Municipal Market Insight

Wealth Management

July 2021 | Portfolio Advisory Group – U.S. Fixed Income Strategies

What's inside:

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Federal Reserve outlook remains cautious

June saw mixed performance in Treasury markets, with yields rising as much as 0.10% on bonds maturing in the next five years and yields dropping between 0.15% and 0.20% on bonds maturing after 10 years. The catalyst for the results was the hawkish tone at the Fed's June meeting, in particular the shift higher in the individual member's interest rate projections—for the first time since the pandemic's start, the median estimate includes a rate hike before 2023. Higher inflation—the Consumer Price Index rose by nearly 4% year over year (y/y) in May, even after food and energy price hikes were excluded—helped solidify the narrative of policy accommodation being withdrawn sooner, prompting investors to migrate away from short-term Treasuries.

Since the meeting, the tone of Fed speeches has bifurcated, with Fed Chair Jerome Powell and others stressing their belief that higher inflation will fade into next year, as longer-term disinflationary trends re-assert themselves. Other Fed members seem less sure, stressing the extent of current inflation and potential for price hikes to become entrenched. Our view is that the Fed may begin to reduce bond purchases slightly earlier than expected—possibly

U.S. Treasury rate forecasts (% as of June 10, 2021)

	2021				2022			
	Q1	Q2E	Q3E	Q4E	Q1E	Q2E	Q3E	Q4E
FF	0.13	0.13	0.13	0.13	0.38	0.38	0.63	0.63
2-yr	0.16	0.20	0.40	0.60	0.90	1.10	1.30	1.50
5-yr	0.92	1.00	1.35	1.45	1.50	1.60	1.70	1.80
10-yr	1.74	1.80	1.90	2.00	2.05	2.10	2.15	2.20
30-yr	2.41	2.40	2.45	2.50	2.60	2.60	2.60	2.60

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 (6/1/21)	0.81%	0.48%	1.61%	0.99%	2.28%	1.51%
Mid-month (6/15/21)	0.78%	0.40%	1.49%	0.89%	2.19%	1.41%
End of month (6/30/21)	0.88%	0.49%	1.46%	0.99%	2.07%	1.50%

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

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starting in Q4 2021—but any rate hike before 2023 is unlikely, given the still-high level of joblessness.

Market investment strategy & market commentary

Market performance – A challenging summer ahead

June proved another challenging month for the fixed income space with tax-exempts and corporates posting positive returns, while Treasury returns remained in negative territory. Despite a low-yield environment, strong institutional investor demand has offset the lack of enthusiasm by retail investors, who have decided to remain on the sidelines during the period opting to wait for higher yields amid growing inflation fears and hopes the Fed will choose to raise interest rates in the event inflation does not remain under control. The Fed raised some concerns about inflation following its last meeting signaling the Fed could raise interest rates ahead of previously suggested target dates.

Tax-exempts returned 0.27% in June, outpacing Treasuries that returned -1.23%. Tax-exempts were unable to outperform corporate bonds, which returned a strong 1.63%. Year to date, tax-exempts are outperforming the Treasury and corporate bond markets. Tax-exempts are returning 1.06% year to date while Treasuries and corporates remain in negative territory returning -4.61% and -1.27%, respectively, year to date.

July and August issuance could cause demand/supply imbalance

For July and August, RBC Capital Markets projects issuance of around $67 billion over the two-month period with investors set to receive $79 billion in redemptions, maturities, and interest payments. While many state and local governments have experienced improved tax collections since the height of the pandemic, we expect state and local governments to remain conservative with respect to near-term borrowing, leaving cash-rich investors with limited investing opportunities.

A mixed month for tax-exempt yields

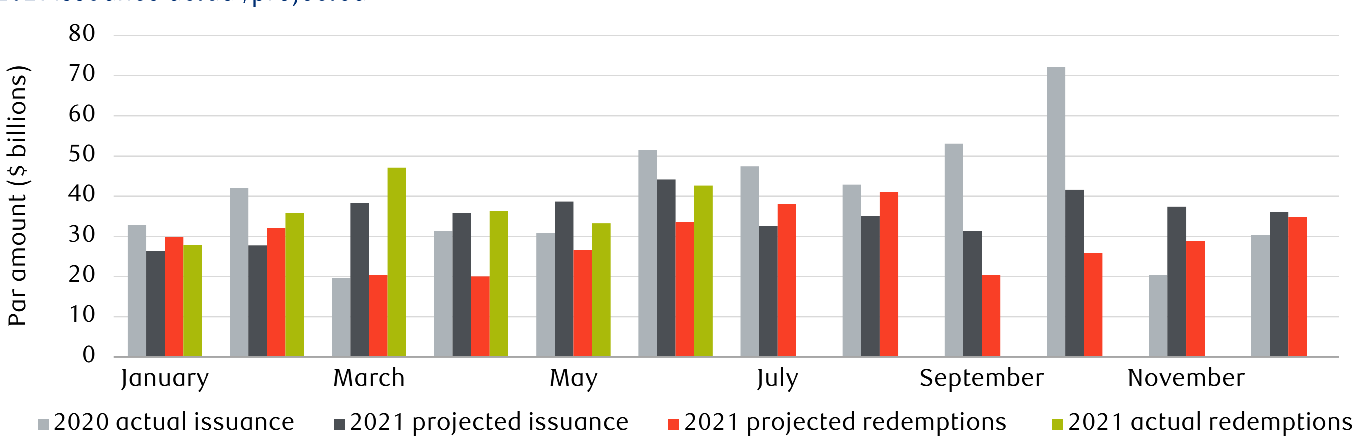
With 5-, 10-, and 30-year yields narrowing to 0.40%, 0.89%, and 1.41% from 0.48%, 0.99%, and 1.51%, respectively, by mid-June, before rising again in the latter part of the month and with 5-, 10-, and 30-year tax-exempt yields ending the month almost exactly where they started at 0.49%, 0.99% and 1.50%, respectively, we expect institutional demand for tax-exempts to remain strong amid inflation fears and the possibility of tax increases still on the horizon.

Through June 30, institutional investors have added cash to municipal bond funds for 17 consecutive weeks and 25 weeks of 26 weeks this year with the four-week rolling average of inflows at $1.8 billion weekly according to Refinitiv Lipper U.S. Fund Flow data. Investors have added just over $37 billion to municipal bond funds year to date. High-yield and long-term funds have been the biggest beneficiaries of this year's inflows garnering $13.4 billion and $14.1 billion of this year's just over $37 billion of inflows. As a result, spreads on high-yield municipal bonds have narrowed significantly and are overvalued, in our opinion, and in position for a potential correction if yields begin rising.

Parting thoughts – Challenging investing environment

We expect a challenging tax-exempt investing environment through year end with cash-rich investors finding it increasingly difficult to put their money to work in a limited-supply, low-yield, and competitive investing environment. We caution investors to remain focused on highly rated municipals that offer extended call protection with 15- to 30-year maturities where we believe investors can maximize yields and returns in the current low-yield environment.

2021 issuance actual/projected



Source - RBC Capital Markets, The Bond Buyer

This month's focus: Southwest drought's effect on municipal water utilities

The value and scarcity of water is being re-evaluated

Drought has erratically plagued the Southwestern U.S. for nearly two decades, and some researchers predict the area has entered an era of decades-long drought. For the first time ever, the federal government is expected to declare a water shortage on the lower Colorado River later this summer. As a result, Nevada and Arizona may experience automatic cuts to their water supply beginning in 2022. The water shortages will have an immediate impact on all affected communities, and likely will require various constituents—including municipal water utilities—to rethink how to persevere with less water. From a municipal bondholder perspective, there are various legal covenants in place to better ensure that municipal water utilities generate sufficient revenues to cover annual debt service despite the prospect of less water delivery.

Lower snowfall in the Rocky Mountains coupled with elevated average temperatures throughout the Southwest has resulted in record low precipitation entering Lake Powell and Lake Mead. The Colorado River is a critical conduit of water in the Southwest and its water is apportioned to California, Nevada, Arizona, Utah, Colorado, New Mexico, and Wyoming. In Nevada, the river primarily supports the domestic needs of the Las Vegas region, whereas in southern California about 70% is used for agriculture.

Genesis of challenge

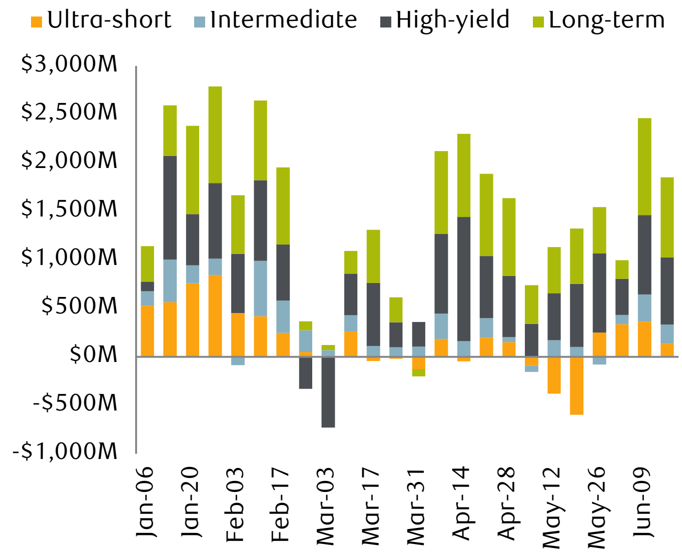
Some experts contend the root problem with the region's water management is that the existing allocations are based on circumstances that no longer exist. The Colorado River Compact, which was signed in 1922, was overly optimistic of the river's continuing ability to support cities and farms in the west. Additionally, the river is managed under the doctrine of prior appropriation, under which water saved by one member is then made available to the member with the next-highest senior water right. As a result, conservation measures by one member do not necessarily benefit that member, thereby decreasing the incentive to conserve for the future.

To state the obvious, water is a scarce resource in the arid Southwest. The area is particularly dependent on surface water supplies such as Lake Mead, which are vulnerable to evaporation. Thus, even a small increase in temperature, causing more evaporation, or a decrease in precipitation can strain the balance between water availability and the region's many competing needs.

Conservation taking root

Nevada recently passed a law banning non-functional grass—such as at office parks and street medians—by the end of 2026. The law will result in the removal of roughly six square miles of grass in the metro Las Vegas area, and conserve 10% of the state's total Colorado River water allocation according to water officials. The law excludes single-family homes, parks, and golf courses—providing exponentially greater future conservation potential, if necessary.

2021 municipal fund flows



Source - Refinitiv Lipper U.S. Fund Flows, RBC Wealth Management; weekly data through 6/30/21

Municipal water districts

Based on a review of several larger municipal water districts in the Southwest region, all have at least a sum-sufficient rate covenant— a legal promise to charge customers at least enough to cover operational costs plus annual debt service. In actuality, most districts generate greater than sum-sufficient debt service coverage to provide a coverage buffer. If the district anticipates delivering less water—for example, due to a drought restriction, the district is compelled to increase the per-unit cost of the water to adhere to the legal promise. If the district inadvertently violates the rate covenant, often times an independent professional rate consultant is retained to suggest ways to correct the violation in future years. Also, if the sum-sufficient rate covenant is ever violated—meaning insufficient net revenues are collected to pay debt service—municipal water districts almost always have financial reserves to cover the unanticipated shortfalls. These financial reserve buffers are especially true for highly-rated municipal water districts.

A municipal utility district's ability to honor its rate covenant should be straightforward, and usually it is. Unfortunately, political and constituent interferences sometimes can muddy the waters. Affordable utility services—such as electricity and water—are viewed as necessities, but often there is a perceptual disconnect between the service and the cost associated with providing the service. Water should always be available and for a nominal cost, but that paradigm has shifted for the arid Southwest. Prolonged droughts could result in less water, yet the fixed costs associated with water delivery do not fluctuate with the amount of water delivered. Therefore, the per-unit cost of water needs to increase if water volumes decrease, all else being equal. Nonetheless, various constituents may balk at paying more for less. Regardless, consumers ultimately will pay for this essential resource, and legal covenants compel municipal water districts to charge rates sufficient to pay for the debt obligations that enable the water utilities to treat and deliver water.

Parting thoughts

Prolonged drought may be the new landscape for the Southwestern states for decades to come. As a result, all constituents need to rethink how to persevere with less water. States have instituted conservation policies, and individual consumers are voluntarily using less water. Municipal water districts are also taking part by finding other water sources such as ground water, recycling water, building desalination plants, increasing water storage, and promoting conservation were possible. Despite the potentially challenging times ahead, including the prospect of less water delivery, municipal water district bonds have various legal covenants to better ensure their bond obligations are fully honored.

Municipal news

General commentary – Signs continue pointing to a rebound

Airport sector receives good news from Federal Aviation Administration (FAA)

The FAA announced it is providing $7.4 billion to numerous commercial airports throughout the U.S. In addition to the airport itself, money will also go to concessionaires within airports including restaurants, shops, and other businesses all which have suffered due to the pandemic. The nation's top 10 commercial airports by size are set to receive $2.4 billion of the allocated funds.

Sales tax collections – year-over-year improvement

States collected $20.2 billion in April, marking a 34% y/y increase, according to data collected from 31 states by the U.S. Census Bureau. States experienced gains in all sales and excise tax collections including general sales and gross tax receipts (up 17% y/y), motor fuel taxes (up 8.1% y/y), tobacco taxes (up 6.2% y/y), alcoholic beverage taxes (up 22% y/y), and lodging taxes (up 83.6% y/y).

State tax collections remain on the mend

First-quarter state tax collections improved to $294 billion, a 9.6% quarter-over-quarter (q/q) increase. Michigan experienced the biggest gain in tax collections at $6.97 billion during the quarter, a 60% q/q increase. Texas' tax revenue dropped most, 6% q/q, to $14.8 billion. States have approximately $340 billion in outstanding General Obligation (GO) bonds, according to Bloomberg data.

Municipal market news

American Dream Mall, NJ – Losing tenants

The American Dream Mall, located in northern New Jersey, which opened in October 2020 following pandemic-related delays reported 84% occupancy as of April 2, but it has dropped to 76%. The project, which was developed by Triple Five Worldwide, issued more than $1.1 billion in municipal bonds to complete the construction of the project, which experienced cash flow issues due to pandemic-related opening delays.

California governor recall election date set

The recall election of Governor Gavin Newsom is scheduled for September 14, 2021, much sooner than was expected. A recent poll by the Public Policy Institute of California shows a majority of likely voters are not in favor of recalling him. The recall petition was signed by more than 1.72 million voters, more than the required 1.5 million to initiate a recall.

California lawmakers abandon plan to pay debt early

State lawmakers scrubbed a plan to prepay $1 billion of outstanding GO tax-exempt debt, not including it in the state's approved FY2022 $196.4 billion budget. The state began FY2022 on July 1.

Hillside Village Senior Care, NH – In default, plans to sell project

Hillside Village, located in Keene, NH, with approximately $60 million of outstanding tax-exempt debt, hired an investment banker to market the continuing care retirement center for a potential sale as part of previously agreed upon forbearance agreement. The borrower defaulted on its January 1, 2021, interest payment. The current forbearance agreement expires August 31. Bondholders have a first-lien mortgage pledge and will be paid with proceeds from a successful sale.

Las Vegas – On the mend as tourism returns

The gambling mecca reported that more than 2.9 million tourists visited the city in May, an 11.8% y/y jump. While the increase is a welcome sign that tourism is rebounding, 2.9 million is down 22% from May 2019. At the same time, the city's hotel business saw occupancy top 71%, up around 5.3% from April. Year to date, there have been 10.5 million visitors, up 21.3% y/y but 40% lower than the same period in 2019.

Illinois - Metropolitan Pier & Exposition Authority – Considering refunding debt

The Authority is considering offering $835 million in tax-exempt debt to refund outstanding debt issued in 2002, 2012, and 2021. The authority plans to offer the bonds on a forward-delivery basis with an expected offering date in mid-July and forward closing date of around March 17, 2022. The Authority is considering the issuance of capital appreciation and current interest bonds as part of its offering.

New Jersey – Updates

Budget passage could signal improving finances

Governor Phil Murphy signed a record $46.4 billion budget for the fiscal year that began July 1. S&P said that “any improvement” in the state’s creditworthiness depends on the state’s ability to implement consecutive years of structural balance absent the use of reserves and additional federal aid.

State ready to make Hudson Tunnel down payment

The governor, in a recent interview, said New Jersey is ready to begin paying its 50% share of the $11.6 billion Hudson Tunnel project. Murphy and New York Senator Chuck Schumer are pushing to move up the beginning of construction to 2022 rather than 2023. The project cost is expected to cover the construction of the new tunnel and a much-needed rehabilitation of the current two-track tunnel built in 1910 used by Amtrak and New Jersey Transit commuter trains. The existing antiquated tunnel has become unreliable in recent years, according to Amtrak. A closure of the current tunnel would disrupt transit on the very busy Northeast Corridor.

The project had been put on hold after former President Donald Trump said that taxpayers should not be responsible for footing a portion of the costs to build the tunnel. President Joe Biden has vowed to provide federal funding to help construct the project.

New York Metropolitan Transportation Authority (MTA) – Ambitious capital plan

The MTA, which experienced dramatic declines in ridership, is beginning to see improved ridership throughout its public transportation system. Daily ridership topped 2.57 million on June 18; however the strong showing remains around 50% lower than pre-pandemic ridership levels. MTA leadership has said ridership needs to return to pre-pandemic levels for MTA to implement its ambitious $51.5 billion capital plan to improve the transportation system. MTA’s current capital improvement plan relies heavily on fare box revenue and an additional $10 billion of future borrowing, which could become more difficult if ridership levels do not return to those levels.

New York City – Mayor and city council agree on budget terms

Mayor Bill de Blasio and the New York City Council agreed on a $98.7 billion budget for the fiscal year that began on July 1. The city has benefited from better-than-expected tax collections and $15 billion in federal aid to help it combat the pandemic. The approved budget is $100 million more than originally proposed by the mayor.

The budget includes funding for pre-kindergarten to include children ages 3 and up, increases spending on reducing violence, promoting tourism, and provides aid to small business that have been among the hardest hit from the pandemic’s impact. The city will also add $500 million to its rainy day fund, bringing the balance to around $1 billion. When combined with other reserve funds, the city has around $5.1 billion in aggregate reserves.

San Francisco – Vacancy tax to be implemented next year

A voter-approved vacancy tax, which was to go into effect during the current fiscal year, was pushed back to January 1, 2022, as a result of the pandemic. In March 2020, voters approved a $250 per street-facing square foot tax on spaces vacant for more than 182 days. The tax increases to $1,000 per square foot if the space remains vacant for more than two years. Implementation of the measure is under consideration by San Francisco Mayor London Breed.

Ratings corner

Notable state and local issuer rating updates

Illinois – Upgraded by Moody; Outlook revised by Fitch

The state, which was rated one notch above junk, was upgraded by Moody’s to Baa2 from Baa3 on June 29. The state, once in peril of falling to below investment-grade is now rated two notches above non-investment-grade. The state’s recently enacted budget repays an emergency Federal Reserve loan, increases state pension fund contributions, and reduces the state’s backlog of accounts payable to less than $3 billion. The state’s accounts payable backlog topped more than $16 billion in 2017. The aforementioned factors were the main drivers of the rating upgrade. The state received around $8.1 billion in federal aid, which provided the state with additional budgetary flexibility. On June 25, Fitch revised the rating outlook to positive from negative.

New York State – Outlook revision

The state’s improved financial outlook, as it continues recovering from the pandemic, prompted Moody’s to revise the state’s rating outlook to positive from stable. The rating outlook revision was primarily driven by better-than-projected tax collections and large infusion of federal aid. Moody’s noted that if the state’s finances continue improving, the state's rating could be upgraded over the next 12–18 months.

SAJ Baseball LLC, VA – Downgraded by Fitch

On June 24, Fitch Ratings downgraded, to CCC from B-, Series 2019A and 2019B bonds issued for the construction of a minor league baseball stadium. The rating downgrade was primarily driven by the stadium's ailing financials, which have been negatively impacted by pandemic. The stadium was scheduled to open in 2020, but the pandemic caused minor league baseball to cancel the season, resulting in the loss of game day ticket revenue.

San Jose, CA – Rating affirmed by Fitch

Fitch Ratings upgraded the city's rating to AAA, the outlook is stable. The city, located in the San Francisco Bay Area is the Bay Area's largest city by population and third-largest city in the state. The city benefits from its large tech-driven economy, which is strong and growing. Fitch "expects the city to manage expected revenue declines related to the current economic downturn while maintaining the highest gap-closing capacity."

Virginia – Affirmed by Fitch

On July 1, Fitch Ratings affirmed the state's AAA rating and maintained a stable outlook on the state's rating. The state's solid financial resources, conservative approach to financial operations, and exceptional financial flexibility were the key drivers to the rating affirmation according to Fitch.

Territorial update

Commonwealth of Puerto Rico

Governor files objection over debt plan

Governor Pedro Pierluisi filed a limited objection to the court overseeing the island's ongoing $22 billion restructuring negotiations. Most recently, the governor signed legislation prohibiting further cuts to the island's underfunded pension system. The Commonwealth owes current and future retirees around $55 billion and is currently paying retirees approximately $2 billion annually in benefits. The governor has said he is in favor of the restructuring but not in favor of additional cuts to current and future retirees.

RBC Wealth Management retail trading (6/1/21 – 6/30/21)

Top 10 CUSIPs selling volume to retail customers

CUSIP	Description	Maturity	Coupon	Volume
544532AR5	LOS ANGELES CA DEPT O	07/01/2049	5.00	3,771
57582RWY8	MASSACHUSETTS ST-C	05/01/2046	5.00	3,286
5444956V1	LOS ANGELES WTR PWR-A	07/01/2049	5.25	2,288
13063DNK0	CALIFORNIA ST	04/01/2045	5.00	2,162
0418265H7	ARLINGTON ISD -REF	02/15/2045	4.00	2,100
13063CUG3	CALIFORNIA ST	08/01/2045	5.00	2,049
385622PT6	GRAND ISLAND	11/15/2028	3.00	1,786
35880CZZ0	FRISCO TX INDEP SCH D	08/15/2049	4.00	1,745
38611TBR7	GRAND PKWY TRANSPRTN	10/01/2048	5.00	1,694
65821DYG0	NC MED CARE MED CARE	03/01/2051	4.00	1,673

Top 10 CUSIPs buying volume from retail customers

CUSIP	Description	Maturity	Coupon	Volume
880541VW4	TENNESSEE-A	08/01/2035	5.00	2,637
13063CUG3	CALIFORNIA ST	08/01/2045	5.00	2,410
13063CPT1	CALIFORNIA ST-REF	08/01/2033	5.00	2,359
13063B3W0	CALIFORNIA	04/01/2037	5.00	2,339
64763FQA0	NEW ORLEANS-TXBL-REF	09/01/2022	3.69	2,072
386186GC8	GRAND RAPIDS BDG-CAB	12/01/2031	0.00	1,781
385622PT6	GRAND ISLAND	11/15/2028	3.00	1,768
13063CPS3	CALIFORNIA ST-REF	08/01/2032	5.00	1,680
38611TBR7	GRAND PKWY TRANSPRTN	10/01/2048	5.00	1,661
64990EW78	NY ST DORM AUTH-E-REF	03/15/2033	5.25	1,540

Source - RBC Wealth Management

RBC Capital Markets institutional trading (6/1/21 – 6/30/21)

Top 10 CUSIPs selling volume to institutional customers

CUSIP	Description	Maturity	Coupon	Volume
48305QAG8	KAISER FOUNDATION HOSP.	06/01/2051	3.00	46,216
48305QAF0	KAISER FOUNDATION HOSP.	06/01/2041	2.81	45,249
351837AA7	FRANCISCAN HEALTH SYS	07/01/2049	3.91	23,286
368497JX2	GEISINGER PA AUTH HLT	04/01/2043	5.00	21,854
20281PNE8	CMWLTH FIN AUTH-A	06/01/2042	2.99	20,452
04352EAB1	ASCENSION HEALTH	11/15/2039	3.11	18,138
13068XBT5	CALIFORNIA ST PUBLIC	05/01/2046	4.00	15,714
60637ATN2	MO HLTH & EDU FACS	07/01/2046	4.00	12,585
626207YF5	MEAG TXB-PLT VOGTLE	04/01/2057	6.64	11,393
61237WAG1	MONTEFIORE OBLIG. GRP	09/01/2050	4.29	10,954

Top 10 CUSIPs buying volume from institutional customers

CUSIP	Description	Maturity	Coupon	Volume
48305QAG8	KAISER FOUNDATION HOSP.	06/01/2051	3.00	43,972
38122NZX3	GOLDEN ST TOBACCO SEC	06/01/2038	3.12	31,394
351837AA7	FRANCISCAN HEALTH SYS	07/01/2049	3.91	23,251
20281PNE8	CMWLTH FIN AUTH-A	06/01/2042	2.99	22,463
04352EAB1	ASCENSION HEALTH	11/15/2039	3.11	22,370
914455UF5	UNIV OF MICHIGAN MI	04/01/2040	2.44	21,766
48305QAF0	KAISER FOUNDATION HOSP.	06/01/2041	2.81	17,627
79642GMZ2	SAN ANTONIO -A-REF	05/15/2051	4.00	13,635
544532CN2	LA DEPT OF WTR-B-REF	07/01/2048	5.00	13,113
60637ATN2	MO HLTH & EDU FACS	07/01/2046	4.00	12,564

Source - RBC Capital Markets

Bond Buyer indexes

Weekly	Current 7/1/21	Previous 6/24/21	2021 high	Date	2021 low	Date
Bond Buyer Revenue Bond Index	2.50%	2.53%	2.80%	(2/25)	2.43%	(6/10)
Bond Buyer 20-Bond Index	2.14%	2.16%	2.44%	(2/25)	2.07%	(6/10)
Bond Buyer 11-Bond Index	1.67%	1.69%	1.97%	(2/25)	1.60%	(6/10)

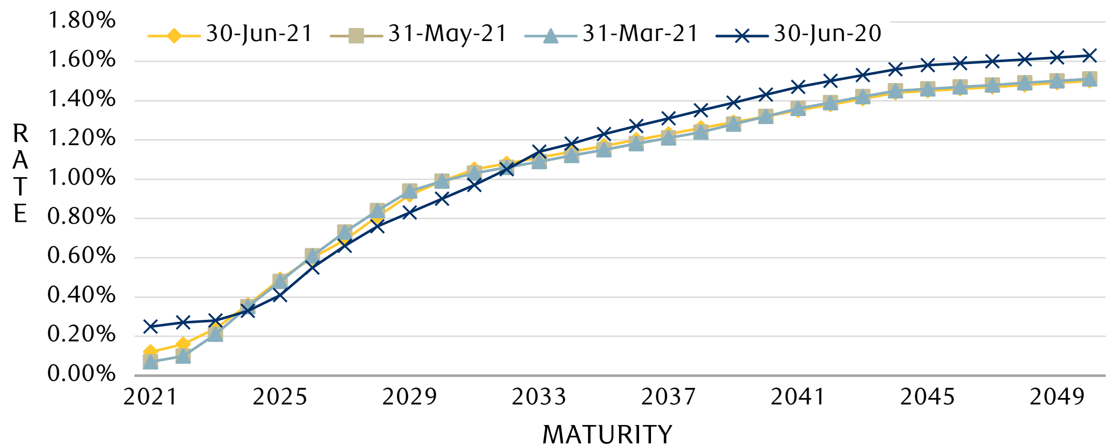
Source - The Bond Buyer

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	0.27%	0.02%	0.19%	0.29%	0.69%	0.12%	0.18%	0.44%	0.67%
Year-to-date total return	1.06%	0.17%	0.57%	1.24%	2.33%	0.06%	0.51%	1.84%	3.91%

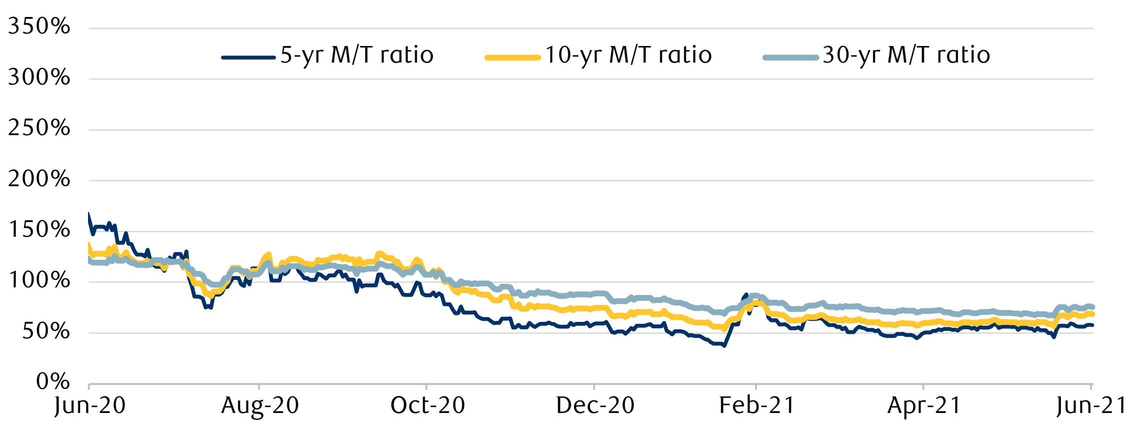
Source - Bloomberg; data through 6/30/21

Muni market data AAA yield curve



Source - RBC Wealth Management, Thomson One Refinitiv; data through 6/30/21

Muni/Treasury ratio comparison



Source - RBC Wealth Management, Bloomberg; data through 6/30/21

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 (negative outlook)	Not rated
Syncora	Not rated	Not rated

Source - RBC Wealth Management; data through 6/30/21

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