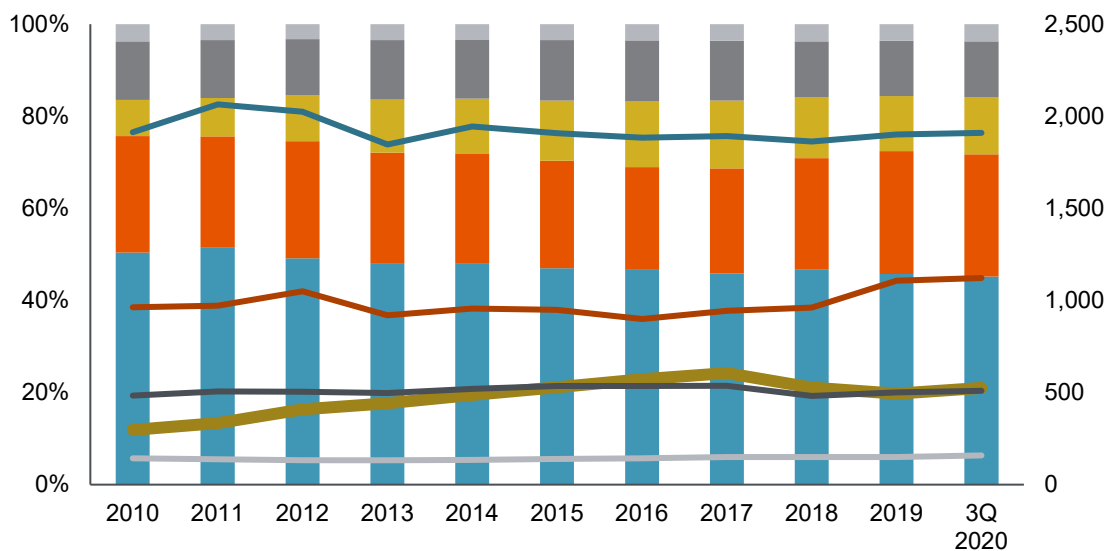
Please see this week's [Rate Sheet](#) and [Yield Curve Opportunities](#).

This week, we asked our in-house experts on Municipals, Peter Stettler and Al Cappelli, to provide an overview of the municipal market. Soon, we will revisit the sector, for some specific strategies that financial institutions can take advantage of. Let's dive right in.

Banks Continue to Invest in Municipals

On the heels of a somewhat volatile year, the Muni Market is starting 2021 with a dearth of supply and high demand compressing spreads to their tightest levels in history. While it is difficult to find value in the current market, we believe there will be opportunities for banks to diversify their asset portfolios with a range of municipal opportunities over the course of the year. Reasons for optimism include the changing political landscape in Washington, with the Democratic majority favoring several favorable provisions for municipal bonds; continued low rates which should sustain the high level of taxable issuance; and an expected near record year of supply, which at some point should surpass demand and lead to wider spreads.

Over the past decade, banking institutions steadily increased their holdings of municipal bonds, rising to a peak of 15% of the market in 2017 before plateauing at approximately 12% of the market the past two years, as the tax reforms of 2017 reduced the benefit of the municipal tax exemption (Figure 1). As of the third quarter of 2020, banks held approximately \$525 billion in municipal bonds, in line with the holdings of insurance companies, as the third and fourth-largest investor segments in the market behind individuals and mutual funds.



Holders % held (left) | Individuals | Mutual Funds | Banks | Ins Cos | Other
 Holdings (\$ bills) (right)

Source: SIFMA; Piper Sandler & Co.

Why Municipals?

Banks find municipals attractive for a variety of reasons beyond their (mostly) tax-exempt status. Municipals offer diversification by geography and industry, with opportunities in utilities, health care, transportation, higher education and other sectors in addition to the traditional general obligation bonds issued by states, cities, counties and school districts. Municipal bonds also offer a high level of safety, with most issuers rated in the top three rating categories and historically low default rates compared to some other fixed income credit markets. Furthermore, municipals generally offer amortizing structures, providing investors a wide variety of coupons, maturities, and call dates by which to optimize the composition of an asset portfolio.

Certain municipal bonds offer banks unique benefits, such as bank qualified bonds. Bank qualified bonds offer an additional tax advantage to commercial banks, established under the Tax Reform Act of 1986, allowing for the deduction of 80% of the interest expense associated with the funds invested in the designated securities. Bonds are designated as bank qualified by the issuer, by indicating it expects to issue no more than \$10 million in bonds during a calendar year. The purpose of bank qualification is to assist small issuers in gaining access to the market by creating demand for a limited supply of bonds while also lowering their interest costs, benefitting both sides of the trade. The bank qualified market is one area to watch for opportunities later this year, as the Democratic Congress is considering increasing the limit on bank qualified issuance to no more than \$30 million in a calendar year, which will increase supply and the depth of the market if enacted.

In certain circumstances, municipal bonds may also assist a bank in meeting its obligations under the Community Reinvestment Act (CRA), which requires regulated financial institutions to meet the credit needs of the communities they serve, particularly the needs of low-to-moderate income borrowers or geographic areas designated as low-to-moderate income. Generally, for municipal bonds to be CRA eligible they must meet community development needs targeted for low-to-moderate income areas or distressed or underserved non-metropolitan middle-income geographies within the financial institution's assessment area. The key to determining bond eligibility is to identify the primary purpose of the borrowing and if this purpose meets the community development definition. Purposes that are likely to meet the criteria include bonds issued for economic development (including tax increment financing bonds); housing, including multi-family and single-family units; healthcare facilities; school programs; and essential services such as water and sewer systems.

2020 Recap

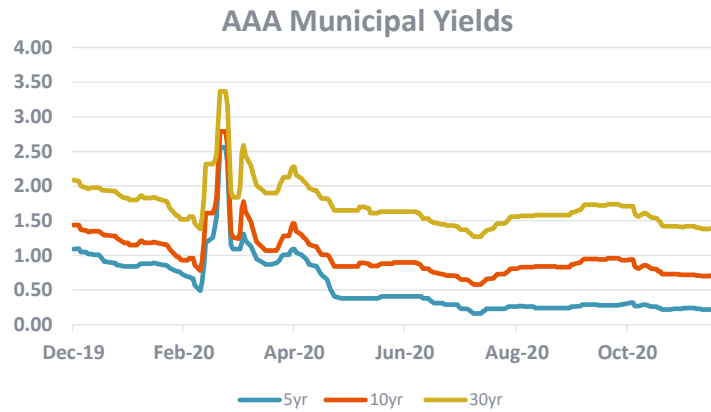
Municipal bonds began 2020 at rich levels compared to U.S. Treasuries; however, with the onset of the COVID-19 pandemic and the related actions attempt to control the disease, which dampened economic activity, municipal yields rose sharply in March and April. Extreme yield volatility, which hit levels not seen in years, curtailed new issuance activity and led to a significant cheapening of the market, creating an outstanding opportunity for value. The rapid rebound in the economy that began in late May and early June, along with the passage of the CARES Act and creation of Federal Reserve programs to backstop the market, such as the Municipal Liquidity Facility, stabilized market conditions more quickly than expected. Issuance volume soared, rising from a record low of \$20.2 billion March to a record high of \$73.2 billion in October, as municipalities rushed to market ahead of the November election. While questions remained regarding the effect of the economic closures and related downturns in tax revenues on credit quality, as the rating agencies shifted outlooks to negative on most sectors, and downgrades began to outpace upgrades, many investors added

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munis in the last half of the year, gathering significant assets as supply surpassed \$450 billion in primary market bond issuance, the highest level on record. As supply eased after the election, while inflows to the market continued unabated, yields again trended toward new lows, while spreads tightened through December, forcing investors to take on lower-rated credits or to press further out the curve in search of reasonable return for invested funds.

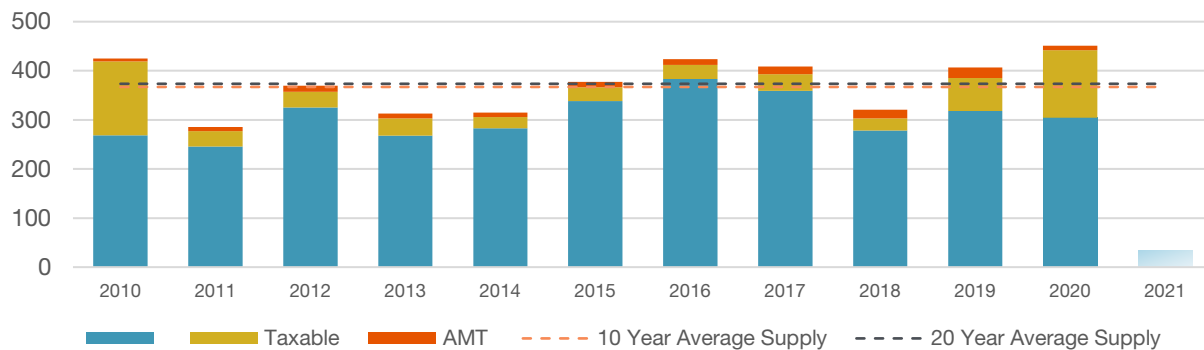


Source: MMD; Piper Sandler & Co.

The Market Outlook for 2021

We anticipate another busy year in the municipal market, with volume to remain near record levels at around \$460 billion in 2021. Furthermore, we expect taxable issuance to remain well above historical norms as issuers take advantage of low rates to advance refund outstanding bonds, as well as issue pension obligation bonds, for both economic savings and budgetary relief in light of deficits encountered in 2020. The recent surge in taxable volume reflects the prohibition of advance refundings – that is the issuance of new bonds with proceeds placed in escrow to repay outstanding bonds more than 90 days before their first call date – in the 2017 tax reforms (current refundings, which refund bonds within 90 days of the first call date remain tax-exempt). However, should the Democratic Congress reinstitute the tax-exemption for advance refundings, a large portion of expected taxable issuance will return to the tax-exempt market.

Figure 3: Annual Municipal Bond Issuance 2010 – 2021



Source: SIFMA; Piper Sandler & Co.

We also expect investment inflows to remain strong, as is the case at present, pressuring rates down and forcing investors to lower-quality sectors in search of yield. This trend has been particularly noticeable in the high-yield sector of the market of late, as spreads for some of the most troubled municipal credits tightened dramatically over the past two months. For example, spreads on the New York Metropolitan Transit Authority's (MTA) taxable bonds were as wide as 400 bps to comparable Treasuries as late as October of 2020, but are recently trading closer to 200 bps spread. Still, we expect periods where supply may outstrip demand, based on seasonal reinvestment patterns, potentially allowing opportunistic periods of wider spreads. The first such period we expect to occur in the late-February to mid-April time frame, with the second period occurring in the late-September to early-November period.

On the credit front, we foresee downgrades outpacing upgrades in the next 12 to 18 months, though the pace may be slower than earlier thought. The strong economic rebound resulted in higher than anticipated revenues over the second half of the year, significantly reducing expected deficits at the state and local level. While this may ease the strain on general governments, travel and tourist-related sectors remain pressured, including transit agencies, convention centers, airports, and hotel financings. The flip of both houses of Congress and the White House to Democratic control is also positive for the municipal sector, with significant spending including an additional round of stimulus expected to fill municipal coffers. The current proposals in Congress include \$130 billion for K-12 schools; \$40 billion for higher education; \$30 billion for transit; and \$8 billion for airports, with state and local government expected to receive on the order of \$350 billion, a figure that is well above the estimated \$100 billion revenue shortfall attributed to the Covid-19 response. With revenues running ahead of estimates and a significant influx of federal revenues, state and local balance sheet positions may improve significantly in fiscal year 2022 easing credit concerns.

For more on our outlook for 2021, please refer to our report, "[Bearing Municipals Beyond Covid-19](#)". And look for our commentary on specific industry sectors in future editions of Balance Sheet Insights.

If any of our observations pique your interest, please contact your Piper Sandler representative or email us at PSFS@psc.com. For derivatives, please email our affiliate, Piper Sandler Hedging Services, LLC, at FSG-Derivatives@psc.com.

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