Maple Capital Management

Fixed Income Commentary

February 4, 2020

KEY TAKEAWAYS

Bond yields declined in January as investors assessed the impact of the coronavirus on the global economy. The rally drove Treasury yields lower by 26 basis points on the 2 year Treasury and 41 basis points on the 10 year Treasury. Spreads on corporate bonds and mortgage-backed securities widened modestly as often happens during a flight to quality, but municipal bonds performed more in line with Treasuries since investor demand has remained quite strong.

Key Rates (%)	Jan 31 2020	Dec 31 2019	Dec 31 2018
Treasury Yields			
2 Year	1.31	1.57	2.49
5 Year	1.31	1.69	2.51
10 Year	1.51	1.92	2.68
30 Year	2.00	2.39	3.01
Credit Yields			
BBB Industrial 10 Year	2.72	3.10	4.35
Muni Yields			
AAA 10 Year	1.18	1.48	2.32
Mortgage Backed Securities			
30 Year FNMA Current Coupon	2.38	2.71	3.50

JANUARY IN REVIEW

- The 10- year Treasury yield finished the month with a yield of 1.51%, down 41 bps month over month.
- Munis were up 1.80% on very strong demand.
- High yield was up 0.03%.

Microscope on Municipals

Bond yields declined in January as investors assessed the impact of the coronavirus on the global economy. The rally drove Treasury yields lower by 26 basis points on the 2 year Treasury and 41 basis points on the 10 year Treasury. Spreads on corporate bonds and mortgage-backed securities widened modestly as often happens during a flight to quality, but municipal bonds held up well as investor demand remains strong. Given this clamor for munis, we thought our readers would find a brief perusal of credit fundamentals for the sector to be both timely and useful. The muni sector is very resilient (this bond investor's favorite trait), but is the sector prepared for the next recession? We think the story is a good one.

Municipal Market Overview

The $3.8 trillion "muni" market was on fire last year as individuals plowed more money into muni mutual funds than the previous five years combined! Since the implementation of the Tax Cut and Jobs Act (TCJA) in 2017, tax-exempt bonds are one of the few remaining avenues to reduce tax burdens for individuals, driving strong demand for the muni sector and pushing valuations to rich levels.

State and local tax collections in the most recent quarter of available data, the third quarter of 2019, were up 6.6% over the same period in 2018, the 13th quarter of consecutive growth (and the 36th quarter of growth in the last 40 quarters). Importantly, all four tax components recorded increases: individual income taxes rose 6%, corporate taxes rose 17.1%, property taxes were up 3.9%, and sales taxes rose 9.5%. Individual income and sales taxes are the primary sources of revenue for states (with some exceptions), while property taxes are the primary source for local governments.

A recent report from Fitch Ratings stated "…the vast majority of state and local governments" are prepared for the next recession. Fitch's average rating for the sector is AA+ and approximately 96% of local government rating outlooks are stable. Only 3 states are rated below the 'AA' category (CT, IL, and NJ) and 80% of local governments are rated in the top two rating categories (AAA and AA).

Moody's also issued a report indicating "most of the largest 25 cities in the US are prepared to handle a recession of similar magnitude to the previous downturn without a material adverse impact." They found that 6 of these cities are stronger and two are weaker (Detroit and Chicago), while the rest show moderate preparedness. Of the key factors examined by Moody's, pension risk remains the top concern, but pensions are a long-term issue that generally do not pose near-term solvency risk for a taxing authority.

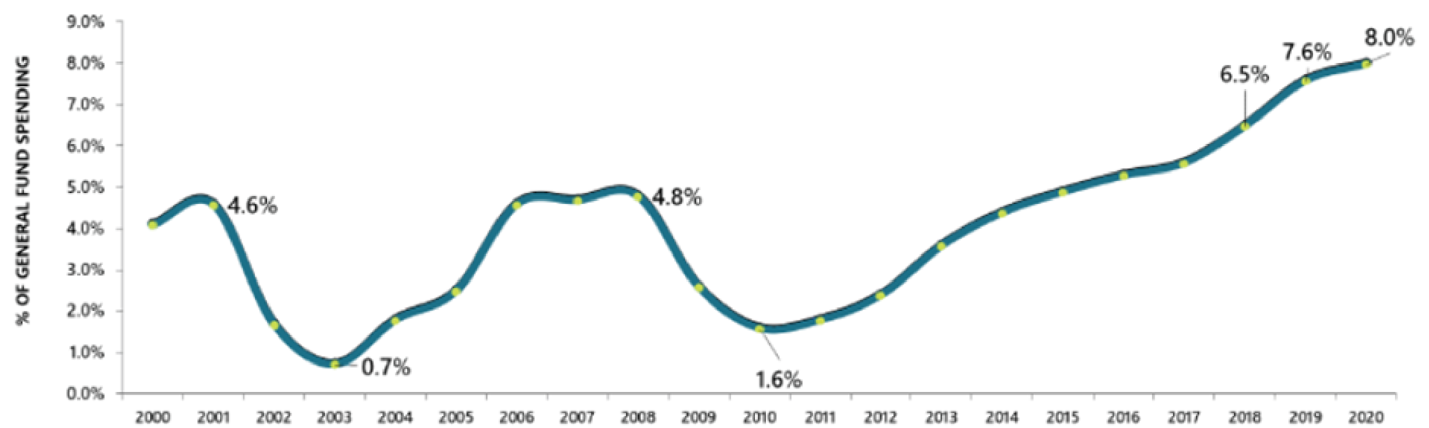
While most of us are familiar with various challenges faced by our local governments such as the homeless situation or police/fire/teacher pay issues, the sector remains resilient due to its ability to adapt by raising taxes and fees, cutting expenses, and changing practices to create efficiencies. Significant challenges remain --- such as finding adequate sources of revenue to pay for badly needed infrastructure improvements --- but the sector has proven to be resourceful in finding new sources of revenue and most of the problems are long-term in nature. Recent examples of new revenue sources include the legalization of marijuana, gambling and/or sports betting, and taxation of out-of-state online retailers (28 states did so last year). It's interesting to note that no state is raising individual income or corporate income tax rates this year, mainly because most are already benefiting from a healthy economy and these new sources of revenue.

States' rainy day funds have also proliferated and grown consistently during these good times as shown in the chart in **Exhibit 1**. Even Connecticut, which has a serious pension underfunding problem, is projecting its rainy day fund to reach $3B by June 2021 (which would be the statutory maximum, or 15% of appropriations). On the other coast, California's recent budget projection is anticipating a $19.2B add to its rainy day fund and its 7th surplus in 8 years.

The muni sector encompasses thousands of diverse borrowers and we do not mean to suggest there are no problem issuers --- there are plenty. Still, the sector's resilience is proven and most of the issuers are well-positioned for the challenges ahead. We exercise great care in our investment process and we continue to find many sound borrowers across the country for our client portfolios.

We hope you found this update on the municipal sector to be helpful and take comfort in the credit worthiness of your municipal bonds should anything disrupt this record-long economic expansion.

EXHIBIT 1: Median Rainy Day Fund Balance—Fiscal 2000 to Fiscal 2020



Source: *Recession Readiness*, PFM Group Consulting LLC, January 2020

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