PORTFOLIO INSIGHTS

Municipal Bond Views

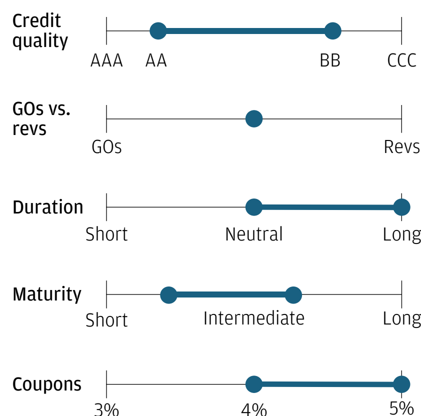
Themes and implications for 4Q 2020

AUTHORS

Richard D. Taormina
Portfolio Manager,
Head of Tax Aware Strategies

Margaret Byrne
Senior Fixed Income Specialist,
Global Fixed Income, Currency
& Commodities

OUR CURRENT MUNI BOND POSITIONING



Source: J.P. Morgan Asset Management; views as of November 17, 2020.

IN BRIEF

- Continued uncertainty moving into year-end is creating imbalances and opportunities.
- We expect record 2020 supply with heavy issuance of taxable municipals in particular.
- Moderate tax-exempt supply and significant issuer call activity have provided a strong technical tailwind for tax exempts.
- Election results are likely to influence the levels of fiscal support to municipalities, however the recent increase in COVID-19 cases may spur Congress to take a more unified approach to maintain economic momentum. Longer term, tax increases may inevitably be necessary to tackle the growing deficits at both the federal and state levels.
- Some municipal bond subsectors that suffered particularly acute price erosion with the initial uncertainty around COVID-19 appear attractive to us.
- What investors may want to consider: moving away from cash, taking advantage of heavier issuance and selectively adding credit.

UNCERTAINTIES, IMBALANCES—AND OPPORTUNITIES

Municipal markets have largely recovered from the initial COVID-19 shock (**EXHIBITS 1A** and **1B**). As we move into the final weeks of 2020 there has been a backup in rates and some spread tightening given very hopeful news on the vaccine front. Yet, uncertainties around the timing of the vaccine and political support for municipalities persist, as do budgetary imbalances. We believe that such uncertainties and imbalances—when paired with critical analysis of credits—can lead to investment opportunity. In this Q&A, **Margaret Byrne**, Senior Fixed Income Specialist, discusses the state of the market, potential opportunities and current portfolio positioning with Portfolio Manager and Head of Tax-Aware Strategies **Richard Taormina**.

MARGARET BYRNE: This year has been especially challenging—to say the least—and now we are navigating the post-election uncertainties and the global increase in COVID-19 cases. What are you seeing in the municipal markets?

RICHARD TAORMINA: The election is likely to have a meaningful impact on longer-term Federal support for states and their municipal subdivisions as well as on tax burdens and, as a result, valuations.

In September and October, we saw supply spike as issuers priced into the market to get ahead of any election uncertainty, realizing that the winners might not be clear immediately.

Ratios have largely recovered from the extreme stress felt across the entire municipal market

EXHIBIT 1A: 10-YEAR AAA MUNI/TREASURY RATIO

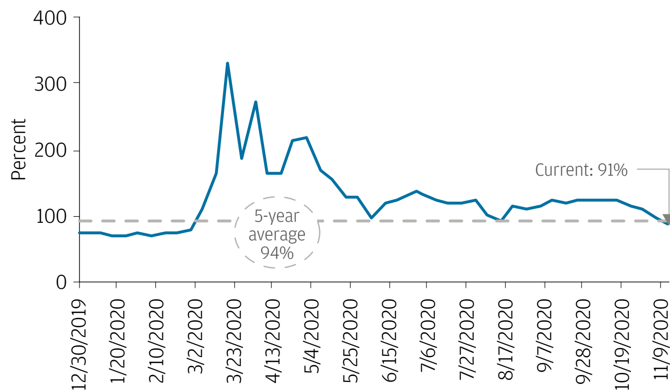
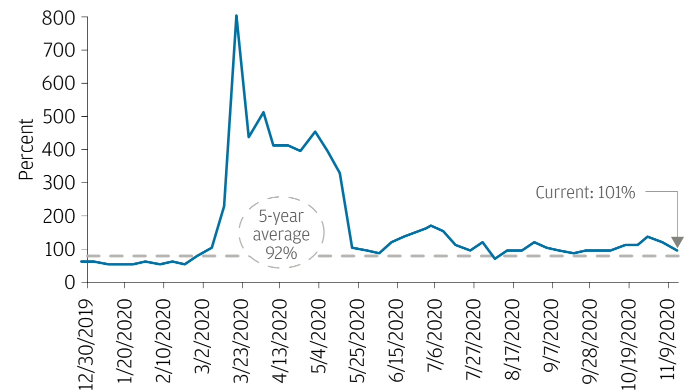


EXHIBIT 1B: 2-YEAR MUNI/TREASURY RATIO



Source: The Municipal Market Monitor (TM3); data as of November 13, 2020.

The year 2020 is bringing record-breaking supply—which we expect to total $490 billion. Historically low rates are driving refundings—as we've seen in most low interest rate cycles. What's different this time is that much of this supply is taxable—a response to the prohibition on tax-exempt advance refundings in late 2017.[1] We expect taxable supply to exceed well over one-third of total supply, meaningfully above the 9% average for 2011 through 2018.

MB: And what do you anticipate beyond 2020?

RT: We expect demand for both taxable and tax-exempt issues to continue growing strongly into 2021. Robust taxable issuance has drawn solid demand from non-traditional municipal buyers both onshore and offshore; we see that demand and healthy issuance continuing. At the same time, tax exempts have benefited from flat supply and continued strong demand from taxpayers. Supply could pick up to fund infrastructure projects or, in the absence of a big stimulus package, to help smooth budgetary gaps. In fact, this week (the week of November 16) one large issuer is selling $4 billion of COVID-19 general obligation bonds to address budgetary gaps. A divided Congress, however, would make it more likely that tax-exempt advance refundings will continue to be prohibited, in which case overall tax-exempt supply would likely remain contained.

[1] The Tax Cuts and Jobs Act of 2017 eliminated the ability of governments to issue tax-exempt advance refunding bonds (which had made up as much as 40% of issuance). As rates fell, issuing taxable municipals, still permitted for advance refunding, became an attractive refunding alternative.

MB: Let's turn to the pandemic. Back in March, COVID-19 essentially shuttered the U.S. economy, severely impairing state and local revenues. Fortunately, Congress (and the Federal Reserve) stepped in. How are states and municipalities faring today?

RT: Year to date, the relative fiscal impact has been less damaging than expected—though the results vary across and within geographies and sectors. We know a lot more about the virus—in terms of transmission, prevention, and care—and recent vaccine trials are extremely encouraging. Areas of the country will open up and pull back at times, especially now with another strong wave of COVID cases, but we don't expect another *full* shutdown.

On the credit side, unless we see significant economic pullback from the recent rise in cases, we do not expect Congress to pass a multi-trillion-dollar stimulus package. Municipal credits are still struggling to handle the revenue decline from COVID-19. The CARES Act directly addressed the increase in expenses due to the pandemic, but its revenue impact was less direct, largely through its support of consumer spending. Without a comprehensive package, including aid to municipal issuers, states will take steps to balance budgets with a combination of cuts, including furloughs, and higher taxes.

MB: What might that mean for credit ratings?

RT: We expect more rating agency activity—downgrades and changes to outlooks—as state and local governments grapple with the revenue declines. *We do not expect any significant*

increase in default rates. State and local governments have recently benefited from a much needed rebound in tax receipts following a precipitous shutdown-induced decline. Remember that coming into the recession, municipal issuers were disciplined; record rainy day funds and conservative management helped keep leverage in check and debt levels low, though pensions may be problematic longer term.

MB: Can you discuss a few subsectors you are focusing on now?

RT: Certain municipal bond subsectors suffered severe price erosion early in 2020; investors feared the potential consequences of COVID-19 on financial operations. These sectors have since experienced price recovery and discovery as the market realized that the credit impact had been exaggerated.

Take senior living: Despite recent price volatility, we believe senior living bonds are supported by strong fundamentals driven by the nation's aging population. Senior living facilities offer a communal option, often with generous amenities and services and a backstop of health care, if needed. Unlike nursing homes, these are primarily private-pay independent and assisted residences that provide reliable revenues not exposed to Medicare and Medicaid rates. The bonds are typically supported by solid collateral, a direct revenue pledge and strong covenants.

We also like charter schools: When COVID-19 shut down schools across the country in March, many charter schools adapted quickly to remote learning and, in some cases, provided a framework for other public schools. This strong response, especially for high-performing institutions, translated to increased enrollment. Charter schools offer parents a unique alternative to traditional public schools and are held accountable by their states for producing positive educational outcomes. During the shutdown, charter schools generally performed very well financially, benefiting from operational expense savings as well as increased revenues from state grants, federal CARES Act funding and Paycheck Protection Program loans.

MB: Given this backdrop what should investors do?

RT: While a high degree of uncertainty still remains, I would offer the following for consideration:

1. Supply was elevated prior to the election, but is manageable heading into year-end. Investors should participate ahead of any tax policy changes at the federal or state level.
2. Focus on after tax yield. This is crucial now and will be even more important as tax rates move higher.
3. Cash is not the place to be. The previous 0% rate cycle lasted longer than anticipated. Examine opportunities in the ultra-short space through a fund or ETF, and look at longer duration investment grade and high yield strategies. The curve is historically steep—we like 5- to 15-year maturities, which can offer a better roll down the curve, strong investor demand and greater liquidity.
4. Selectively add to credit: Higher rated, lower beta bonds have rebounded more quickly following the initial days of COVID-19. While these investments offer strong credit quality and should be the core of portfolios, selectively adding lower credit and higher beta sectors that can benefit from spread compression as the economy recovers may improve investment outcomes.

BUILD STRONGER MUNICIPAL PORTFOLIOS WITH J.P. MORGAN

We have built and evolved our municipal capabilities with just one aim: to build stronger portfolios that address our clients' needs. Today we are one of the top fixed income managers in the world and our municipal bond team is a critical part of the fixed income organization.

Diverse perspectives, integrated solutions:

- Access the power of a globally integrated team of investment professionals and our proprietary research, encompassing fundamental, quantitative and technical analysis.
- Benefit from actionable insights designed to help you invest with conviction, from our regular macro and market views to our fixed income portfolio construction tools.
- Choose from a wide variety of outcome-oriented solutions designed to address all your fixed income needs.
- Tap into the proven success of one of the world's largest fixed income managers, with broad experience gained across regions and market cycles.

NEXT STEPS

- Learn more about our municipal bond capabilities
- Read our global fixed income quarterly perspectives
- Contact your J.P. Morgan Representative

Investments in bonds and other debt securities will change in value based on changes in interest rates. If rates rise, the value of these investments generally drops. Some investors may be subject to the Federal Alternative Minimum Tax and to certain state and local taxes.

This document is a general communication being provided for informational purposes only. It is educational in nature and not designed to be as advice or a recommendation for any specific investment product, strategy, plan feature or other purpose in any jurisdiction, nor is it a commitment from J.P. Morgan Asset Management or any of its subsidiaries to participate in any of the transactions mentioned herein. Any examples used are generic, hypothetical and for illustration purposes only. This material does not contain sufficient information to support an investment decision and it should not be relied upon by you in evaluating the merits of investing in any securities or products. In addition, users should make an independent assessment of the legal, regulatory, tax, credit, and accounting implications and determine, together with their own financial professional, if any investment mentioned herein is believed to be appropriate to their personal goals. Investors should ensure that they obtain all available relevant information before making any investment. Any forecasts, figures, opinions or investment techniques and strategies set out are for information purposes only, based on certain assumptions and current market conditions and are subject to change without prior notice. All information presented herein is considered to be accurate at the time of production, but no warranty of accuracy is given and no liability in respect of any error or omission is accepted. It should be noted that investment involves risks, the value of investments and the income from them may fluctuate in accordance with market conditions and taxation agreements and investors may not get back the full amount invested. Both past performance and yields are not reliable indicators of current and future results.

J.P. Morgan Asset Management is the brand for the asset management business of JPMorgan Chase & Co. and its affiliates worldwide.

To the extent permitted by applicable law, we may record telephone calls and monitor electronic communications to comply with our legal and regulatory obligations and internal policies. Personal data will be collected, stored and processed by J.P. Morgan Asset Management in accordance with our privacy policies at https://am.jpmorgan.com/global/privacy.

This communication is issued by J.P. Morgan Investment Management Inc. or J.P. Morgan Alternative Asset Management, Inc., both regulated by the Securities and Exchange Commission and JPMorgan Distribution Services, member FINRA.

If you are a person with a disability and need additional support in viewing the material, please call us at 1-800-343-1113 for assistance.

Copyright 2020 JPMorgan Chase & Co. All rights reserved.

PI-MV_4Q20 | 0903c02a82689816

J.P.Morgan
Asset Management