Quarterly Municipal Market Review and Outlook

August 2020

CLINTON INVESTMENT MANAGEMENT

SUMMARY

- **The Federal reserve cut rates to zero and began unlimited purchases of US government securities, instituting the next phase of Quantitative Easing**
- **The municipal bond market recovered dramatically from the liquidity induced drawdown of March and April.**
- **The Bloomberg Barclays Municipal Bond Index returned +12.6%, from the high in municipal yields on 3/21/20 to 7/31/20 while our municipal Market Duration and Credit Opportunities strategies returned +13.5% and +16.1% respectively over the same period**
- **A Biden presidency would materially increase the relative attractiveness of tax-free income municipal bonds**
- **Absolute, tax-free yields on municipal bonds are currently more than 100% of the yield of "taxable" bonds across the entire curve**

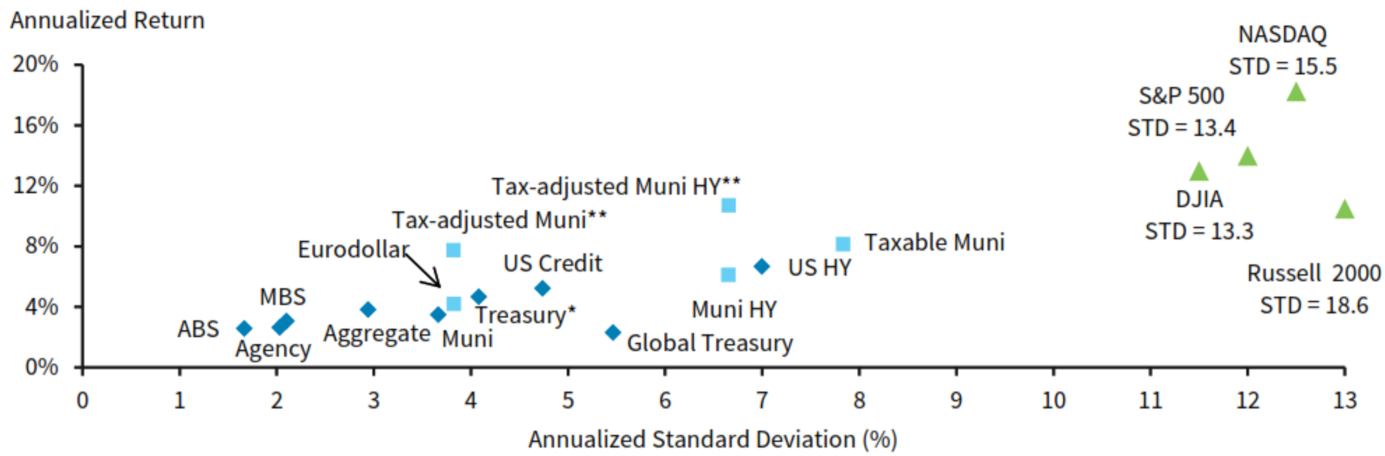
It may be the understatement of the century to say that the global spread of COVID-19 has created chaos and collateral damage like no other event in our lifetimes. Truly extraordinary actions were required by the Federal Reserve, together with trillions of stimulus dollars provided by the Federal government, to stabilize financial markets. We have witnessed a truly remarkable recovery of asset values since the nadir of the health crisis. This recovery has occurred while the US economy probes the depths of one of the severest recessions our country has ever seen. We witnessed a contraction of -32.9% in the annual rate of US GDP growth during the second quarter, the greatest contraction in GDP growth in our nation's history. The spread of the virus has truly tested the limits of governments, corporations, municipalities, and individuals alike. Interest rates plunged as the Federal reserve cut rates to the zero bound, once again, and began unlimited purchases of US government securities, instituting the next phase of Quantitative Easing. They took this action to mitigate the economic damage from the nationwide shutdowns. Corporations sought to cope with an almost total seizure in economic activity by laying off millions of American workers causing the unemployment rate to surge more than fourfold. The extraordinary measures taken by the Fed enabled markets to begin healing as regional economies began to reopen. The strength of the recovery gathered momentum as the quarter progressed. However, corporations continue to struggle with the new reality of dramatically slower growth, severely diminished consumer demand, and a correspondingly weak job market. Unfortunately, we expect these conditions to persist for years to come.

The municipal bond market recovered dramatically as well from the liquidity induced drawdown of March and April. Throughout the stay-at-home orders, investors came to recognize and truly appreciate the essential nature of the services municipalities provide. The extremely attractive absolute and tax-free yields, resulting from the recent liquidity driven selloff, compelled investors to return to the relative safety of municipals bonds. May and June performance, for the municipal bond market, was particularly strong as investors rushed back into municipal bonds to take advantage of one of the most incredible municipal bond investment opportunities since the Great Recession of 2008/09. To illustrate the degree of recovery that the municipal bond market has enjoyed, the Bloomberg Barclays Municipal Bond Index returned +12.6%, from the high in municipal yields on 3/21/20 to 7/31/20. Many of our clients added to their allocations in our strategies, given the more opportunistic and tactical nature of our investment philosophy and process. Our municipal Market Duration and Credit Opportunities strategies returned over +13.5% and +16.1% respectively, over the same period. While the recovery in municipal bonds was dramatic, the municipal bond market remains dislocated relative to Corporate and Treasury bonds and munis poised to outperform going forward in our view.

Municipal bonds continue to be one of the best performing asset classes on taxable equivalent and risk-adjusted basis, see Figure 1.

Figure 1

Taxable Equivalent Returns for the Past 10 Years, Ending June 30, 2020



* US Treasury income is exempt from state income taxes and is adjusted using a national state average (top bracket), net of federal income tax. ** Based on an equally weighted national average federal and state (top bracket) income tax rate; local taxes have not been considered.
Source: Bloomberg, Bloomberg Barclays Indices, Barclays Research

We believe the best opportunities in the municipal bond market can now be found in lower investment grade bonds. Absolute yields for AAA and AA rated municipal bonds are now below 0.20%, for maturities less than five years. These yields are simply not compelling for long-term investors in our view. The significant dislocation that recent market volatility has created continues to present attractive investment opportunities allowing us to capitalize on fast changing market dynamics. This environment is ideally suited to our firm's total return orientation as we continue to identify undervalued issuers and take advantage of significant structural mis-pricings.

As the third quarter draws to a close and we look toward year-end, we anticipate the US Presidential election will take center stage. Vice President Joe Biden holds a meaningful lead in the poles over President Trump, however, his lead is narrowing, according to the most recent data. Biden has spoken openly, throughout his campaign, about his intentions to roll back the Trump tax cuts, which have had a material positive impact on the economy and the equity market performance over the last few years. Biden has also been outspoken about his desire to raise taxes on the wealthy in addition to raising capital gains and equity dividend tax rates to ordinary income tax levels. It is our view, therefore, that a Biden presidency would materially increase the relative attractiveness of the tax-free income that municipal bonds deliver. We expect investor demand would increase significantly. Given the limited supply of municipal bonds, the increased demand would likely result in materially higher bond valuations. It is evident that the possibility of this outcome is not currently reflected in municipal bond prices, however, as the absolute, tax-free, nominal yields of municipal bonds are currently higher than the yield of "taxable" bonds across the entire curve. This is a rare occurrence and speaks to the broader attractiveness of the municipal bond market. Considering the relative safety of municipal bonds, over the course of history, we believe the environment is ideal for investors seeking to increase yield in light of the elevated risk of much higher tax rates in the future and the likelihood of municipal bond yields falling further.

If you should have any questions regarding the content above or the municipal bond market more broadly please do not hesitate to contact us directly.

Important Disclosure Information

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