Why structure matters in municipal bonds

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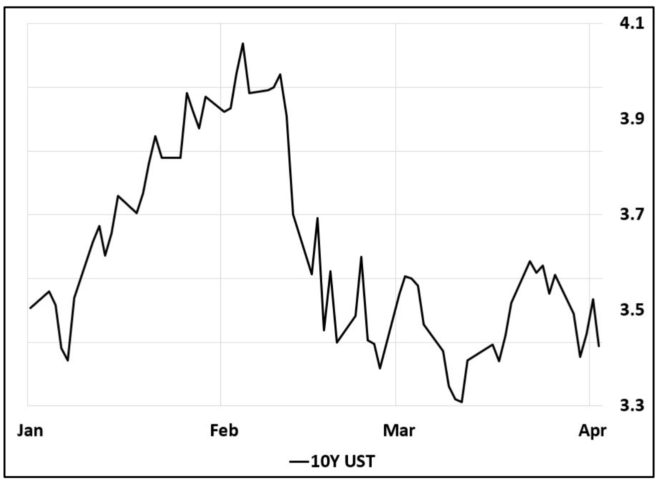
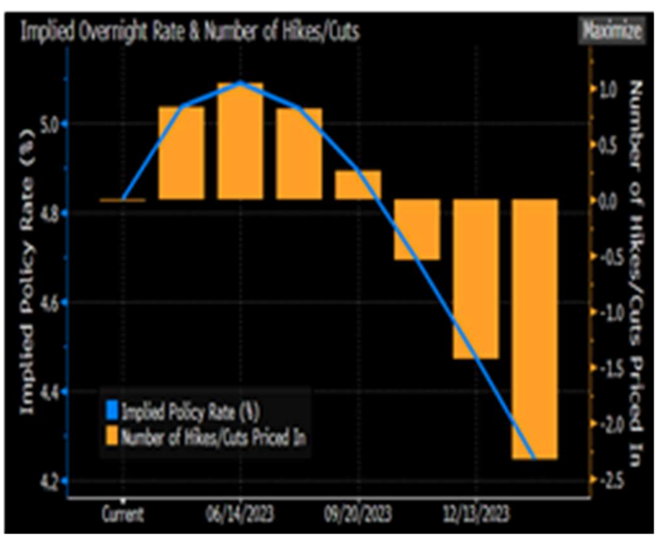
The FOMC is widely expected to hike another quarter-point this week and the market is assigning high odds of a peak terminal rate for this cycle. Lagging indicators support the consensus, but leading indicators suggest otherwise. The U.S. rates market made a bullish reversal this week and we anticipate a sentiment regime shift that may push rates significantly lower. The regional banking crisis has created a fear of contagion and yet to run its course are the effects of recent layoff announcements and tightening credit conditions. In our recent report, 'Tides do what tides do – they turn' we also note the positive seasonal environment for rates.

[1] 10Y TREASURY YIELD YEAR-TO-DATE 2023



Source: Bloomberg as of April 29, 2023

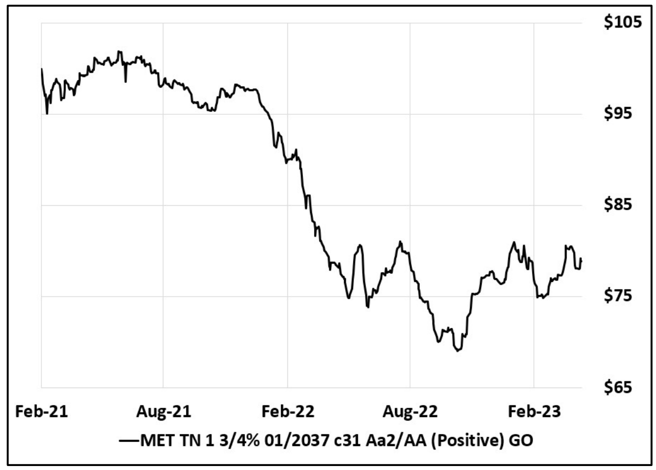
[2] IMPLIED OVERNIGHT RATE & NUMBER OF HIKES/CUTS



Source: Bloomberg as of April 29, 2023

Rumors of a 'failed auction' SVB/Signature Bank municipal portfolio ran through the market late Friday. The $7b+ portfolio was said to have been shopped privately with no-bidders. The holdings consist of structure not credit risk, which likely will require deep concession relative to 'evals' given liquidity and U.S. de minimis tax risk.

[3] SVB LARGEST SINGLE TAX-EXEMPT MUNI POSITION



Source: Bloomberg as of April 29, 2023

Today's backdrop does not lend itself to a sale without knock-on regulatory benefits in terms of clearing the SVB/Signature Bank portfolio. Uncertainty of today's backdrop only got worse over the weekend with First Republic Bank (FRC). FRC is one of the largest bank holders of municipal bonds. Successful liquidation of this magnitude warrants patience, deep access to a global pool of capital, more granular reach across the entire regional municipal market, and a commitment to a more strategic implementation of individual line-item sales as opposed to all or nothing. We do not believe there is an all or nothing buyer out there. There is a narrow buyer base for these bonds and there is a need to *think outside the box* to achieve the desired outcome.

SVB/Signature Bank presents an opportunity for the global fixed-income buyer to focus on tax-exempt municipals in addition to taxable municipals as mentioned in our most recent regulatory capital special report. If these tax-exempt structures trade, they are likely to do so at yields similar to or higher than their taxable equivalents and corporate bonds. The holdings provide supply into the market at a time of low issuance and higher rates. Tax-exempts at corporate equivalent yields should be a compelling opportunity for hold-to-maturity investors. Many of the issuers in the portfolio also do not issue taxable municipal bonds, which provides investors with an opportunity to diversify credit.

Think outside the box also includes reverse inquiry into municipalities who issued the bonds. These municipalities should consider buying back their debt. If the securities trade at a deep discount, it may create a compelling opportunity for municipalities to work around the advance refunding restrictions, if applicable. More interesting, municipalities can buy back their debt at a deep discount and issue new debt at prevailing market structures to lower interest expense and savings. The Federal government instead of potentially looking to give out knock-on regulatory benefits should incentivize municipalities with rich reserves to use COVID relief funds that were never used or repaid.

Basel III regulation has contributed to banks yield-seeking behavior and exposing them to liquidity risk in times of stress. Basel III assigns a preferential risk weight of 20% for all general obligation (GO) municipal bonds (50% for revenue bonds), regardless if a security is investment or speculative grade, or even unrated and uninsured. Moreover, regulation also treats municipal bonds as a safe asset class in terms of both credit risk weights and liquidity regulation. SVB/Signature Bank is a structure/liquidity problem not duration or credit.

Why do banks own tax-exempt municipal bonds in the first place? In Section 265(b)(7) of the regulatory code for banks there is what's called a '2% de minis rule' which permits financial institutions to deduct 100% of the cost of buying and carrying tax-exempt bonds (even if not classified as bank qualified bonds) to the extent their tax-exempt holdings do not exceed 2% of their assets. Interest on the bonds is a 'financial institution preference item' under Section 291 which means that 20% of the interest expense allocable to such bonds is nondeductible.

What is a BQ bond? Bank-Qualified (BQ) bonds were created in 1986 to encourage banks to invest in tax-exempt bonds from smaller, less-frequent municipal bond issuers, and to provide municipalities with access to lower cost borrowing. Municipalities issuing $30M or less per year can designate those bonds as bank-qualified, which allows them to bypass the traditional underwriting system and sell their tax-exempt bonds directly to local banks. SVB/Signature Bank has some exposure to BQ bonds.

Why structure matters in municipal bonds. The tax-exempt municipal market is largely driven by yield-seeking investors and products tend to be passive rather than total return by design. Yield-seeking investors often reach in the form of discount coupon structures more than credit risk. This has compounding liquidity effects as discount coupons are more sensitive to hitting 'the de minimis threshold', after which they gap in price due to a change in tax treatment. The U.S. de minimis tax rule defines when a municipal bond is taxed at the capital gains rate rather than as ordinary income. Consequences extend beyond tax-risk as the pool of liquidity providers often contracts more than at the onset. The majority of bonds held by SVB/Signature Bank are 3% coupons and lower, all of which are subject to de minimis at current interest rate levels, hence the smaller buyer base of U.S. tax payers. The 5% coupon is prevalent in the market for good reason, 4% coupon is second, and anything below is the wild west in terms of liquidity risk. Please visit our website, Fall of 2020 'Understanding Market Discount and De Minimis.' Again, credit and duration risk are not the issue for SVB/Signature Bank, liquidity however is by having stretched for yield via discount coupons.

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16Rock is a full-service asset management firm specializing in U.S. Municipal Bonds with a global perspective. We cater to the modern needs of institutions and high-net-worth individuals around the world. Our passion is to help clients translate their desires and aspirations into sophisticated outcomes that exude order. Our team leverages decades of experience to construct highly curated portfolios. We offer tailored managed account solutions, transition management services, and through our alternative investment capabilities, products designed to deliver absolute return excellence.