



This Month's Contrarian Idea — Tactical Muni Bond Position

BBB-AAA Spread Compression & Fiscal Stimulus Provide Catalysts

Bottom Line

This Friday Strategist presents a contrarian investment idea. While contrarian investment ideas may not necessarily agree with our overall investment view, the report's goal is to highlight an off-the-beaten-path investment idea to add value to your investment process. This report focuses on the municipal bond market, which faces elevated credit risk after mandated economic shutdowns led to declining revenues and increasing expenses.

In our view, two catalysts are merging to create a tactical municipal bond opportunity. The primary catalyst is BBB-AAA compression. We believe the BBB-AAA spread will compress in the coming months after more than doubling from 0.67% at the end of February 2020 to 2.04% at the end of June 2020. A secondary catalyst is the potential for additional fiscal stimulus targeted at state and local governments. We believe the A and BBB muni bond segments offer attractive value today despite their uncertain future.

Main Points

► Muni Bond Yields Fall vs Corporates; ETF Flows Rebound

- Muni yields increasingly attractive vs corporates based on after tax yields.
- After pulling out \$1.4Bn in March, investors reinvested \$3.2Bn from April 2020 through the end of June 2020. This follows strong 2019 demand.

► 2H 2020 Thematic Catalysts; BBB-AAA Municipal Spread Remains Elevated

- A Democratic sweep could lead to increased personal & corporate tax rates. Additional state & local government stimulus could boost sentiment.
- The BBB-AAA spread is 2% vs a 1.6% 20-year avg and 0.67% on 2/28/2020.

► Focus on Municipal Bond ETFs with More A & BBB Exposure & Longer Duration

- This tactical municipal bond position is focused on two exposures: A & BBB credit rating and long duration. BBB-AAA spread compression is the primary catalyst, and long duration should help boost returns as the spread

► State Budget Shortfalls & Higher Default Rates Represent Key Risks

- COVID-19 is hitting state revenues and expenses at the same time. States are forecasting budget shortfalls above 2001 & 2008 levels.
- The data indicates muni bond defaults and bankruptcies remain rare. According to Moodys, the 5-year cumulative default rate for muni bonds during the 1970-2018 period was 0.1% compared to 6.6% for corporates.

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Audio Link

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Trade Details

Trade Type

U.S. Credit / Municipal

Trade ID

USCR.2020-10

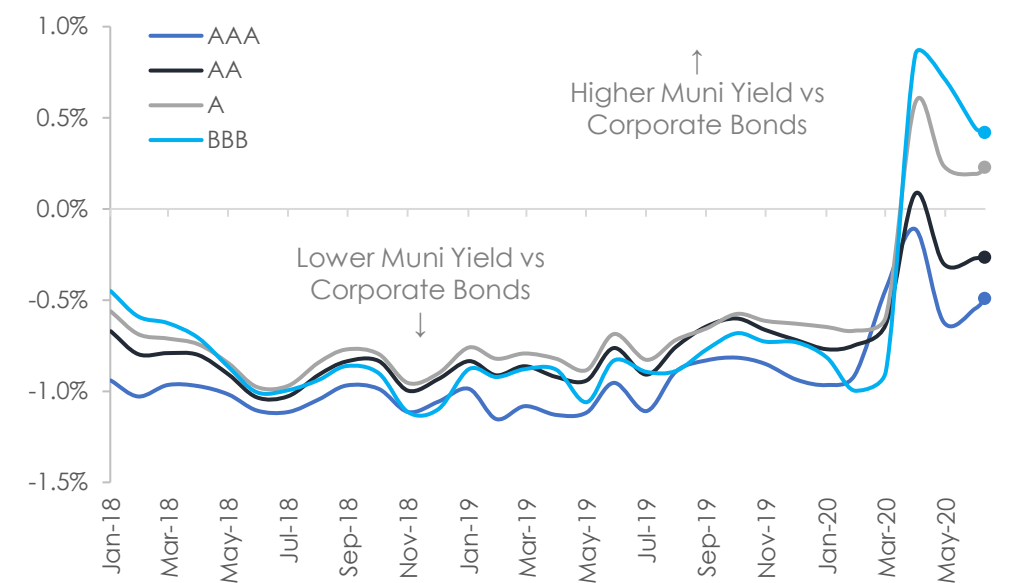
Ticker(s)

ETFs: BAB, FMB, MLN, MUNI, RVNU, TAXF

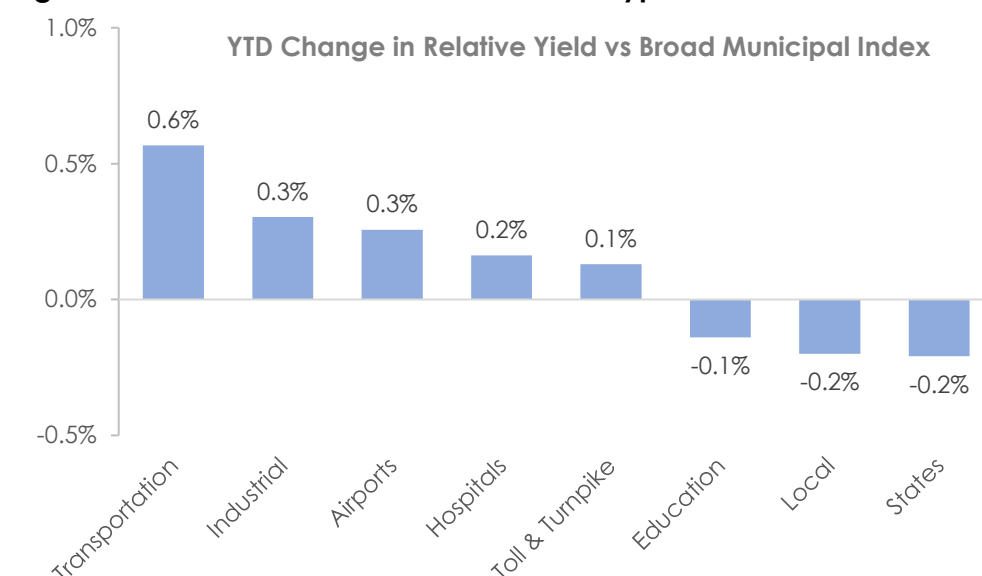
Benchmark

Bloomberg Barclays U.S. Aggregate Bond Index (AGG)

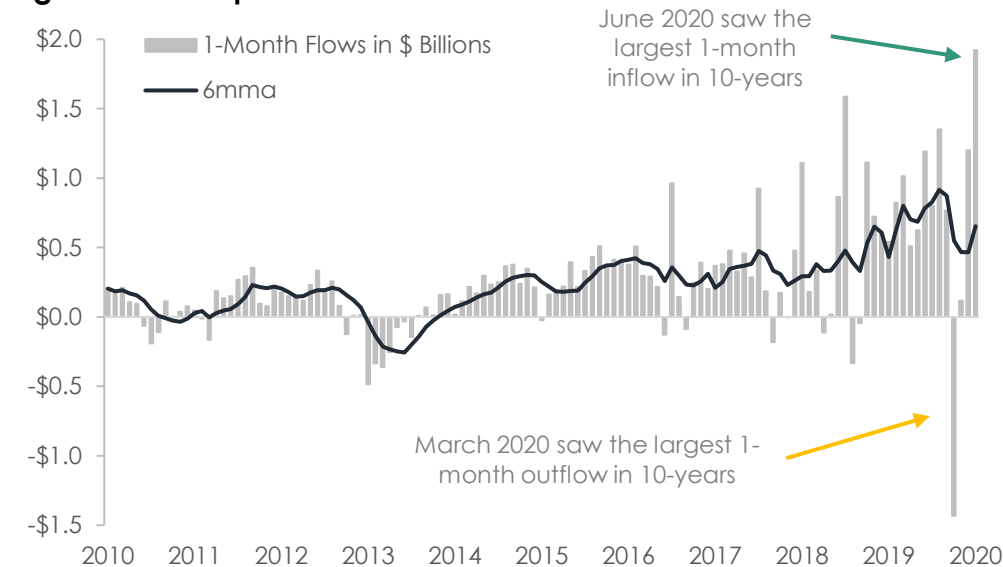
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Figure 1: Muni Yields Relative to Corp Bonds by Rating

Source: MarketDesk Research. **Note:** Uses Yield to Worst (YTW)

Figure 2: Relative Yields Across Muni Bond Types

Source: MarketDesk Research

Figure 3: Municipal Bond ETF Flows

Source: MarketDesk Research. **Note:** Fund flow analysis uses the following municipal bond ETFs (BAB, MLN, PZA, RVNU, FMB, MUB, TFI, ITM, JMUB, VTEB, TAXF, MUNI).

Municipal Bond Yields Surge Higher vs Corporate Rated Peers ...

- Figure 1 charts the relative yield spread between municipal bonds and corporate bonds in the same credit rating segments. Municipal bonds usually have lower relative yields due to their tax treatment advantages.

- Municipalities were negatively impacted during the COVID-19 mandated shutdowns in 1H 2020. Tax and fee revenues of all types, such as gas and sales taxes and toll fees, plunged as economic activity froze. Municipal credit risk surged more than corporate credit risk, which caused municipal yields to widen relative to their corporate peers.

COVID-19 Creates Significant Dispersion Among Municipal Bond Segments ...

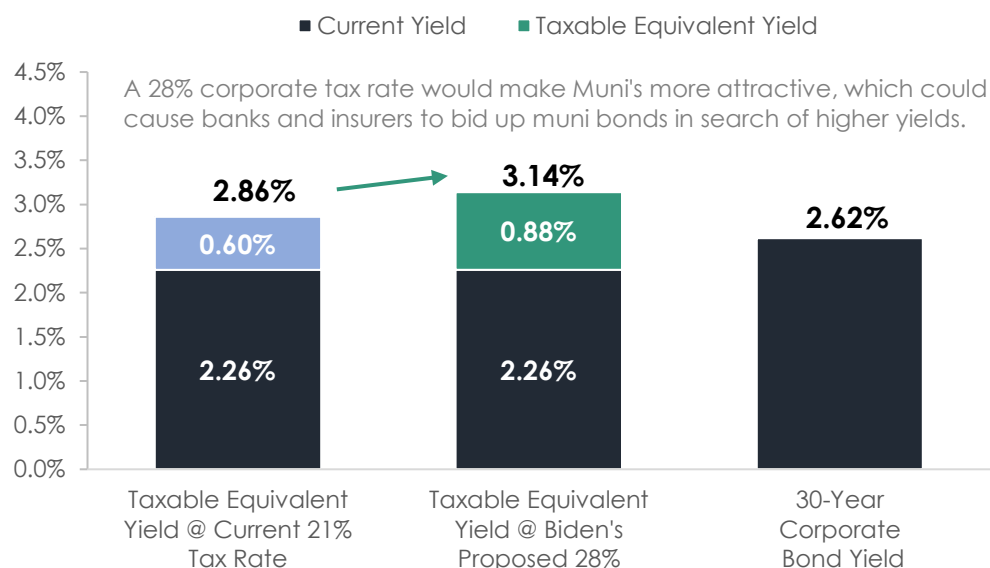
- Figure 2 graphs the YTD change in relative yield between key municipal bond segments and the broader municipal bond index. A positive YTD change indicates the segment offers more relative yield today, which is likely due to higher credit risk.

- The chart highlights municipal segments most impacted by economic shutdowns. For example, transportation yields significantly increased vs the broad municipal index. Airports and toll / turnpike yields also increased, as did industrial revenue bond yields. We believe these positive YTD changes offer the most attractive tactical opportunities.

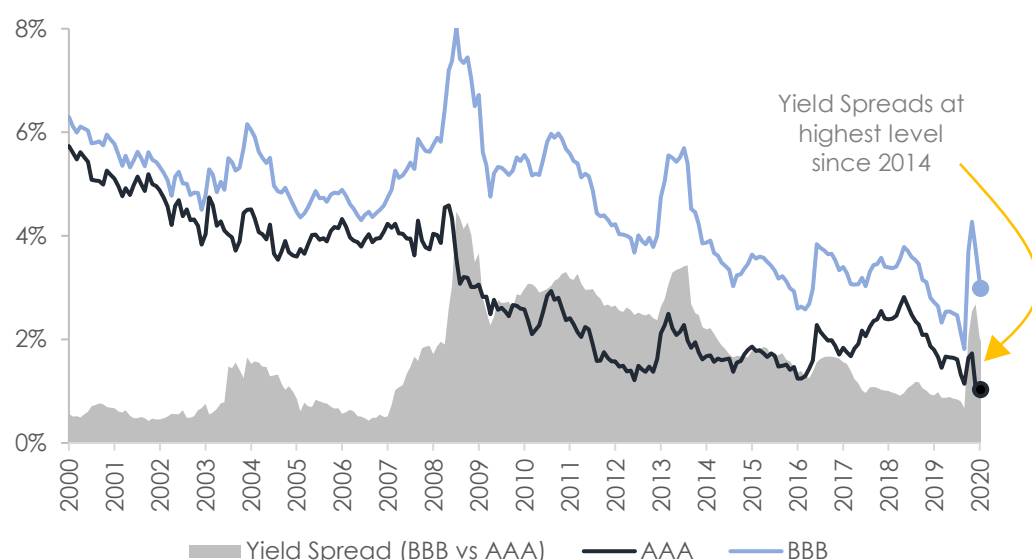
Investors Stampede Back into Municipal Bonds ...

- Figure 3 charts monthly municipal bond flows and the 6-month rolling average. March 2020 represented the largest 1-month outflow in the past 10 years. June 2020 represented the largest 1-month inflow in the past 10 years. After pulling out \$1.4Bn in March, investors reinvested \$3.2Bn from April 2020 through the end of June 2020. This follows strong 2019 demand.

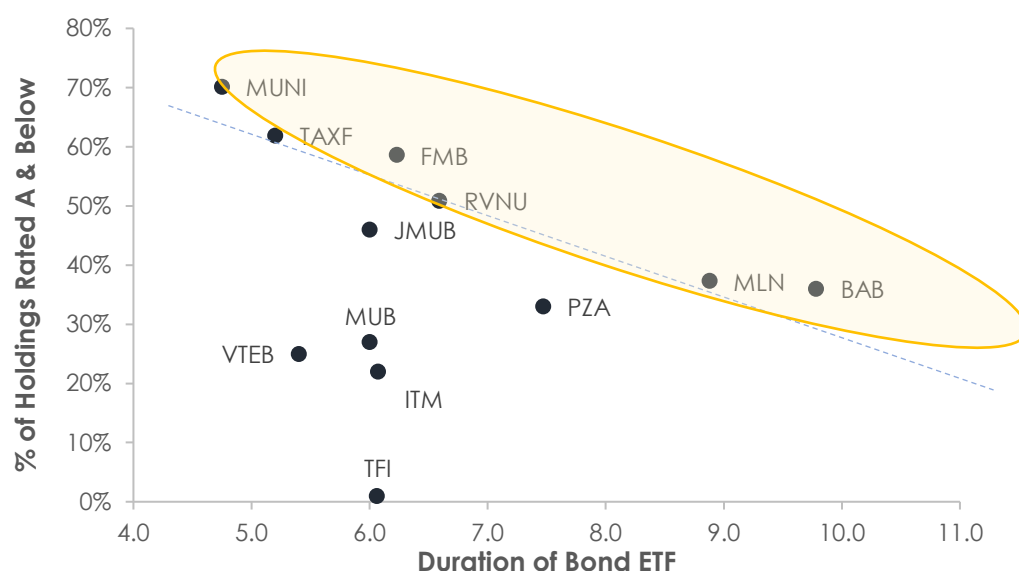
- Strong 2019 investor municipal bond demand was attributed to a combination of tax reform (\$10,000 state / local tax deduction limit), improving state financial conditions, and declining default rates.

Figure 4: 30-Year Taxable Equivalent Muni Yield vs Corporate Yield


Source: MarketDesk Research

Figure 5: IG Muni Bond Spread - BBB vs AAA


Source: MarketDesk Research

Figure 6: Municipal ETFs - A & BBB Exposure vs Duration


Source: MarketDesk Research

A Democratic Sweep & Congressional Stimulus for State & Local Governments ...

- A Democratic sweep could spur additional demand. Higher corporate and personal tax rates make municipal bonds more attractive. Figure 4 graphs the projected taxable equivalent yield of A rated muni bonds at today's 21% corporate rate vs Joe Biden's proposed 28%. Muni bonds are more attractive to banks and insurers at a 28% tax rate, especially given low interest rates.

- Muni bonds could also benefit from more congressional stimulus. Democrats are pushing for \$750Bn for state and local governments, while Republicans are against more state aid. Congress has a small window to act in late July. We believe a deal will be finalized with more fiscal stimulus.

Position at Lower End of Municipal Bond Investment Grade Spectrum ...

- Figure 5 charts AAA and BBB municipal bond yields, as well as the BBB-AAA credit spread. The BBB-AAA credit spread represents the extra yield an investor earns by moving from the highest IG rated segment (AAA) to the lowest IG rated segment (BBB). It can be used as a positioning indicator within the IG municipal space.

- The BBB-AAA credit spread currently sits at 2% vs the 20-year average of 1.6%. For reference, it was 0.67% at 2/28/2020. We believe there is a tactical opportunity to overweight the A and BBB credit segments relative to the AAA and AA segments. This is based on our expectation of BBB-AAA spread compression.

Finding an Optimal Balance Between A & BBB Exposure & Duration ...

- For this tactical position, we are focused on two exposures: A and BBB ratings and duration. Figure 6 plots portfolio exposure to A rated and below bonds vs duration for multiple muni bond ETFs. Lower IG rated muni bonds should benefit from the BBB-AAA spread compression, while duration should boost returns as overall municipal bond spreads tighten vs corporate bonds.

- In general, there is a tradeoff between A and BBB exposure and duration. The yellow circle highlights the mixtures of credit exposure and duration we would target. Our preference is for higher A and BBB exposure over duration given the BBB-AAA spread remains elevated.

Key Risks — State Budget Shortfalls & Increasing Default Rates ...

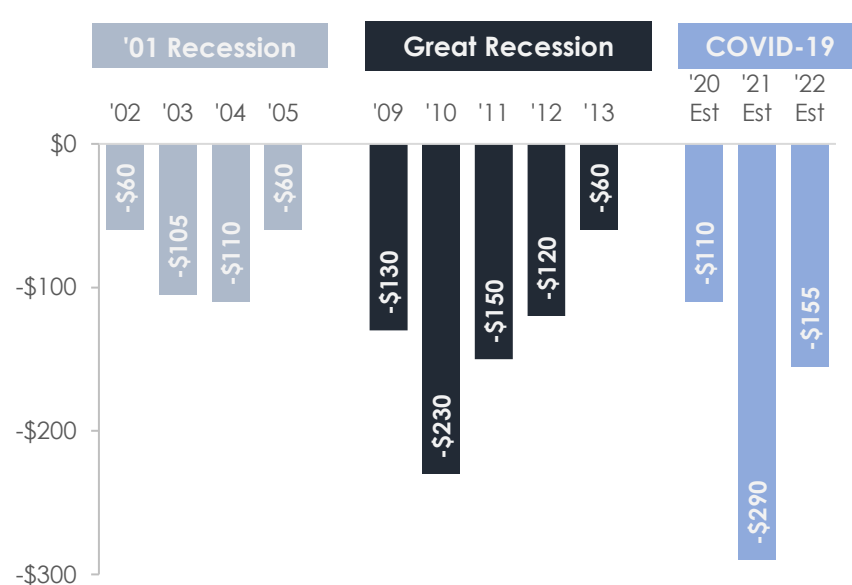
There are two primary risks to a tactical municipal bond position. State and local governments are in an uncertain position due to the global health pandemic. While state and local government fiscal health was improving as 2020 started, plunging revenues increased the default risk.

#1 State Budget Shortfalls: COVID-19 is battering state budgets from both a revenue and expense perspective at the same time. State and local governments are experiencing plunging tax (e.g. gas and sales) and fee (e.g. tolls, turnpikes, public transit) revenues as economic activity remains weak. Expenses are increasing due to a surge in the unemployment population and increased costs related to slowing and containing the virus's spread. The simultaneous impact from revenue declines and expense increases is straining state budgets.

States are updating their budgets based on information currently available. The estimated budget shortfalls are concerning. Figure 7 compares estimated COVID-19 budget shortfalls against the 2001 and 2008 recessionary periods. Early estimates for fiscal years 2020 and 2021 predict \$290Bn and \$155Bn budget shortfalls. There is a risk these projections could worsen as more information becomes available. Delayed income and sales tax filings, which would normally have been filed in recent months, mean revenue projections are more susceptible to further downgrades.

The budget shortfalls create significant issues for state and local governments. Most states are legislatively required to pass a balanced budget. Unfortunately, this means many states will be required to cut services and funding across various departments. Multiple states are evaluating the need to furlough employees as an additional way to balance budgets. The risk is states' financial health continues to deteriorate.

Figure 7: Estimated COVID-19 State Budget Shortfalls (\$Bn)



Source: MarketDesk Research

#2 Potential for Increasing Default Rates: Increased unemployment and extended lockdown orders mean states continue to lose out on key revenue sources used to pay bondholders. The municipal bond market could face continued downgrades in the coming months. There is also the potential for a delayed wave of municipal bankruptcies. However, the data indicates municipal bond defaults and bankruptcies remain rare.

Moody's Investors Service recently released updated municipal bond market statistics for the 1970-2018 period. The average default rate for municipal bonds during the 1970-2018 period was 0.1% compared to 6.6% for corporate bonds. During normal times, the data indicate municipal bonds offer a steady, fiscally sound source of income. However, it should be noted the municipal bond market has not faced an extended period of mandated economic shutdowns like today.

Municipal bond prices will likely remain volatile over the coming months as investors receive updated information to reprice credit risk. These credit risk fluctuations make it increasingly difficult to price municipal bonds. The risk is an investor could be a forced municipal bond seller at an unattractive price during a period of high price volatility.

Trade Implementation — Focus on Municipal Bond ETFs with Exposure to the A & BBB Segments

This tactical municipal bond position is focused on two municipal bond exposures: A & BBB credit rating and long duration. Our preference for lower IG exposure (e.g. A & BBB) is due to the BBB-AAA spread remaining elevated (**Figure 5**). Our preference for long duration is based on our belief interest rates have a higher probability of remaining low than increasing. While we are cautious on long duration in the U.S. treasury and corporate bond markets, we believe long duration is beneficial in the municipal IG market as spreads continue to tighten. We are less focused on the short duration and high yield municipal bond segments.

This tactical position is more about gaining exposure to the municipal bond market as a whole than actively picking bonds. In our view, municipal bond ETFs offer the most diversification and ease of trading.

The timeframe for this tactical position is in the 6-12 month range in our view. If Congress were to pass additional stimulus measures, it would be in the coming months. Additionally, the election outcome will be known in November.

Refer to page 5 for our preferred municipal bond ETFs, including a brief description of why we have chosen the selected ETFs. In addition, we have included two closed end funds (CEFs), although those should only be used on a case by case basis. Both CEFs have a leverage component, which could boost returns but will make them riskier to hold.

Figure 8: Selected Municipal Bond ETFs & CEFs

Ticker	Company	YTD Return	Notes / Rationale
Municipal ETFs			
BAB	Invesco Taxable Municipal Bond ETF	5.0%	In our view, benefits more from duration than BBB-AAA spread compression. 9.8 year duration; ~75% exposed to AAA & AA, with A (18%) and BBB (6%)
FMB	First Trust Managed Municipal ETF	-0.1%	In our view, benefits from both duration and BBB-AAA credit spread compression. 6.2 year weighted average duration; ~41.4% exposed to AAA & AA, with A (32%) and BBB (11%); 14% exposure to the hospitals
MLN	VanEck Vectors AMT-Free Long Municipal Index ETF	0.8%	In our view, benefits more from duration than BBB-AAA spread compression. Similar exposure to BAB -- 8.9 year duration (second longest); ~62.7% exposed to AAA & AA, with A (26%) and BBB (11.2%)
MUNI	PIMCO Intermediate Municipal Bond Active ETF	1.5%	In our view, benefits more from BBB-AAA spread compression than duration. 4.8 year duration; ~30% exposed to AAA & AA, with A (26.8%) and BBB (14%). 11.1% NY and 9.4% IL geographic exposure. Actively managed fund.
RVNU	Xtrackers Municipal Infrastructure Revenue Bond ETF	1.1%	In our view, benefits from both duration and BBB-AAA credit spread compression. RVNU also has a third embedded catalyst due to its infrastructure focus (e.g. 30.6% airports and 20.9% toll facilities) 6.6 year duration; ~49.% exposed to AAA & AA, with A (42.7%) and BBB (8.2%)
TAXF	American Century Diversified Municipal Bond ETF	0.5%	In our view, benefits more from BBB-AAA spread compression than duration. Similar exposure to MUNI -- 5.2 year duration; ~38.1% exposed to AAA & AA, with A (19.3%) and BBB (18.6%); 13.6% exposure to special tax bonds (e.g. repaid with revenues derived from taxation of particular activity or asset), which creates potential risk of dependence on a single tax source
Municipal CEFs (Note: These CEFs are riskier due to their leverage component.)			
BAF	BlackRock Municipal Income Investment Quality Trust	-0.1%	In our view, this CEF has multiple embedded catalysts: BBB-AAA spread compression, higher duration via ~41% leverage exposure, and trades at a discount to net asset value. 11 year duration; ~53.8% exposed to AAA & AA, with A (27%) and BBB (11%); 17.1% transportation exposure makes it vulnerable to an extended shutdown; Traded at a -6.85% discount to NAV on 7/10/2020
MFT	BlackRock MuniYield Investment Quality Fund	0.3%	Similar to BAF -- Multiple catalysts: BBB-AAA spread compression, higher duration via ~41.2% leverage exposure, and trades at a discount to net asset value. 11.9 year duration; ~40.1% exposed to AAA & AA, with A (36.5%) and BBB (14.3%); 29.4% transportation exposure; Traded at a -3.7% discount to NAV on 7/10/2020

Source: MarketDesk Research. **Note:** The benchmark for this tactical opportunity is the Bloomberg Barclays Aggregate Bond Index

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