2021 Municipal Bond Outlook
Municipal Bond Management

JANUARY 2021

16TH AMENDMENT ADVISORS LLC™

Overview

These are unique times indeed. The municipal bond market is trading at historically rich levels on a relative and absolute basis (see our Market Commentary 1/7/21) and the stock market is at or near all-time highs. This, during a global pandemic, high unemployment, political and civil unrest, and, with respect to the municipal market, little to no stimulus given to states and municipalities struggling from COVID-19. This past year teaches us that when you build a professionally managed municipal bond portfolio comprised of high quality, liquid credits with an emphasis on essential service and general obligation bonds, you should be able weather just about any storm. Municipals have shown their resilience to withstand the challenges of this past year, albeit with some unprecedented volatility. Our view remains steadfast; you need to know what you own, emphasize essential services and liquidity, while remaining proactive to strategically adjust the portfolio as circumstances may dictate. This, we believe, are the essential keys to a successful outcome over the long term, even during periods of volatility and uncertainty.

With that said, where do we go from here? What does 2021 look like for the municipal bond market? What will a new administration bring?

We will try to answer those questions below in our annual municipal bond outlook.

Possible Political Policy Implications for Munis

The municipal market is a difficult market to navigate. It has been said that the Treasury market has the yield curve, the mortgage market adds optionality, the corporate market adds credit, and the muni market adds politics. One of the key factors that drives the municipal market is supply and demand, which is often driven by legislation. As a result, with the 2021 election finally concluding, we now look forward to what a Democrat run government may mean for the municipal market. We believe a Biden Administration will have a net positive impact on municipals in 2021. Below we will try to summarize some of the key issues that may affect the municipal market.

COVID-19 AID AND STIMULUS PACKAGES

The likelihood of a substantial stimulus package directly helping states and certain municipalities is higher with the Biden administration. President Biden mentioned in a speech recently that he is looking at many avenues for stimulus with increased deficit spending. Some are estimating we could see deficit spending of $2 trillion -$4 trillion over the next 10-years.[1] We expect there will be aid for state and local governments as part of one of these larger stimulus packages. We would expect this should help with any fiscal deficits states and certain municipalities might face due to the pandemic. The challenge, of course, will be how the money is allocated. Net, net, this is a positive from a credit standpoint.

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TAXES

President Biden has indicated that he plans higher taxes on wealthy Americans, defined as people earning more than $400,000 per year. While there is still a lot to flesh out, he has commented that he wants to increase the corporate tax rate to 28% and increase the personal income tax rate for high earners to 39.6%. He is also asking that those making more than $1 million to pay the same rate on investment income that they do on their wages.[2][3] We may also see the AMT rate reinstated to pre- Tax Cuts and Jobs Act levels. If these changes are enacted, we believe this should increase the value of tax exemption and municipal demand for high-net-worth investors.

INFRASTRUCTURE/TRANSPORTATION

The Biden plan calls for unprecedented investment in infrastructure with estimated ranges in the multi-trillion-dollar range. Among the beneficiaries are transit systems, highways, roads & bridges, rail, smart cities, aviation, freight, energy, water, and broadband. During the press event nominating Pete Buttigieg for US Secretary of Transportation, the president mentioned his approach to infrastructure was going to be about public-private partnerships with state and local governments and the private sector.

The infrastructure program will also have a green energy emphasis. One policy idea is the construction of a national electric-vehicle charging network to power the increasing use of electric vehicles. In addition, the president has suggested the building of a national high-speed rail network and would like to work with the state and local governments along with the private sector to modernize our nation's electric grid, making it smarter, more resilient, and ready to meet the changing needs of a net-zero greenhouse-gas-emissions economy.[3] In a December 15th, 2020 letter to then President-elect Biden, the National Association of Bond Lawyers highlighted a "series of proposals they believe would enable state and local governments immediate access to much needed capital at a time when support to our communities is of paramount and immediate concern". The NABL believes a "robust infrastructure package is inextricably tied to job creation and should be a significant component of the country's economic recovery plan."

Tax-exempt municipal bonds help finance capital infrastructure that have a direct impact on the American people. Many of the proposals the NABL supports can be found in the Moving America Forward Act (H.R. 2 of 2020) and include many provisions that would call for Congressional support of tax-advantaged bonds. A passage of the Moving America Forward Act would preserve and enhance PABs (Private Activity Bonds) and likely result in higher issuance of such bonds to help state and local governments finance essential projects such hospitals, institutions of higher education, airports, seaports, mass transit and other transportation facilities along with affordable housing.[13] We expect a lot of supply for infrastructure in 2021.

HEALTHCARE

We expect the Biden administration to protect the Affordable Care Act from any continued legislative efforts to remove or restrict the Act. As arguably a co-author of the law, we expect Biden to further the Act's intended goal of providing every American access to affordable health insurance.[3] With respect to the municipal bond market, we believe there will still be some financial pain for hospitals in 2021. As long as COVID-19 is a major risk for Americans and hospitals viewed as epicenters of transmission, hospitals are likely to see a further drop in elective procedures which is their primary source of revenue. A second and possible third wave of COVID-19 is likely to put further pressure on the sector without any additional support from the federal government. S&P continues to have a negative outlook on the sector, however this could change if the federal government includes support in any new stimulus packages. More detail is needed here. This has been one sector we have generally avoided. We plan to do the same in 2021.

EDUCATION

According to the American Society of Civil Engineers, public schools' facilities received a grade of a D+.[4] Each year, it is estimated the US underfunds school infrastructure by $46 billion[5], resulting in thousands of schools being unfit for education of our children. Included in Biden's infrastructure legislation we expect there will be funding specifically for improving school buildings.[3] This should bring increased supply.

The education market in the US is large and diverse. There is the distinction between private and public schools as well as "national" universities and local school districts. As a general matter, higher education, particularly at the college and university level, experienced a difficult 2020. Colleges and universities have large fixed costs (i.e. building and maintenance) and with the loss of students on campus coupled with spending money on COVID-19 preparedness, budgets were stressed. We continue to be underweight higher education/university credits although we expect their prospects to improve in 2021 through greater penetration of vaccinations and schools opening to students. Longer term we do worry about higher education as we may see a demographic shift away from the traditional model to more online. Our view remains cautiously positive on local school districts in part because they benefit from local property taxes as a revenue stream.[6] On the expense side, local school districts have been able to function on lower budgets through reducing expenses such as student transportation, building maintenance, and costs associated with extracurricular activities. These credits should continue to perform well in 2021. The one challenge to local school district bonds for 16th Amendment is that they are often small deal sizes, which tends to compromise a bond's liquidity.

ENERGY & UTILITIES

One of new president's signature plans is to generate clean, American-made electricity with the intended goal of achieving a carbon pollution-free power sector by 2035.[3] Most utilities will need significant capital expenditures to achieve carbon free power. There will likely be increased costs, particularly for energy producers, that rely more heavily on fossil fuels and which carry a much higher CO_2 footprint. It is expected the Biden Administration will take an aggressive approach to fossil fuel companies and other polluters. Biden has commented that he would like to see the United States on a path to achieve a 100% clean energy economy with net-zero emissions, economy wide, by no later than 2050.[3]

The municipal bond market will not be immune to some of these changes proposed by the new administration. In the municipal market there are municipal run electric power utilities that run on fossil fuels. One example would be The Los Angeles Department of Water and Power (LADWP), the largest municipal utility in the nation. Recently, LADWP announced they have committed to 100 percent renewable power by 2050. This transformation will entail transforming a coal-fired power plant to one that will run on "green" hydrogen – hydrogen produced using renewable energy.[15] Power plants that generate power for municipal run energy utilities could face higher costs to try to meet new demand by utilities needing to purchase clean power. The conversion of fossil fuel power plants into new clean power producing energy plants will come at a cost. We will monitor this sector of the muni market closely this year to see what legislation could impact these issuers. However, municipal utilities focused on water and sewer revenue continue to be one of our top positions going forward in 2021. We believe the essential service nature and the rate setting capabilities of these entities will continue to provide positive credit metrics going forward.

Municipals in 2021

COVID-19 and its impact will still be felt well into 2021. The path to economic recovery will depend on how efficiently vaccines are deployed and how quickly people revert to their living/working habits pre-COVID-19. In December 2020, Moody's outlook for US States in 2021 was still negative as the pandemic continued to hamper revenue. Moody's is predicting that many states will not recover their lost revenue from 2020 until later 2021 and some into 2022. This negative outlook, however, does not consider if states were to receive direct aid from the federal government.[10] On January 14th President Biden's proposed a $1.9 trillion plan to combat COVID-19 and boost the economy. The proposal includes an additional $350 billion in direct aid to state and local governments to help bridge any budget shortfalls. As mentioned above, this is a positive for municipal credit.

RICH MUNICIPAL VALUES...

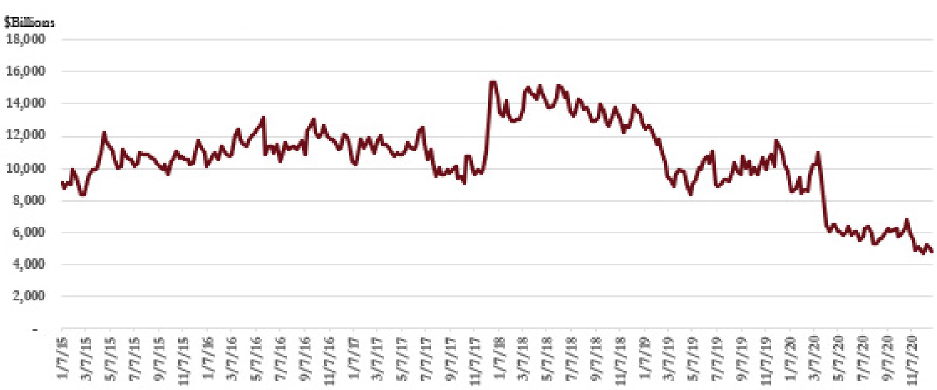
The municipal market is starting off 2021 with most of its sectors trading at or close historically rich levels. Current municipal/treasury ratios are at historic lows as seen in the chart below. (see our Market Commentary 1/7/21)

DATE	10 YR TREASURY YIELD	10 YR MUNI YIELD	RATIO
Nov. 2, 2020	0.85%	0.94%	110.6%
Jan. 22nd 2021	1.09%	0.77%	70.6%
Change	0.24%	-0.17%	-40%

DATE	30 YR TREASURY YIELD	30 YR MUNI YIELD	RATIO
Nov. 2nd 2020	1.62%	1.71%	105.6%
Jan. 22nd 2021	1.86%	1.44%	77.4%
Change	0.24%	-0.27%	-28%

Although historically rich, the market continues to outperform due to strong technical factors including continued positive municipal bond inflows, coupon and principal reinvestment in January, and a lighter than average new issue calendar. With the Georgia run-off elections concluded and the presidential inauguration complete, investors are seeking tax advantaged investments with the prospect of higher taxes under the new administration. Combine these factors along with the fact that dealers and customers have plenty of cash, municipals should continue to outperform in the short term.[9]

PRIMARY DEALER INVENTORY OF 10+YEAR MUNI'S AT RECORD LOW



**Federal Reserve Bank of New York*

Generally speaking, municipals tend to continue to perform well when dealer balance sheets are light. The lighter dealer balance sheets suggest there is a lack of secondary supply to choose from thus moving spreads tighter and driving continued performance in the marketplace. If rates were to move higher and dealer inventories were to build you would likely see cheaper bids from dealers moving spreads wider and bonds at cheaper levels. This is something we watch regularly.

CONTINUED ROBUST SUPPLY LEVELS

One technical that could change this current outperformance is supply. As we have discussed frequently, the municipal market is a supply/demand market in the purest sense. Without the ability to create synthetic tax-free municipal debt, everything that gets issued must find a beneficial owner at the market clearing price. With the expected increase in new issuance projected for 2021 along with the recent rise of treasury rates, one would expect a better entry point for investors at higher rates and cheaper ratios. In 2020, we saw a record issuance of $470 billion and 2021 looks to surpass that with some predicting as high as $518 billion in new issue supply. The five-year average stands at $427 billion. We list *(in the chart to the right)* some top dealers' new issuance projections for municipals in 2021.

($ in billions)

FIRM	TAX EXEMPT MUNI	TAXABLE MUNI	2021 TOTAL
Morgan Stanley	$300	$218	$518
Citigroup	$355	$145	$500
JP Morgan	$335	$152	$487
Barclays	$320	$110	$430
Ramirez	$327	$122	$449
Bank of America	$315	$185	$500
Average Supply Forecasts for 2021	$325	$155	$481
2020 Year End Total	$320	$150	$470

HIGHER US TREASURY RATES?

Another technical factor we are focusing on is the recent rise in treasury yields following the election. With some Wall Street firms forecasting a 10-year US Treasury yield as high as 1.75% this year, we are always cognizant of a move in treasury rates and how this change may correspond to a move in municipal yields. Municipal rates can lag treasury moves, especially in the short term, but over a longer period of time there is a correlation. A sharp spike in yields, generally around 40bps in the 10-yr US Treasury, over a short period of time, often triggers outflows, to which extent would be determined by the degree and duration of the rising rate environment. If there is a sharp sell-off in rates this year, we can expect some outflows followed by a period of underperformance in municipals. We list *(in the chart to the right)* some 10-yr US Treasury yield forecasts by some of the top dealers in the market.[7]

FIRM	10YR TREAS RATE FORECAST FOR 2021
Morgan Stanley	.80%-1.75%
Citigroup	1.45%
JP Morgan	1.15%-1.40%
Barclays	1.00%-1.50%
BofA	.90%-1.5%
Charles Schwab	.50%-1.60%
Wells Fargo Investment Institute	1.00%-1.50%

**as of January 5th 2021*

The Federal Reserve recently said that more fiscal support and the mass distribution of vaccines should lead to a strong US recovery in the second half, setting the stage for a discussion of potential tapering of bond buying before year's end. The Fed has said that any tapering of bond buying would be communicated well in advance to avoid a sharp rise in Treasury bond yields, however this is another factor to keep in mind in 2021. If the Fed were to stop bond buying at a much faster rate without any advance warning to the market, we would likely see a sharp move higher in long term rates resulting in municipal underperformance and possible outflows from mutual funds. Many investors will recall the Taper Tantrum of 2013 and the impact on interest rates.

Municipal Specific Legislation

In the Moving American Forward Act (H.R. 2 of 2020) referenced above, two municipal policy proposals are resurrected. The MAF Act recommends a return of Advance Refundings as well as the reinstatement the Build America Bond program. Both of these programs will increase municipal supply.

A reinstatement of advanced refunding would increase tax-exempt supply if rates continued to remain low. When interest rates move lower, issuers often explore refinancing their outstanding debt. Previously issued municipal bonds typically have call protections that prevent the bonds from being paid off immediately until those call protections expire. Advance refunding allows states, local governments and other eligible issuers to refinance their existing debt at the lowest possible level when market conditions permit.

A case for the reinstatement of a BAB's type program is also being floated around Congress. These are taxable bonds where the US Treasury Department pays a percentage of the interest due directly to the state or local government issuer of the bonds to directly offset the difference in the costs of borrowing on a taxable basis. A Build America Bond resurrection would increase the issuance of taxable municipal bonds, allow states and local governments access to a much larger universe of investors (foreign buyers) that want to invest in infrastructure and who typically do not receive any of the benefits of the tax advantages associated with traditional tax-exempt municipal debt.(11),12) We will be certainly be monitoring these two possibilities in the upcoming months.

Conclusion

As mentioned earlier we start 2021 with optimism surrounding the distribution of the COVID-19 vaccine. With the expected federal aid to municipalities, and a pent-up demand for tourism, travel and spending, state and local governments should see improvements to their economies. We continue to favor state/local general obligation bonds as well as essential service bonds with rate setting capabilities. Any increase in default rates should be more concentrated in the high yield sector of the muni market, such as continuing care facilities and nursing homes. Credit quality, bond structure and liquidity continue to be our focus while managing portfolios for our clients. The current risks we are most focused on are delays in availability of the vaccine, a risk that Federal fiscal stimulus is either delayed or does not pass at all, any large credit defaults, or rates moving significantly higher due to economic growth and inflation expectations. We will continue to monitor all these possible outcomes in the year ahead.

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(2) https://businessinsider.com/joe-biden-policy-positions-most-important-election-issues-2020-9
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(4) https://www.infrastructurereportcard.org/cat-item/schools/
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(6) Citi Research, Municipals December 2020
(7) Citi, Morgan Stanley, JP Morgan, Barclays, BofA Research
(8) J.P. Morgan 2021 Municipal Market Outlook November 24, 2020
(9) https://www.newyorkfed.org/markets/counterparties/primary-dealers-statistics
(10) Moody's Investor Service Outlook December 2020
(11) https://www.jdsupra.com/legalnews/recent-bipartisan-actions-to-restore-14397/
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(13) Final_Biden Transition_NABL Letter 2020
(14) The Bond Buyer
(15) https://www.governing.com/next/Americas-Largest-Municipal-Utility-Invests-from-Coal-to-Hydrogen-Power.html

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