Municipal Market Insight

January 2021 — Portfolio Advisory Group – U.S. Fixed Income Strategies

What's inside

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Farewell 2020, welcome 2021

Barring any unforeseen circumstances, on January 20, President-elect Joseph Biden will be sworn in as the 46th president of the United States and so will begin what should be the seamless transition of power to a new administration. We expect Democratic control of both the White House and Congress to provide a boost to this year's municipal market performance. The likelihood of higher income taxes, increased spending on infrastructure, and other stimulus measures could push demand for municipals higher as investors in higher tax brackets attempt to shield their income.

The improving possibility of additional federal stimulus and state and local government federal aid should provide a boost to the overall municipal market in demand and bond issuance as investors navigate a COVID-19-plagued economy, near-zero interest rates, and limited fixed income investing options. While we expect municipals to post gains again this year, the road ahead is not completely without road blocks. We think state and local governments will continue facing financial headwinds at least until the COVID-19 pandemic is perceived to be under control, and the economy on the rebound. Investors should remain focused on higher credit quality municipal bonds, in our opinion, while avoiding the temptation to reach for yield, especially during periods of uncertainty as was the case in 2020 and that could carry over in to 2021.

U.S. Treasury rate forecasts (% as of Nov. 12, 2020)

	2020		2021			
	Q3	Q4E	Q1E	Q2E	Q3E	Q4E
FF	0.25	0.25	0.25	0.25	0.25	0.25
2-yr	0.25	0.30	0.30	0.30	0.35	0.35
5-yr	0.36	0.45	0.50	0.60	0.70	0.80
10-yr	0.57	0.70	0.75	0.90	1.00	1.05
30-yr	1.11	1.25	1.30	1.40	1.45	1.50

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 (12/1/20)	0.42%	0.24%	0.93%	0.72%	1.67%	1.41%
Mid-month (12/15/20)	0.37%	0.22%	0.91%	0.70%	1.65%	1.38%
End of month (12/31/20)	0.36%	0.22%	0.92%	0.71%	1.65%	1.39%

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

RBC Wealth Management

State and local governments issued a record $474.1 billion of municipal debt in 2020, surpassing 2017's record $448.6 billion and well ahead of 2019's $426.3 billion of issuance.

Market investment strategy & market commentary

Market performance – Municipals post strong results in December

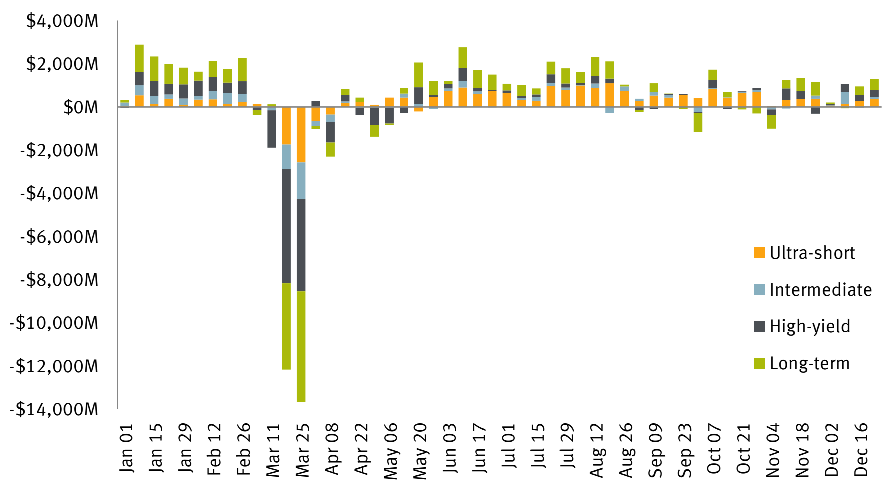
Despite the pandemic, the U.S equity market posted records, while fixed income markets posted solid returns including the municipal market. Solid investor demand amid near-zero interest rates and record issuance was enough to push municipals to post strong returns in December and year to date.

State and local governments issued a record $474.1 billion of municipal debt in 2020, surpassing 2017's record $448.6 billion and well ahead of 2019's $426.3 billion of issuance. The year held many challenges for state and local governments, which were forced in many cases to revise budgets as the effects of the pandemic caused a significant decline in tax revenue during the height of the outbreak. State and local governments in some cases raised taxes, cut expenditures, and, if necessary, furloughed or terminated employees to balance their budgets.

Demand outweighs record issuance that boosted December returns

Despite 2020's record issuance and outflows of over $30 billion from municipal bond funds during the height of the pandemic, investor confidence in the municipal market returned in mid-April. Municipal bond funds ended the year with net inflows of $20.5 billion despite withdrawals of $30.9 billion from March 4 through April 8.

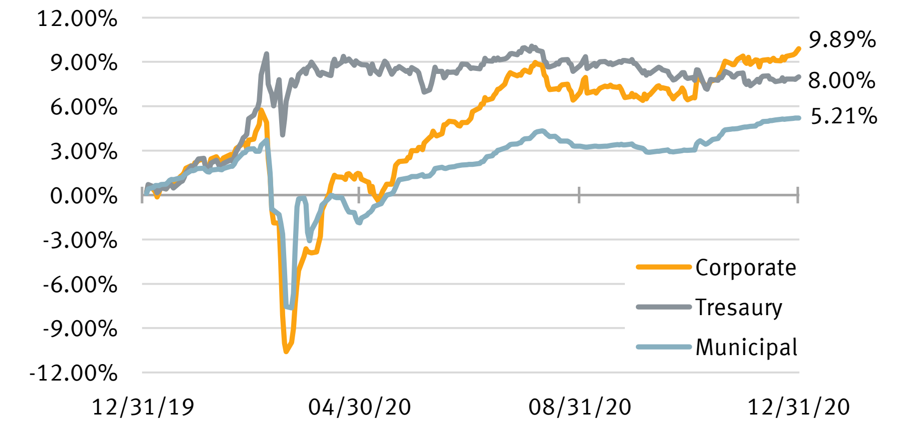
2020 muni fund flows



Source - Refinitiv Lipper U.S. Fund Flows, RBC Wealth Management; weekly data through 12/30/20

The Bloomberg Barclays Municipal Bond Index returned 0.61% in December, outperforming the Bloomberg Barclays Treasury Index's -0.23% and the Bloomberg Barclays Corporate Index's 0.46% December returns. Year to date, all three fixed income asset classes performed well with corporates returning 9.89%, followed by the Treasury market's strong 8.00% return, and the municipal market's still strong 5.21% for the year. The U.S. Treasury market's returns were buoyed by investor flight to safety during height of the pandemic, driving Treasury yields to record low levels. The year's strong municipal performance marks the seventh straight year of gains, a trend we expect to continue in 2021.

Bloomberg Barclays indexes



Source - Bloomberg; data through 12/31/20

We expect increased infrastructure spending to benefit the municipal market as a result of its low rate structure and tax-exempt status.

Strong technicals, demand, and Democratic control of the federal government should favor municipals

What will a Biden presidency mean for the municipal market? The first thing that comes to mind is "infrastructure, infrastructure, and infrastructure." The country's deteriorating infrastructure system is in much need of capital spending, and Democrats have pledged increased infrastructure investing. We expect the increased infrastructure spending to benefit the municipal market as a result of its low rate structure and tax-exempt status. In addition to infrastructure spending, the likelihood of increased federal aid to state and local governments should help improve their financial conditions heading in to fiscal year end, which for many is June 30.

In addition to increased infrastructure spending, Biden has said he plans to raise taxes on those earning over $450,000 annually, a move we think will provide an added incentive for people in higher tax brackets to shield their income from federal and state taxes.

Strong demand and issuance to play a key role in this year's municipal market performance

RBC Capital Markets is projecting municipal issuance of around $425 billion in 2021. But the projection could rise if the COVID-19 pandemic remains unchecked and state and local tax coffers continue experiencing shortfalls, potentially causing the need for additional borrowing. With a new year, new incoming administration, and COVID-19 still presenting significant challenges to the country, municipal technicals remain strong and should drive another strong performance in 2021, in our opinion, but challenges and headwinds remain and could alter the course of this year's market performance. The benchmark 10-year municipal bond traded at its richest level since 2001, yielding a low 67.5% of the comparable Treasury in late December.

This month's focus: New York, New York, it's a heck of a town

New York City (NYC) is the enviable epicenter of many things including fashion, finance, the arts, culture, media, and real estate. However, the city was also an unwanted epicenter for the initial COVID-19 outbreak.

NYC's density is part of what makes the city so vibrant; there is so much to do, see, taste, and experience in a relatively small area. But that density allowed the virus to spread more easily. As a result, NYC has become the city that actually does sleep. Even the NYC subway, for the first time in over a 100 years, suspended overnight service. Office buildings are at nominal capacity, some city residents have relocated to more idyllic settings, restaurants are shuttered, and the Broadway lights have gone dark. Thus, some

New York City has exceptional budgetary controls that were implemented after the city's 1975 financial crisis.

investors may be questioning if the city can shake off yet another economic blow, or if this time is actually different.

But the news is not all bad. Wall Street profits—which account for a meaningful percentage of state and city revenues—are at a decade high, luxury home sales for the past several months have surpassed pre-pandemic levels, and tax collections are $750 million more than New York's comptroller expected for the first four months of fiscal 2021. This information signals to us that many business sectors are thriving in a remote world, multi-millionaires are still gravitating to the city as a desirable place to live, and budget predictions are not as dire as originally forecast. In fact, NYC's projected fiscal 2021 budget gap was 5.4% of revenues, which while still problematic, was much less than the almost 10% gap in fiscal 2009 during the Great Recession.

Bumpy road ahead

The city has financial challenges, and a full economic recovery to pre-pandemic levels could be slower than the nationwide averages especially because certain sectors may be particularly slow to rebound. The tourism and hospitality sectors may be on a particularly long road to recovery because NYC draws the most international tourists of any U.S. city, but fewer people have been traveling. Nonetheless, we think the strong performance of the financial sector, which accounts for almost 25% of total earnings, and historically stable property taxes should help buffer the city's finances.

Thankfully, NYC also has exceptional budgetary controls that were implemented after the city's 1975 financial crisis, including four-year forecasts that are updated three times annually. Additionally, the city's financial performance is monitored by several outside parties including the Financial Control Board, the state comptroller, the Independent Budget Office, and the Citizen's Budget Commission. This level of third-party oversight likely dampens any politically irresponsible or expedient tendencies, and is a defining and positive credit characteristic, in our opinion.

The fiscal 2021 budget is balanced but relies upon non-recurring solutions including a $1.6 billion draw on reserves, which, while not ideal, appears reasonable given the extraordinary circumstances. The balanced budget also depends on full receipt of state aid revenues, debt savings from refinancings, and modest wage deferments in to fiscal 2022. The city is projecting between $3 billion and $3.8 billion of annual out-year budget gaps in its four-year budget projections ended fiscal 2024, but to put that in to perspective, the gaps account for between 1.8% and 2.7% of annual revenues.

All told, we think NYC's financial situation and ratings are not on a slippery slope. NYC has a difficult hole to dig itself out of—similar to many other municipalities—but officials have many tools to rebalance the city's operations, and multiple layers of third-party oversight to better ensure fiscally responsible actions are pursued. We believe, over a multi-year period, NYC will rebound as the city that again never sleeps, subways will be running 24/7, restaurants will be bustling, and Broadway's light will shine brightly. Of course, getting from here to there is likely to be bumpy, but we believe the city's attributes that contributed to its past success will serve it well to contribute to future prosperity and an ongoing ability to service its constituents and debt obligations.

Municipal news

General municipal commentary – Mixed news for state and local governments

Bond Insurance – A COVID-19-driven renaissance

Following the Great Recession, municipal bond insurers experienced a steep drop in new policy origination, and some legacy bond insurers are no longer writing policies. The COVID-19 pandemic drove municipal bond insurers to have their best year since 2009. During 2020, approximately $34 billion or 7.5% of new issues came to market with bond insurance. The municipal bond insurance business is now primarily divided between Assured Guaranty and Build America Mutual. We expect investor demand for bond insurance to continue in to 2021.

States – Tax revenue shows signs of rebounding

States collected $306.7 billion in tax revenue in the third quarter, a 20% year-over-year (y/y) increase, according to U.S. Census Bureau data. California benefitted the most from the improved tax revenue flows, collecting $65.9 billion or 48% more, while New Jersey experienced a 9.8% decline to $6.5 billion y/y in the third quarter.

Third-quarter personal income plummets absent additional stimulus

All 50 states experienced personal income declines in the third quarter as prior stimulus aid began to wind down.

All 50 states experienced personal income declines in the third quarter as prior stimulus aid began to wind down. West Virginia had the largest contraction with an annual rate of 30%, while incomes in Georgia contracted 1.0%, according to U.S. Commerce Department data. A significant decrease in transfer payments, comprised of state unemployment benefits and Medicaid, which dropped to $1.3 trillion in Q3 2020 from $2.4 trillion in Q2 2020, was a major cause of the personal income decline. The quarter-over-quarter disparity was due in large part to the end of $600 weekly federal unemployment benefits and $1,200 stimulus payments. We think the drop in personal income highlights the need for additional stimulus to help boost an economy that is facing many hurdles as we move deeper in to 2021.

Transportation chiefs turn to Washington for federal aid

The chiefs of the country's largest transportation systems are asking the federal government for a combined $32 billion in federal aid to help mitigate lost farebox revenue and increased cleaning expenses caused by COVID-19. The country's largest public transportation provider, New York's MTA, has been considering cutting subway and bus service by as much as 40%, commuter rail service by 50%, and potentially laying off approximately 9,400 employees.

State and local government updates

California – Governor proposes school reopening plan

Governor Gavin Newsom proposed spending $2 billion to reopen California schools for in-person instruction as early as spring 2021. The move comes despite a surge in COVID-19 cases throughout the state. His plan will prioritize testing, ventilation, and personal protective equipment to ensure a safe teaching environment.

Illinois – Tax revenue surprises to the upside

A boost in sales, personal income, and corporate tax collections netted the state a 6.8% y/y bump in December revenue, despite the economic slowdown caused by COVID-19. In addition to the improved tax collections, the state realized $74.8 million in revenue from legalized marijuana sales through the first six months of the fiscal year which ended Dec. 31.

Unfunded pension liabilities rise

At fiscal year-end 2020 (June 30, 2020), the state's unfunded pension liability rose $3.8 billion to $141 billion from $137.2 billion at fiscal year-end 2019. The primary driver for the rise was actuarially insufficient state contributions that by itself caused a $2.2 billion increase. Actuarial losses from lower-than-projected investment returns across all five of the state's major pension systems also contributed.

Minnesota – Mall of America gets a reprieve

After state-mandated COVID-19-related closures, the Mall of America (MoA), the country's largest shopping center became delinquent on mortgage payments. The MoA

Texas collected $2.9 billion in sales tax in December marking a 5% y/y decline.

is now current on its mortgage payments following an agreement with lenders to loosen terms on its $1.4 billion debt. The new terms, which were modified in December 2020, will allow the mall's owners to make interest-only payments. As part of the deal, the owners agreed to increased reporting requirements and submitting monthly net-cash payments to its lenders.

Texas – Sales tax collections drop

The state collected $2.9 billion in sales tax in December marking a 5% y/y decline. The COVID-19 pandemic continued the trend of lower sales tax revenue with most of the state's major economic sales tax drivers experiencing significant year-over-year declines. Sales tax revenue is the state's largest revenue source, accounting for approximately 59% of its tax collections.

Ratings corner

Connecticut – Affirmed by Fitch

On December 8, Fitch affirmed the state's A+ rating and maintained a stable outlook on the state's rating. The affirmation was based on Fitch's "expectation that the state's wealthy and mature economy will likely experience relatively limited growth over time, challenging the state in matching revenues to expenditures."

Iowa – Affirmed by Fitch

On December 23, Fitch affirmed the state's AAA rating and maintained a stable outlook on the rating. The state's stable economic and employment trends along with solid medium-term revenue growth prospects were key drivers to the rating affirmation, according to Fitch.

New York City – COVID-19 impact's city's rating

On December 8, Fitch downgraded the city's rating one-notch to AA- from AA. The downgrade, which also impacted the city's Hudson Yards Infrastructure Corporation revenue bonds, "reflects Fitch's expectation that the impact of the coronavirus and related containment measures will have a longer-lasting impact on New York's economic growth than most other parts of the country."

South Carolina – Affirmed by Fitch

On December 23, Fitch affirmed the state's AAA rating and maintained a stable outlook on the rating. The affirmation reflects the state's "proven ability and willingness to maintain a high level of financial flexibility, aided by a constitutional reserve requirements and established replenishment provisions."

Washington State Convention Center Public Facilities District

On December 8, Moody's downgraded the district's convention center senior lien bonds three notches to Baa1 from A1 and the district's subordinate bonds to Baa3 from A3, the outlook on both senior and subordinate bonds remains negative. The downgrade was primarily driven by expectations of a continued slow recovery in the travel and leisure sector for the state's Puget Sound region.

Territorial update

Commonwealth of Puerto Rico

Help on the way

The Trump Administration has said it will award the commonwealth $3.7 billion in federal grants to help finance repairs to the island's Hurricane-Maria-damaged water and sewer systems. The $3.7 billion is expected to be used to finance the reconstruction

The PROMESA Board continues working with commonwealth officials, bond insurers, and creditors in an attempt to reduce the outstanding $18 billion of general obligation secured debt.

and repairs of water and wastewater treatment plants, pumping stations, dams, and reservoirs. The commonwealth had previously been awarded $9.6 billion for island's electrical infrastructure and $2 billion for education facilities.

Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA) Board appointments complete

President Donald Trump, with the reappointment of current board member David Skeel and appointment of former board member Arthur Gonzalez, now has a full seven-member board in place to help complete the commonwealth's ongoing restructuring now heading in to its fourth year. The board continues working with commonwealth officials, bond insurers, and creditors in an attempt to reduce the outstanding $18 billion of general obligation secured debt.

U.S Federal Bankruptcy Judge Laura Taylor Swain, tasked with overseeing the commonwealth's restructuring, has given the board until Feb. 10 to file a plan of reorganization, which we expect will incentivize negotiators to reach an agreement prior to the court-ordered deadline.

RBC Wealth Management retail trading (12/1/20 – 12/31/20)

Top 10 CUSIPs selling volume to retail customers

CUSIP	Description	Maturity	Coupon	Volume
544495Z72	LOS ANGELES DEPT WTR	07/01/2047	5.00	11,244
882854B84	TX WTR DEV BRD-A	10/15/2047	5.00	4,029
64972HK50	NYC TRANS FIN-S-3	07/15/2043	5.00	3,761
16772PDJ2	CHICAGO IL -BAM	12/01/2055	5.00	3,442
64971XFW3	NYC TRANS FIN AUTH-A1	08/01/2042	5.00	3,145
235241UV6	DALLAS TX AREA RAPID	12/01/2039	4.00	3,052
64971XLL0	NYC TRANS FIN AUTH	05/01/2043	4.00	2,565
952718N59	W FARGO-A-REF-BAM	05/01/2043	2.13	2,524
64966QBF6	NEW YORK-D-SUBSER D1	12/01/2044	5.00	2,516
246388UK6	DELAWARE ST HLTH FACS	10/01/2049	4.00	2,497

Top 10 CUSIPs buying volume from retail customers

CUSIP	Description	Maturity	Coupon	Volume
79765RZ69	SAN FRANCISCO CITY	11/01/2047	5.00	4,678
93974CP53	WA ST-D	02/01/2026	5.00	4,224
296804N52	ESSEX CO	09/01/2041	3.00	3,337
64971QRM7	NYC TRANSL FIN AUTH-D	11/01/2038	5.00	3,111
660043CZ1	N HUDSON SWR-A-UNREF	06/01/2042	5.00	2,860
64990C3D1	NY DORM AUTH-A-PREREF	10/01/2023	5.00	2,074
745160QC8	PR AQUEDUCT SR LIEN-A	07/01/2047	5.13	2,016
956622E91	WV HOSP FIN-A-REF	06/01/2044	5.50	1,989
646136A76	NJ TRANSN TR FD-A	06/15/2041	5.50	1,590
802385MZ4	SANTA MONICA CCD-B	08/01/2044	4.00	1,427

Source - RBC Wealth Management

RBC Capital Markets institutional trading (12/1/20 – 12/31/20)

Top 10 CUSIPs selling volume to institutional customers

CUSIP	Description	Maturity	Coupon	Volume
452151LF8	IL ST TXB-PENSION	06/01/2033	5.10	57,448
79467BCJ2	SALES TAX SECURTZTN-C	01/01/2043	5.25	36,364
79467BCH6	SALES TAX SECURTZTN-C	01/01/2043	5.00	35,696
455412AV8	INDIANAPOLIS WTR-B	10/01/2037	5.00	17,191
60412ATH6	MINNESOTA ST -A	08/01/2030	5.00	16,499
802385SB1	SANTA MONICA CCD-TXBL	08/01/2040	2.70	16,075
650036AL0	NEW YORK ST URBAN DEV	03/15/2041	5.00	14,516
6262072S2	MUNI ELEC AUTH OF GEO	01/01/2049	4.00	13,950
52480RFF2	LEHIGH CO GEN PURP	11/01/2037	0.67	13,727
576000ZW6	MASSACHUSETTS ST SCH	05/15/2043	2.95	13,275

Top 10 CUSIPs buying volume from institutional customers

CUSIP	Description	Maturity	Coupon	Volume
452151LF8	IL ST TXB-PENSION	06/01/2033	5.10	31,607
186612TJ6	CLEVELAND ISD-B	02/15/2054	4.00	22,553
646039YN1	NEW JERSEY ST-A	06/01/2029	5.00	21,677
64966QBF6	NEW YORK-D-SUBSER D1	12/01/2044	5.00	18,577
650036CH7	NEW YORK ST URBAN DEV	03/15/2047	5.00	16,763
60412ATH6	MINNESOTA ST -A	08/01/2030	5.00	16,484
6262072S2	MUNI ELEC AUTH OF GEO	01/01/2049	4.00	16,177
802385SB1	SANTA MONICA CCD-TXBL	08/01/2040	2.70	15,552
576000ZW6	MASSACHUSETTS ST SCH	05/15/2043	2.95	13,774
52480RFF2	LEHIGH CO GEN PURP	11/01/2037	0.67	13,723

Source - RBC Capital Markets

Bond Buyer indexes

Weekly	Current 12/31/20	Previous 12/24/20	2020 high	Date	2020 low	Date
Bond Buyer Revenue Bond Index	2.53%	2.57%	3.34%	(4/02)	2.44%	(8/06)
Bond Buyer 20-Bond Index	2.12%	2.12%	2.84%	(4/02)	2.02%	(8/06)
Bond Buyer 11-Bond Index	1.65%	1.65%	2.37%	(4/02)	1.55%	(8/06)

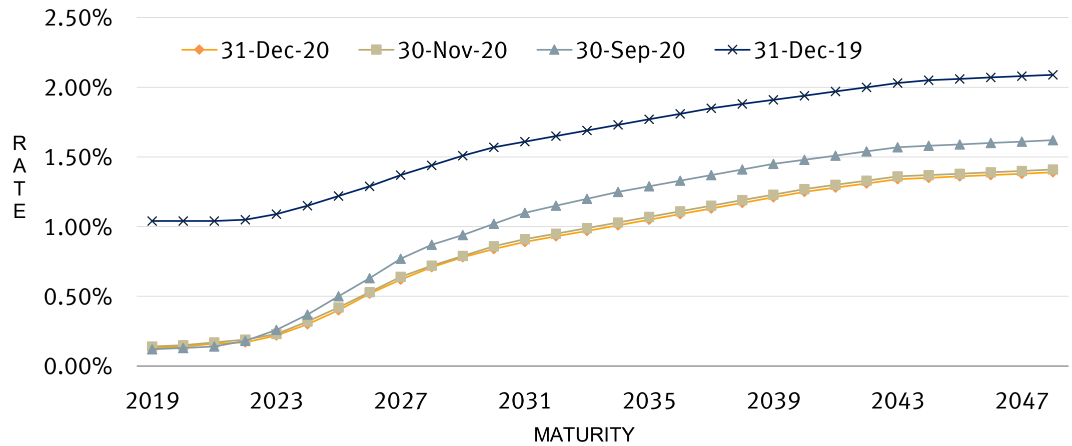
Source - The Bond Buyer

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	0.61%	0.36%	0.61%	0.77%	0.92%	0.28%	0.43%	0.82%	1.72%
Year-to-date total return	5.21%	4.29%	5.62%	6.32%	6.25%	5.51%	5.24%	5.27%	4.55%

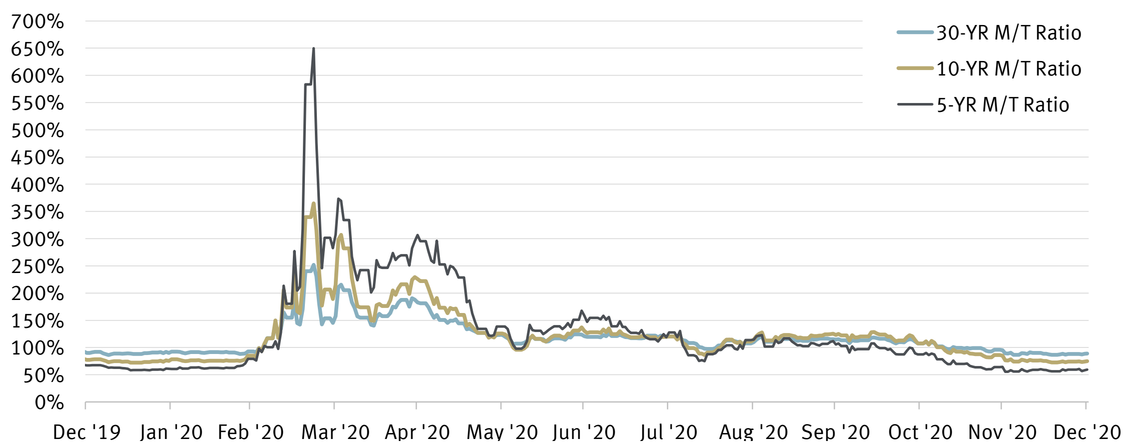
Source - Barclays; data through 12/31/20

Muni market data AAA yield curve



Source - RBC Wealth Management, Thomson Reuters TM3; data through 12/31/20

Muni/Treasury ratio comparison



Source - RBC Wealth Management, Bloomberg; data through 12/31/20

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 12/31/20

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