BBH Tax-Exempt Fixed Income

Quarterly Strategy Update / 2Q 2020

Keep Your Guard Up

Financial markets recovered dramatically during the second quarter with riskier assets leading the way, as winners and losers from the first quarter switched places. We found this juxtaposition ironic given the rising trajectory of U.S. coronavirus infections and the economic uncertainties it is creating. While the official response of "throwing money at it" has strengthened markets and offset some lost incomes in the short-term, what happens next is anyone's guess. Along with more expensive valuations comes a thinner margin for error. Our natural response when facing rising risks and declining compensation is to remain defensive and keep our guard up.

While many investors may be rejoicing their short-term returns, we know all too well how rapidly conditions and sentiment can change. Most recently in March, 60 consecutive weeks of inflows into Municipal mutual funds turned into turmoil and record outflows in just two weeks. Only with time and the benefit of hindsight will we be able to judge the reopening of the American economy and the sustainability of its recovery. We know that reopening does not equal the resumption of normal economic activity, and we suspect that our service-based economy will struggle with social-distancing.

With a return of over 20%, the S&P 500 almost recovered its first quarter losses while Investment-Grade Corporates generated nearly 10%. Following their stellar 9% performance during the first quarter, U.S. Treasuries returned a mere 20 basis points[1] during the second quarter. Municipals fared better than Treasuries but were slower to recover as well with net mutual fund flows not turning positive until May. Amid stable Treasuries, Municipal yields fell 60 to 80 basis points in 2- to 5-year maturities and about 40 basis points for 10-year and longer maturities. For the quarter, intermediate-maturity Municipals generated a return of 2.7%, bringing the year-to-date total to 2.1%. Even with the late-quarter rally in credit-sensitive bonds, lower-rated securities continue to lag significantly year-to-date.

Performance By Credit Grade (%)

	2020		
	June	2Q	YTD
AAA	0.03	2.86	3.42
AA	0.38	2.69	2.73
A	1.49	2.7	1.36
BBB	3.28	2.79	-2.05
Lower than BBB	3.96	4.55	-2.64

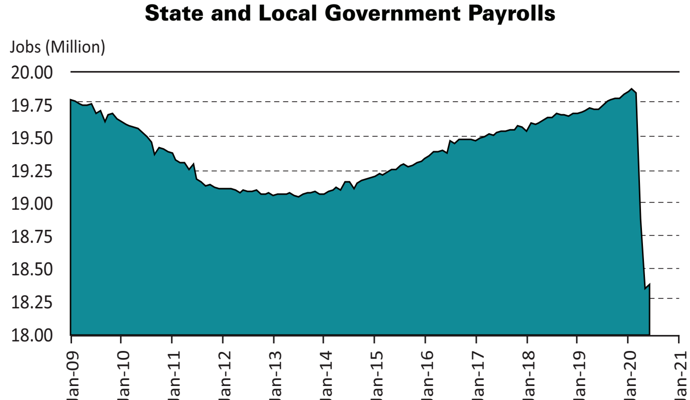
Sources: Bloomberg and BBH Analysis

As Municipals recovered, so did their yield ratios versus Treasuries. The first quarter witnessed the largest disconnect ever between Municipals and Treasuries. During the second quarter, the 2-year ratio declined from 420% to 180%, while the 10-year ratio fell from 200% to 140%. Despite the large decline, these ratios are still historically high and likely to compress further. However, we do not expect ratios to fully mean-revert to their long-term averages for the simple reason that the lower the yield, the lower the tax value of municipal income. Said differently, at very low yield levels, the better liquidity and quality of Treasuries become a bigger part of the equation.

Municipal and Investment-Grade Corporate bonds suffered their worst month of relative performance versus Treasuries in March. During April, Corporates recovered about half their losses and continued to perform well for the rest of the quarter. In contrast, Municipals continued their underperformance in April before bouncing back in May. We attribute this delayed response in Municipals to the extreme divisiveness in Washington and much-less-robust Federal Reserve (Fed) support measures than those implemented in the major taxable bond sectors.

Early in the quarter, Senate majority leader McConnell stoked fear in the household-dominated Municipal market by suggesting that states should be enabled to file for bankruptcy. The last time the concept of state bankruptcy was floated was following the Great Financial Crisis (GFC). Lawmakers quickly shutdown the idea. Today, as then, enabling states to file for bankruptcy would entail enormous hurdles, likely including a constitutional amendment which would require supermajority votes in the House and Senate along with ratification of three-quarters of states. Unfortunately, the ongoing politicization of a future aid package for states is all too real.

State and Local Government Payrolls



Data reported monthly from January 31, 2009 to June 30, 2020
Sources: Bureau of Labor Statistics and BBH Analysis

States have been on the front line in fighting the virus, incurring billions in non-budgeted expenses. Additionally, states are facing significant revenue shortfalls from the rapid and deep decline in

[1] Basis point is a unit that is equal to 1/100th of 1% and is used to denote the change in price or yield of a financial instrument

economic activity. In total, states are estimated to have an aggregate $500 billion budget shortfall, or roughly 25% of total budgets. If federal aid is ultimately withheld, the likely results would include cuts to healthcare, education, infrastructure projects, and massive layoffs – all of which would work directly against federal stimulus measures. These cuts and layoffs have already begun.

In facing the current pandemic, the Fed has re-opened its GFC-playbook and then went beyond it. In addition to bringing its target rate down to near zero, the Fed jump-started a new open-ended quantitative easing program – growing its balance sheet from $4 trillion to $7 trillion since Mid-March. The Fed has also introduced a host of other facilities.

Federal Reserve Facilities: Loans Outstanding

	Maximum Amount Authorized ($ Bil)	Total Loans Outstanding ($ Bil)
Commercial Paper Funding Facility	-	4.3
Main Street Lending Program	600	0.0
Money Market Mutual Fund Liquidity Facility	-	23.5
Municipal Liquidity Facility	500	1.2
Paycheck Protection Program Liquidity Facility	659	59.4
Primary Dealer Credit Facility	-	4.0
Corporate Credit Facility	750	8.7
Term Asset-Backed Securities Loan Facility	100	0.0

Data as of June 30, 2020
Sources: Federal Reserve and BBH Analysis

In the Money Market Mutual Fund Liquidity Facility (MMFLF), the Fed lends to banks supporting their money market funds, accepting a range of collateral including Treasuries, commercial paper, and municipal variable-rate demand notes. During March, liquidity problems in prime and Municipal mutual money market funds led to a spike in ultrashort-term tax-exempt yields. As evidence of the stress, top-rated 1-week Municipal paper started the second quarter with a yield of 4.7%. Once enacted, the MMFLF quickly stabilized the money markets with ultrashort-term Municipal rates falling to below 0.25%.

Investors had high hopes when the Fed formulated its Municipal Liquidity Facility (MLF). At a maximum authorized amount of $500 billion, the size of the program appeared to offer an effective bridge for lost revenues during the crisis. Investor hope broadly waned as use of the program entailed meaningful penalty rates. We view this program as consistent with the Fed mandate as lender of last resort. When compared with the Fed's support for Corporate bonds, which is 50% larger and conducted through secondary market purchases, the MLF appears relatively weak.

Despite a two-week pause, Municipal new issuance ended the first half of 2020 at over $200 billion, more than 15% ahead of last year's pace. On the surface, this looks positive; however, we must recognize that roughly one-fourth of this year's issuance was taxable. The Municipal market continues to feel the strong after-effects of 2017's tax reform that eliminated tax-exempt advanced refundings. Consequently, a significant portion of refinancing activity has been occurring in taxable bonds. This has left 2020's year-to-date tax-exempt supply similar to that of last year and barely adequate for reinvestment demand.

MLF vs. Open Market Spreads

Rating	Spread (basis points)
AAA/Aaa	150
AA+/Aa1	170
AA/Aa2	175
AA-/Aa3	190
A+/A1	240
A/A2	250
A-/A3	265
BBB+/Baa1	325
BBB/Baa2	340
BBB-/Baa3	380
Below Investment Grade	590

Sources: Federal Reserve and BBH Analysis

When the new issue market did reopen early in the second quarter, significant concessions existed for bonds with non-standard coupons, such as zero's or low coupon bonds, and also for issuers in sectors more directly impacted by the crisis, such as healthcare and transportation. Lastly, issuance in smaller, less liquid sectors such as State Housing Finance Authorities (HFA) were also priced to clear easily. By quarter-end, new issue dynamics were similar to that which existed pre-crisis, with tighter spreads and heavy over-subscriptions.

We had a busy quarter participating in a range of new issues. A Hermiston School District in Oregon and Glendale Community College District in California were two such zero-coupon issues that offered over 100 basis points of spread for intermediate to longer maturities. We also participated heavily in a range of maturities in a new issue for Northshore University Health, affiliated with the University of Chicago. Spreads ranged from 80 to 120 basis points for the new deal, about double their prevailing spreads pre-COVID-19. Mid-quarter, Connecticut issued bonds backed by an assortment of state-level transportation-related taxes and fees. Even with the slowdown in economic activity, these bonds offered well over two-times coverage relative to their maximum annual debt service. Despite their strong protection, the bonds offered over 100 basis points of spread. We have been a long-time holder of this credit and added to our position in the new issue. Lastly, we participated in new issues for North Carolina and Nebraska HFAs, among others. They both offered spreads in the 100-to-120 basis point range.

We also leaned into a number of secondary market opportunities including the Metropolitan Transportation Authority (MTA) and New Jersey Transportation Authority. The MTA provides critical mass transit services to the New York City area and experienced upwards of a 95% decline in its ridership following the onset of the crisis. MTA has also incurred heavy costs related to worker illness and virus-related cleaning costs. Maintaining market access and liquidity are two very important aspects of the MTA's credit. As the nation's largest mass transit system, the MTA requested, and received, $4 billion in Coronavirus Aid, Relief, and Economic Security (CARES) Act funding and is eligible for Federal Emergency Management Act (FEMA) payments. MTA also continues to enjoy strong support from the state of New York. To help see the MTA through this difficult period, New York State recently established an internal 3-year term $10 billion lending facility, dedicated all statewide internet sales taxes, and agreed to contribute $3 billion to the MTA's capital budget for the next two fiscal years, mirroring an identical grant by New York City. New York State also enabled the MTA to borrow from the Fed's MLF, if necessary. These measures, as well as MTA's own liquidity raise, which included the sale of its former mid-town headquarters for $1 billion, should provide a more-than-ample bridge through the crisis. The two-year maturity bonds we purchased yielded over 4%.

Along with New York, New Jersey was hit hard in the early stage of the crisis. Heading into the pandemic, New Jersey had been making steady progress to bolster its financial position. The largest credit variable in New Jersey relates to its pension, and the state's willingness to make its full annual payments. Pension holidays and other skipped payments had led to numerous downgrades under the watch of former administrations. Currently, the state is entering year 8 out of 10 in stepping up to its full annual pension contributions and both the Governor and legislature are committed to staying on track. Importantly, during the recent past, New Jersey has dedicated its net state lottery revenue to its pension for 30 years and also passed a law requiring quarterly pension contributions. Prior to this, the payment was typically made on the last day of the fiscal year, which made it easy to skip or reduce in the face of a budget imbalance. The bonds we purchased yielded over 4% and are backed by an assortment of constitutionally-dedicated transportation-related revenues, which, like those in Connecticut, offer greater than 2-times coverage.

Over the first half of the year, we have had the equivalent of a full credit cycle in Municipals and we are proud that we ended June with above-benchmark performance and in a strong position relative to our peers. We face more uncertainties today than we have in decades. None of us had invested through a pandemic in which a wide swath of the country was told to stay at home. We are struck by the dichotomy presented between ebullient financial markets and a challenged fundamental backdrop that continues to worsen, the deepening partisan divide, record Treasury issuance to fund the record stimulus, and the unfortunate need to again flatten the coronavirus infection curve. Although progress is being made on an effective therapy and potential vaccines, the human and financial costs of a delay are growing rapidly. Today, we face a historically wide range of potential future outcomes. The goal for us, as always, is to protect against things going wrong along the way. Owning durable credits[2] has never been more important.

Thank you and stay well.

Sincerely,

Gregory S. Steier
Portfolio Manager

[2] Obligations such as bonds, notes, loans, leases, and other forms of indebtedness, except for cash and cash equivalents, issued by obligors other than the U.S. Government and its agencies, totaled at the level of the ultimate obligor or guarantor of the Obligation.

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