Municipal Market Insight

March 2020

Portfolio Advisory Group – U.S. Fixed Income Strategies

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Fed moves ahead of scheduled meeting

The recent selloff in U.S. equity markets has seized the attention of the Federal Reserve and Chair Jerome Powell, who released a statement on Friday, February 28 that said the Fed was closely monitoring the coronavirus situation. While the statement did not immediately calm U.S. markets, by Monday (March 2) U.S. markets surged. The rally was sparked by market expectations the Fed could act on interest rates ahead of its scheduled March 18 policy meeting. A move was made on March 3 when the Fed took the extraordinary measure of cutting the benchmark rate by 50 basis points.

Oddly enough, credit markets shrugged off the equity market rally on March 2 as investors remain concerned about the impact of the coronavirus, opting to remain in safe-haven vehicles. Despite record low yields, we think the strategy playbook remains the same. There are simply more downside risks for yields than there are scenarios for yields to move materially higher. Therefore, we still favor duration exposure to lock in current coupons and yields for as long as possible, across most sectors.

U.S. Treasury rate forecasts (% as of February 29, 2020)

	2019		2020			
	29-Feb	Q4	Q1E	Q2E	Q3E	Q4E
FF	1.88	1.63	1.63	1.63	1.63	1.63
2-yr	1.63	1.65	1.70	1.75	1.75	1.75
5-yr	1.55	1.70	1.80	1.90	1.90	1.90
10-yr	1.68	1.90	2.00	2.10	2.10	2.10
30-yr	2.12	2.40	2.45	2.50	2.50	2.50

Source - RBC Economics

Treasuries vs. municipals

	5-yr TSY	5-yr Muni	10-yr TSY	10-yr AAA Muni	30-yr TSY	30-yr AAA Muni
Beginning of month (2/1/20)	1.35%	0.84%	1.53%	1.15%	2.00%	1.80%
Mid-month (2/15/20)	1.42%	0.88%	1.59%	1.18%	2.04%	1.82%
End of month (2/29/20)	1.01%	0.00%	1.22%	0.00%	1.72%	0.00%

Source - Bloomberg (Treasuries), Thomson Reuters TM3 (Municipals)

Wealth Management

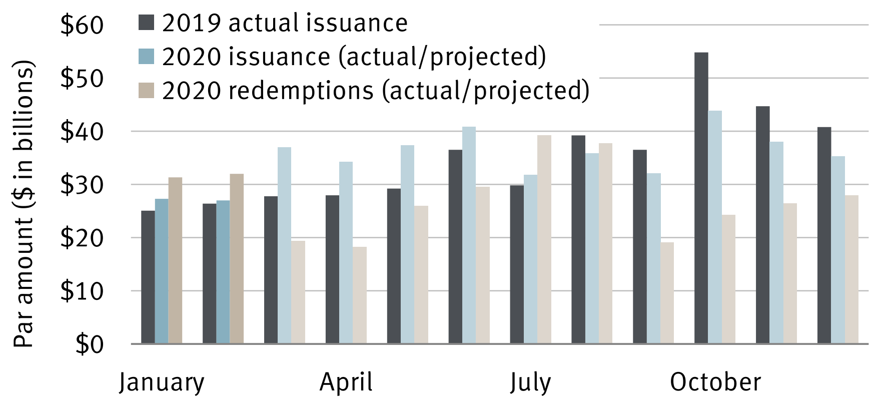
The rush to safety by investors allowed munis to reverse the negative returns seen earlier in the month.

Market investment strategy & market commentary

Market performance – Munis rally on COVID-19 fears

U.S. government bonds and municipal bonds rallied in February as the tentacles of the COVID-19 virus spread worldwide, prompting a global equity market selloff amid global economic uncertainty as investors sought safe-haven government bonds worldwide. As a result, the 10-year U.S. Treasury rallied to end February yielding 1.15%, down from 1.51% at the end of January. The rally benefited the muni market, which posted strong gains for the month despite a 38.4% y/y rise in issuance and what was the busiest February since Bond Buyer began tracking data in 1986.

2020 issuance and redemptions projections



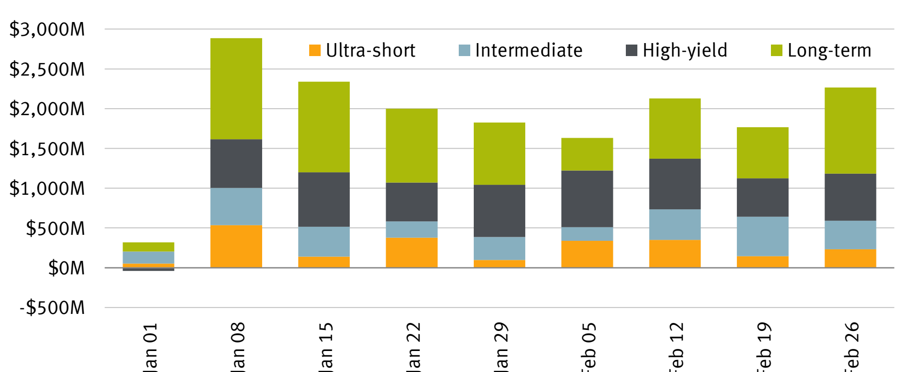
Source - RBC Capital Markets; 2020 issuance and redemptions reflect actual totals through February, projections thereafter

The rush to safety by investors allowed munis to reverse the negative returns seen earlier in the month and close February returning 1.29%, according to the Bloomberg Barclays Municipal Bond Index. Despite their strong showing, munis trailed both corporate bonds and U.S. Treasuries, which returned 1.34% and 2.65%, respectively, according to Bloomberg Barclays indexes. Munis have returned a healthy 3.11% through the first two months of the year.

What lies ahead, and will demand remain strong?

Looking ahead from March through June, RBC Capital Markets projects investors will receive $93.1 billion in redemptions (maturities, interest, and called bonds) compared to $149 billion in projected issuance. While we look for a surge in issuance over the coming months, we expect taxable municipal bonds to constitute 25% to 30% of total issuance, a trend that began in August 2019 amid low interest rates.

2020 muni fund flows



Source - Lipper U.S. Fund Flows, Refinitiv, RBC Wealth Management; weekly data though 2/28/20

With the markets pricing in a 50 basis point rate cut by the Fed in March, the trend of using taxable municipal bonds to advance refund tax-exempt bonds will gain steam, in our view. The surge in taxable municipal bonds has opened the market to non-traditional buyers, including crossover buyers from outside the U.S. where the benefits of tax-exemption has no impact. We expect greater market support from institutional buyers who remain flush with cash. Investors have added cash to muni funds for 60 consecutive weeks, with the four-week rolling average at just under $2 billion, a trend we expect to continue as investors hunt for yield.

We remain bullish on the muni market

The muni market should continue to benefit from the global uncertainty surrounding the coronavirus outbreak and the extent to which it will spread. Over the near term, we expect investors will continue to flock to safe-haven opportunities, including Treasuries as well as state and local government debt. With munis touching record low levels multiple times in February, we would expect more of the trend toward safe havens in March and beyond in the event the coronavirus fears continue to spook investors. The market uncertainty surrounding the disease's impact on the global economy should positively impact the overall performance of the muni market, in our opinion.

We expect investors will continue to flock to safe-haven opportunities.

This month's focus: PROMESA board proposes improved recovery prospects for certain Puerto Rico debt

The PROMESA fiscal oversight board, as representative of the commonwealth of Puerto Rico, reached an agreement with certain bondholders who collectively own 43% of the aggregate outstanding general obligation (GO) and Public Building Authority (PBA) debt obligations.

Under the proposed agreement, Puerto Rico GO and PBA debt would be reduced from $35 billion to just under $11 billion. The new aggregate annual debt service would equal $1.5 billion, or about 9% of revenue compared to $4.2 billion annually pre-bankruptcy. Debt service payments would be paid over 20 years instead of 30 years, as outlined in the initial restructuring plan filed in September 2019.

Furthermore, the oversight board agreed to end litigation that was attempting to invalidate GO and PBA debt obligations issued after 2010 arguing the debt exceeded the constitutional debt limitation.

Puerto Rico officials and bond insurers opposition

Presently, the government of Puerto Rico does not support the new debt restructuring proposal because public pensioners' recovery is not improving. The PROMESA board countered the commonwealth's resistance by highlighting the pension restructuring was already agreed upon by the official retirees committee. The board also emphasized that most retirees will not experience any haircut, and pensioners that will receive pension cuts may be restored during years that Puerto Rico outperforms certain financial metrics.

While the PROMESA oversight board may not need the commonwealth's support to sanction the debt restructuring, Puerto Rico support is necessary to legislatively authorize the new debt to restructure the outstanding obligations.

The municipal bond insurers, who collectively insure $12.2 billion of total Puerto Rico debt, also object to the proposal. According to the insurers, the agreement "is predicated on inaccurate and incomplete information relating to Puerto Rico's economy, cash balances, federal funding, revenue projections and debt capacity." The insurers also stated the agreement is "the product of a flawed process - a process in which the Oversight Board did not meaningfully engage with the parties, despite the financial guarantors being the largest creditors and longest serving financial supporters of Puerto

We are highly skeptical of the proposed restructuring timeline given the multi-front opposition to the plan.

Rico" and "yet another untested and unsupportable legal experiment by the Oversight Board, which undermines negotiation of a consensual restructuring."

Terms

Under the restructuring agreement, existing GO and PBA bondholders would receive $10.1 billion in new bonds consisting of 50% GO bonds and 50% Junior COFINA sales tax bonds, as well as $3.4 billion in cash. Bondholders would receive 16 new bonds: seven tax-exempt and one taxable GO bonds and seven tax-exempt and one taxable Junior COFINA sales tax bonds. Proposed bondholder recoveries are outlined below.

Proposed timing

As currently proposed, bondholder voting would be concluded by September 29, 2020 and the restructuring would be finalized by mid-October 2020. However, we are highly skeptical of the proposed timeline given the multi-front opposition to the plan.

Security pledges

The proposed GO bonds would be secured by the commonwealth's full faith and credit, and moneys would be deposited monthly with the trustee. Furthermore, the

Summary of GO and PBA recovery values ($ in millions)

						Recovery	
	Claim	Cash	% of total	New bonds	% of total	Total	%
GO:							
Pre-2011	$5,843	$819	19%	$3,556	81%	$4,375	**74.9%**
2011 (D/E/PIB)	$646	$89	19%	$387	81%	$476	**73.7%**
2011	$476	$63	19%	$273	81%	$336	**70.6%**
2012	$2,939	$385	19%	$1,669	81%	$2,054	**69.9%**
2014	$4,182	$512	19%	$2,222	81%	$2,734	**65.4%**
PBA:							
Pre-2011	$2,661	$883	43%	$1,181	57%	$2,064	**77.6%**
2011	$1,335	$441	43%	$584	57%	$1,025	**76.8%**
2012	$674	$217	45%	$270	55%	$487	**72.3%**
Total	$18,756	$3,409	25%	$10,142	75%	$13,551	**72.2%**

Source - PROMESA restructuring term sheet proposal; recovery values do not include PSA Restriction Fee, Consummation Costs, or PBA Settlement; claims include principal plus accrued interest

Proposed bond structures ($ in thousands)

	General obligation bonds				Junior COFINA			
	Tax-exempt		Taxable		Tax-exempt		Taxable	
7/1/21	$891,320	5.750%	—	—	$424,925	5.000%	—	—
7/1/23	$634,195	5.750%	—	—	$344,070	5.000%	—	—
7/1/25	$558,445	5.750%	—	—	$448,975	5.000%	—	—
7/1/27	$461,425	5.750%	—	—	$570,320	5.000%	—	—
7/1/29	$359,795	5.750%	—	—	$690,060	5.000%	—	—
7/1/33	$800,635	6.000%	—	—	$1,323,405	4.750%	—	—
7/1/39	$972,040	5.625%	$656,440	7.125%	$876,535	4.875%	$656,325	6.125%
Total	$4,677,855		$656,440		$4,678,290		$656,325	

Source - PROMESA restructuring term sheet proposal

This tentative agreement moves the bankruptcy forward but is far from a done deal.

commonwealth would fund up a Debt Service Reserve totaling $533 million by no later than five years from the date of issuance.

The Junior COFINA sales tax bonds would be secured by a statutory lien on the commonwealth's share of the 5.5% sales tax, but subordinate to the first dollar funding of the senior lien COFINA bonds. The collection mechanics would mirror the senior lien COFINA bonds.

Baby steps

This tentative agreement moves the bankruptcy forward but is far from a done deal. In our opinion, the Puerto Rico government's resistance to this proposed agreement is mostly political posturing in an election year, but the bond insurer opposition should be fierce because the insurers guarantee a consequential amount of other Puerto Rico debt obligations that are expected to receive only a 3% recovery under this current debt restructuring proposal.

If the deal is consummated as proposed, investors will receive 14 new tax-free and two new taxable bonds and will continue to be exposed to Puerto Rico's ongoing credit risks, including hurricanes, earthquakes, and the commonwealth's historical propensity for fiscal mismanagement and widespread corruption. On the flip side, the proposed restructured debt will have well-above market interest rates.

We believe that GO and PBA recovery prospects are unlikely to notably improve from current levels if there are further refinements to the debt restructuring plan. Furthermore, if the bond insurers are successful in improving the recovery for other Puerto Rico credits, then recovery values for the GO and PBA bonds would likely suffer as a result because we believe aggregate recovery of all Puerto Rico debt is a zero-sum game at this juncture.

All told, there is near-term uncertainty that this proposal will come to fruition and longer-term fiscal uncertainty given the commonwealth's historical unprincipled behavior and fiscal mismanagement, and exposure to natural disaster risks.

Territorial updates

Puerto Rico – Moving ahead gingerly

Federal aid on the way

The U.S. Department of Housing and Urban Development notified the commonwealth of an agreement to disburse $8.2 billion of Hurricane Maria-related federal aid. The commonwealth will receive the Community Development Block Grant for Disaster Recovery money, which will then be sent to the governor for spending on infrastructure projects. Part of the new agreement includes a provision that the PROMESA fiscal oversight board must approve funded projects.

Puerto Rico Electric Power Authority (PREPA) – Officials defecting

What once seemed like an amicable restructuring agreement between bondholders and the island's power authority is now in jeopardy as government leaders, including the governor, take a stand against raising rates to pay off bondholders. The $8.3 billion restructuring agreement, which required bankruptcy court approval and support from the island's government, led to a rally in PREPA debt. Optimism has waned in recent weeks as the island's political leaders hardened their stance against rate increases, bringing into question the restructuring deal.

Upgrades to state and local government debt outpaced downgrades for the fifth consecutive year in 2019.

State news

State and local government debt credit metrics on the upswing

Upgrades to state and local government debt outpaced downgrades for the fifth consecutive year in 2019, according to Moody's. The rating agency upgraded 517 credits versus 254 downgrades; the year had the most upgrades since 1989, a sign that state and local government debt remains on an upward credit trajectory.

Investor interest in ESG grows

During a recent Texas Public Finance Conference panel discussion, market participants said state and local governments are working to improve their disclosure with respect to environmental, social, and governance (ESG) factors to meet increasing investor requests for information. Ben Watkins, director of Florida's bond sales, said that "muni investors have been requesting Florida's emergency management plans and adaption measures because of the state's vulnerability to extreme storms and hurricanes."

State ratings roundup – A month of rating affirmations

California – Rating affirmed

On February 28, Fitch Ratings affirmed California's AA rating and maintained a stable outlook due to the state's "large and diverse economy, which supports strong, albeit cyclical, revenue growth prospects, solid ability to manage expenses through the economic cycle, and a moderate level of liabilities."

New Hampshire – Affirmed

On February 12, Fitch affirmed the state's AA+ rating; the outlook is stable. The state's low liabilities and strong ability to control its budget both in terms of revenues and expenditures were the main catalysts for the rating affirmation.

Louisiana – Rating affirmed

On February 26, Moody's affirmed the state's Aa3 rating and maintained a positive outlook on the state's GO, lease, and State Highway Improvement bonds. The rating affirmation "Reflects the state's large and diverse tax base and moderate combined debt and pension burden." According to Moody's, the state's rating is lower than the average state rating because of Louisiana's vulnerability to the energy sector and its below-average socioeconomic profile.

Massachusetts – Rating affirmed

On February 12, Fitch affirmed the state's AA+ rating with a stable outlook due to the state's considerable economic resources, strong budget controls, and a record of careful financial management. According to Fitch, "The Stable outlook on the long-term ratings reflects the expectation the Commonwealth will continue to act as needed to ensure budget balance and maintain an adequate reserve position."

Other state news

Arizona – Building up reserves

Governor Doug Ducey's $12.3 billion FY2021 budget includes adding $25 million to the state's $1 billion+ rainy day fund. The state, which was hit hard by the Great Recession, has been building reserves and paying down debt for over a decade. The budget raises spending for the current fiscal year (ends June 30) by $659 million from FY2020's $11.65 billion budget.

Governor Phil Murphy's third attempt to implement a millionaire's tax in order to carry out unprecedented spending in the Garden State seems to be gaining some support.

New Jersey – Third time's the charm?

Governor Phil Murphy's third attempt to implement a millionaire's tax in order to carry out unprecedented spending in the Garden State seems to be gaining support among some elected officials. New Jersey Senate President Stephen Sweeney said he would consider the tax measure if the governor would propose a larger-than-budgeted pension payment in FY2021. The governor's $40.9 billion budget calls for record spending on New Jersey Transit, pensions, and the state's schools.

Regional updates and other market news

Local issuer rating updates

Detroit, MI – Outlook revision

On February 25, Moody's revised the city's Ba3 rating to positive from stable to reflect "the improving though still tenuous capacity of the city's budget to finance service improvements, capital investments and accommodate a large spike in pension contributions."

East Orange School District, NJ – Downgraded one notch

Moody's downgraded the school district's rating to Baa3 from Baa2 at the end of January. The downgrade was driven by the district's negative fund balance and weak liquidity. The outlook was revised to stable from negative following the downgrade. Moody's expects the district's finances to remain highly pressured in the near-to-medium term due to a historical inability to match rising expenditures with revenues and a high reliance on state aid.

Hartford, CT - Upgraded

On February 25, Moody's upgraded Hartford's rating to Ba3 from B1 and revised the outlook to stable from positive. Moody's cited stable financial operations and improved liquidity that have resulted from the city's recovery plan, the state's contract assistance payments, and cost cutting undertaken by the city.

Jupiter Medical Center, FL – Rating affirmed

Fitch affirmed Jupiter Medical Center's BBB+ rating on February 25; the outlook remains stable. The affirmation stemmed from the medical center's leading market position and favorable service area. Fitch expects the recent completion of a main campus project and improved services along with a new patient tower to further solidify the center's leading market position.

New York City, NY – Rating affirmed

Fitch affirmed the city's AA rating with a stable outlook, stating: "Exceptionally strong budget monitoring and controls have been in place since New York City's fiscal crisis in the 1970s supporting Fitch's robust assessment of operating performance."

Pittsburgh, PA – Outlook revision

On February 26, Fitch revised the city's outlook to positive from stable based on "the expansion of the local economy due to significant private investment and rebuilding efforts that have bolstered the city's revenue growth prospects."

San Francisco Airport Commission (SFO), CA – Outlook revision

Moody's affirmed the commission's A1 rating and revised the outlook to positive from stable on February 25. SFO's entrenched market positions and operations in the large and economically vibrant Bay Area and limited competition were key drivers to the outlook revision.

February saw the first municipal bankruptcy filing in 2020.

Wayne County Airport Authority, MI – Upgraded

On February 25, Moody's upgraded the airport's senior lien revenue bonds to A1 from A2 and the junior lien bonds to A2 from A3; the outlook is stable. The upgrade reflects growth in origination and destination traffic at Detroit's Metropolitan Wayne County Airport as a result of economic improvement in Detroit and the surrounding six counties, including Wayne County.

Other municipal-related news

National Museum for American Jewish History, Philadelphia, PA – Files Chapter 11

The museum filed for Chapter 11 bankruptcy protection and is seeking to restructure $30 million of bonds issued through the Philadelphia Authority for Industrial Development to refinance the construction of the museum's current property. The bankruptcy follows previous museum defaults, including the National Law Enforcement Museum and the journalism-based Newseum in Washington, D.C., Philadelphia's Please Touch Museum, and the New York Folk Art Museum.

Jack County Hospital District, TX – Files for bankruptcy protection

The district, which operates Faith Community Hospital in Jacksboro, Texas, filed for Chapter 9 bankruptcy protection on February 29, the first municipal bankruptcy filing in 2020. The district estimated both assets and liabilities of between $10 million and $50 million, according to Bloomberg News.

RBC Wealth Management retail trading (2/1/20 – 2/29/20)

Top 10 CUSIPs selling volume to retail customers

CUSIP	Description	Maturity	Coupon	Volume
032556HY1	ANAHEIM CA HSG & PUBL	10/01/2050	5.00	7,980
650010CP4	NY ST THRUWAY AUTH-B	01/01/2053	4.00	3,595
246388UK6	DELAWARE ST HLTH FACS	10/01/2049	4.00	2,957
792897PB0	SAINT PAUL ISD #625	02/01/2038	3.00	2,684
66537EAY8	NTHRN MARIANA ISL	06/01/2030	5.00	2,621
726736GW5	PLAINVIEW ISD -A	02/15/2046	5.00	2,284
738034HE0	POTTER CO-CTFS OBLIG	08/01/2049	4.00	2,222
032556HX3	ANAHEIM CA HSG & PUBL	10/01/2045	5.00	2,096
269696MD9	EAGLE MOUNTAIN & SAGI	08/15/2050	4.00	1,988
65830RCS6	NORTH CAROLINA	01/01/2042	3.00	1,929

Top 10 CUSIPs buying volume from retail customers

CUSIP	Description	Maturity	Coupon	Volume
755783AN7	REAGAN HOSP DIST-A	02/01/2039	5.13	4,318
38611TAC1	GRAND PARKWAY-B	10/01/2051	5.25	3,174
13063DAZ1	CALIFORNIA ST	11/01/2047	4.00	2,451
246430AD4	DELAWARE TRANSN	06/01/2055	5.00	2,155
64990EKW6	NY DORM-A	02/15/2043	5.00	1,933
592248AX6	MET PIER	06/15/2050	5.00	1,895
796247CE2	SAN ANTONIO EDU FAC	06/01/2047	5.00	1,626
64972GPZ1	NEW YORK CITY NY MUNI	06/15/2048	5.00	1,494
271014C59	EAST BAY MUN UTL DT-C	06/01/2045	4.00	1,400
296809TM8	ESSEX CNTY NJ IMPT AU	11/01/2049	4.00	1,376

Source - RBC Wealth Management

RBC Capital Markets institutional trading (2/1/20 – 2/29/20)

Top 10 CUSIPs selling volume to institutional customers

CUSIP	Description	Maturity	Coupon	Volume
626207YF5	MEAG TXB-PLT VOGTLE	04/01/2057	6.64	44,067
186612SZ1	CLEVELAND ISD	02/15/2052	4.00	40,260
650010CK5	NY ST THRUWAY AUTH-B	01/01/2050	4.00	24,942
74529JPX7	PR SALES TAX FING-A1	07/01/2058	5.00	23,656
59261AC96	MET TRANSPRTN -A-1	11/15/2042	4.00	23,093
20772J4M1	CONNECTICUT ST	10/15/2033	5.00	22,511
088365KH3	BEXAR CNTY TX HOSP DT	02/15/2050	4.00	21,527
650010CL3	NY ST THRUWAY AUTH-B	01/01/2053	4.00	19,670
64990GXY3	NEW YORK ST DORM AUTH	07/01/2046	4.00	19,221
576000WY5	MASSACHUSETTS ST SCH	02/15/2049	5.00	16,683

Top 10 CUSIPs buying volume from institutional customers

CUSIP	Description	Maturity	Coupon	Volume
452151LF8	IL ST TXB-PENSION	06/01/2033	5.10	58,013
186612SZ1	CLEVELAND ISD	02/15/2052	4.00	38,156
70152RAA7	PARKVIEW HEALTH SYSTEM	11/01/2050	3.45	33,264
626207YF5	MEAG TXB-PLT VOGTLE	04/01/2057	6.64	33,135
650010CK5	NY ST THRUWAY AUTH-B	01/01/2050	4.00	22,949
20772J4M1	CONNECTICUT ST	10/15/2033	5.00	22,407
13063CVN7	CALIFORNIA ST-REF	08/01/2033	5.00	21,575
650010CL3	NY ST THRUWAY AUTH-B	01/01/2053	4.00	20,859
889184AA5	TOLEDO HOSPITAL/THE	11/15/2045	4.98	19,899
118217CZ9	BUCKEYE OH TOBACCO-B2	06/01/2055	5.00	19,623

Source - RBC Capital Markets

Bond Buyer indexes

Weekly	Current 2/27/20	Previous 2/20/20	2020 high	Date	2020 low	Date
Bond Buyer Revenue Bond Index	2.77%	2.96%	3.20%	(1/02)	2.77%	(2/27)
Bond Buyer 20-Bond Index	2.27%	2.46%	2.73%	(1/02)	2.27%	(2/27)
Bond Buyer 11-Bond Index	1.80%	1.99%	2.26%	(1/02)	1.80%	(2/27)

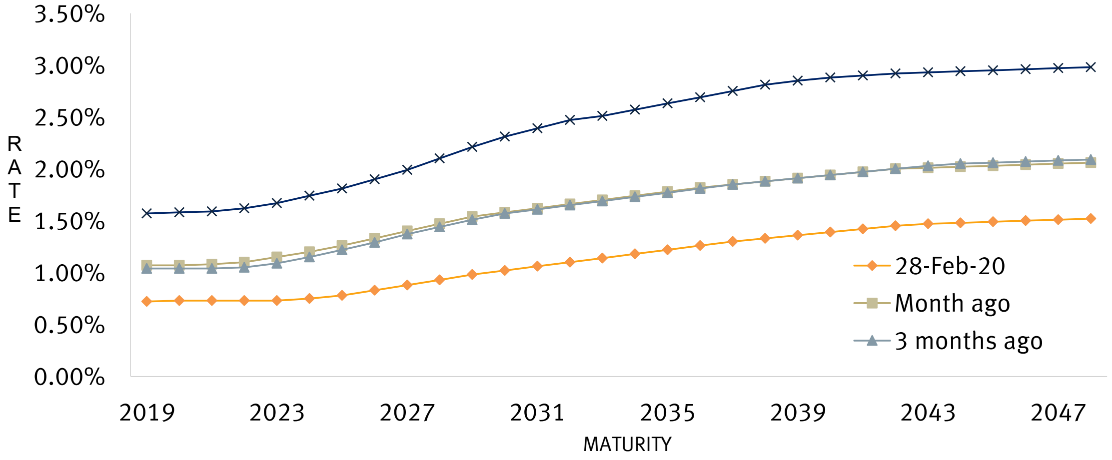
Source - The Bond Buyer

Barclays Municipal Index returns

	INDEX								
	1 Month	5 Year (4-6)	10 Year (8-12)	15 Year (12-17)	Long Bond (22+)	AAA	AA	A	BAA
Month-to-date total return	1.29%	0.60%	1.18%	1.64%	2.15%	1.12%	1.17%	1.39%	2.02%
Year-to-date total return	3.11%	1.82%	3.14%	3.96%	4.63%	2.83%	2.90%	3.27%	4.37%

Source - Barclays; data through 2/29/20

Muni market data AAA yield curve



Source - RBC Wealth Management, Thomson Reuters TM3; data through 2/28/20

Municipal bond insurers

Insurer	Moody's	Kroll Ratings
ACA	Not rated	Not rated
AMBAC	Not rated	Not rated
Assured Guaranty (AGC)	A3 (stable outlook)	AA (stable outlook)
Assured Guaranty Municipal Corp. (AGM)	A2 (stable outlook)	AA+ (stable outlook)
Berkshire Hathaway (BHAC)	Aa1 (stable outlook)	Not rated
Build America Mutual (BAM)	Not rated	Not rated
FGIC	Not rated	Not rated
Municipal Assurance Corporation	Not rated	AA+ (stable outlook)
National Public Finance (MBIA)	Baa2 (stable outlook)	Not rated
Syncora	Not rated	Not rated

Source - RBC Wealth Management; data through 2/29/20

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Third-party disclaimer

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