Municipals in 2021: The Sun Also Rises

We see three key themes to watch in the new year. Some echo themes highlighted in 2020 that remain relevant today. Each may unlock income opportunities for municipal bond investors in 2021.

IN THIS EDITION

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The Sun Also Rises

The Covid-19 pandemic made 2020 a year like no other. But the municipal bond market largely weathered the storm. Investors endured unprecedented volatility early in the year, followed by a rapid rebound.

Three themes drove municipal performance:

- **A developing opportunity set** – Taxable municipal issuance created after-tax income opportunities for flexible municipal managers.
- **Selectivity within credits** – High-yield muni spreads narrowed in early 2020, creating opportunities in medium-grade municipals. After a volatile spring, managers were able to add exposure in underperforming sectors.
- **US presidential election** – A changing of the guard at the White House and speculation about potential policy change created little market disruption.

Where does this leave us in 2021, and how should investors position their municipal bond portfolios?

We see three themes investors should keep an eye on in 2021:

- **Supply Surge: Use It to Your Advantage**
- **Status Quo or No? Eye on Fiscal Policy**
- **Taking Credit in 2021**

Key Considerations

If Treasury yields remain at or near historically low levels, we will likely see taxable munis comprise a large portion of total municipal supply again in 2021. Similar to 2020, we believe this shift in the composition of municipal issuance allows for compelling relative value opportunities for disciplined and active muni investors.

–Scott Diamond, Co-Head GSAM Municipal Fixed Income

Policy changes under a new administration have the potential to lead to increased interest rate volatility in 2021. Investors are encouraged to continue to evaluate duration risk within portfolios, and for some, this may mean considering a flexible, actively managed approach that is ready to take advantage of opportunities across the yield curve.

–Sylvia Yeh, Co-Head GSAM Municipal Fixed Income

Strong revenue growth prior to the pandemic provided an important anchor that helped municipalities persevere through the difficult April-June period. If the US economy continues to return to normal trends, municipal credit should broadly benefit. Credit selection will always be paramount given the idiosyncratic nature of the municipal market.

–David Alter, Head of GSAM Municipal Research

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Supply Surge: Use it to Your Advantage

Investors may get the chance—again—to maximize after-tax yields.

2020 in Review

The muni market absorbed an unparalleled $500 billion in new issue supply in 2020, and market participants are forecasting another record year in 2021. While investors may be wary of the new issue calendar's impact on technical factors, we think those who use a dynamic approach to pivot between tax-exempt and taxable municipal securities may discover opportunities to maximize after-tax yields. In particular, below-average tax-exempt municipal supply coupled with the continued increase in taxable municipal supply should create an investing environment ripe for toggling between the two supply streams while optimizing for after-tax yields and returns.

Taxable Municipal Issuance

The exponential growth in taxable municipal issuance can be traced back to the 2017 Tax Cuts and Jobs Act (TCJA), which continues to affect the overall municipal market. This legislation eliminated tax-exempt advance refundings, which had been a key refinancing tool for municipalities. That prompted many issuers to tap the taxable municipal market instead at a time when Treasury yields—and, by extension municipal financing costs—were low. Before the TCJA, taxable issuance generally accounted for well under 10% of overall municipal issuance. That began to change in 2019, and in 2020, taxable issuance made up one-third of the overall municipal supply making last year a record year in primary market volumes.

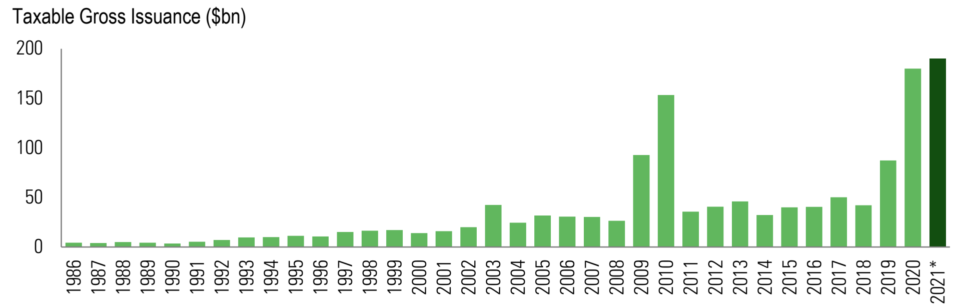
With Treasury yields expected to stay at low absolute levels in 2021, municipal issuance is projected to look a lot like it did in 2020, with supply driven by a continued surge in taxable issuance. This means more than a third ($190 billion) of total municipal supply is expected to be in taxable form, which is greater than twice the five-year volume average and four times more than the annual average prior to 2019 (Exhibit 1). This unprecedented surge is expected to grow taxable municipal debt outstanding to about $800 billion by the end of 2021[1].

Tax-Exempt Municipal Issuance

Tax-exempt supply, on the other hand, is expected to be closer to $335 billion, below its five-year average (Exhibit 2). Longer-term, there is sizeable potential for more refinancing issuance that may reduce future outstanding tax-exempt debt. These diverging supply patterns should create active opportunities where one portion of the overall municipal market may be more attractive than the other and vice versa throughout 2021. In what is expected to be a challenging yield environment in 2021, this potential yield pick-up may prove to be a significant portion of an investor's portfolio.

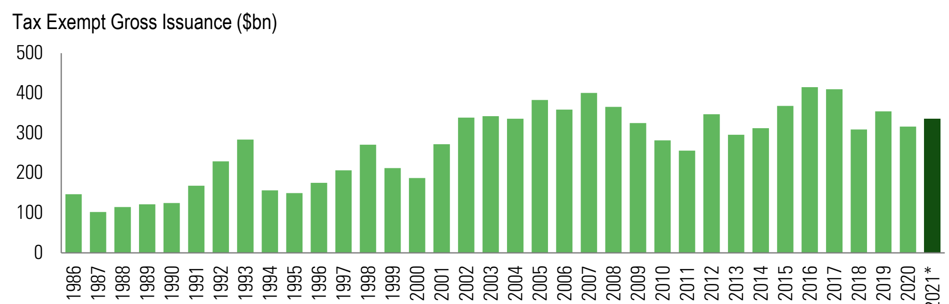
[1] Source: Barclays Research. November 10th, 2020.

Exhibit 1: Taxable Muni Bonds are Expected to Issue at Record Levels and Outpace Tax-Exempt Muni Issuance



Source: GSAM, Refinitiv, Bloomberg Finance L.P, and JPMorgan. Note: Corporate CUSIP included. 2021 figures reflective of JPMorgan forecasts. As of December 31, 2020.

Exhibit 2: Meanwhile, Tax-Exempt Supply is Expected to Come in Below Five-Year Average Volume Issuance



Source: GSAM, Refinitiv, Bloomberg Finance L.P, and JPMorgan. Note: Corporate CUSIP included. 2021 figures reflective of JPMorgan forecasts. As of December 31, 2020.

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Status Quo or No?: Eye on Fiscal Policy

New administration, New priorities. New policies?

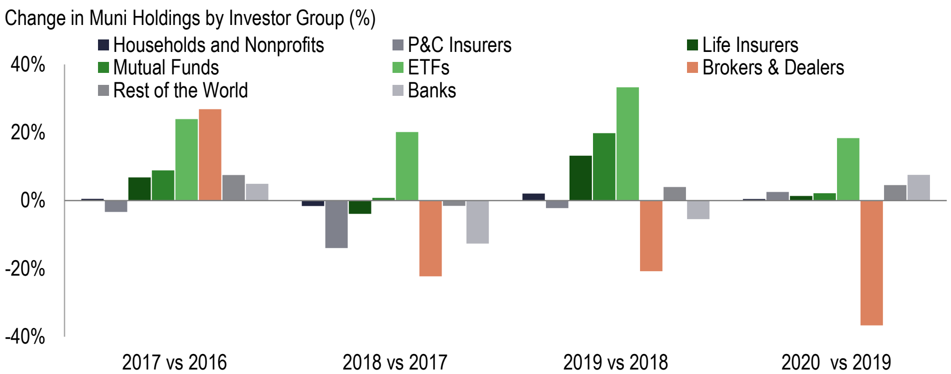
The new year brings a new US administration and should provide some early clues about whether we'll see a meaningful policy shift. With Democrats in control of the White House and Congress, most investors will be closely watching for any shifts in areas such as tax and healthcare. We think it's also important to keep an eye out for possible changes that others may be overlooking. One recent example is the elimination of tax-exempt advance refundings under the 2017 Tax Cuts and Jobs Act. As noted earlier, this led to a sharp increase in taxable supply in 2019 and 2020 and reduced new tax-exempt issuance. In 2021, there are a few possible policy scenarios that we think municipal investors should be paying close attention to.

Positive Market Impacts

Increased Tax Rates

All else being equal, a rise in taxes for either individuals or corporations should enhance the appeal of holding tax-exempt municipal bonds, which would be a positive for this sector of the market. We have witnessed a shift in holders of municipal bonds over the years (Exhibit 3).

Exhibit 3: As Broker-Dealer Participation Has Declined Over the Years, Other Investor Groups Have Steadily Increased Their Muni Bond Holdings



Source: Federal Reserve. As of 3Q 2020.

Dealer holdings have consistently declined while holdings by individual investors (as indicated by SMA, ETF and mutual fund flows) remain steady. Bank and insurance companies have selectively increased their positions since tax reform and an increase in the corporate tax rate may prompt traditional institutional and crossover muni investors to enter the tax-exempt market sooner during periods of stress, potentially decreasing market volatility and offsetting retail outflows.

Additional Fiscal Stimulus

While 2020 has featured various forms of fiscal stimulus that have been supportive of many municipal credit sectors, the continued economic impact of Covid-19 on the US has led to calls for additional and more expansive stimulus from the incoming Biden administration. Although municipal credit on the whole has been resilient over this past year, additional fiscal stimulus has the potential to be a strong tailwind for the market and could lead to tighter credit spreads if the economy continues to recover.

Negative Market Impacts

Tax-Exemption Benefit Cap

In the past, there have been proposals aimed at capping the benefit of holding tax-exempts at 28%. The impact of such a policy would likely lead to a rise in tax-exempt yields relative to other asset classes (muni to Treasury ratios would move higher), as the after-tax benefit to holding tax-exempt munis would decrease.

Removal of the SALT Deduction Cap

As part of the Tax Cut and Jobs Act, the benefit on the state and local tax deduction (SALT) was capped at $10,000. The impact was a compression of credit spreads in high tax states like California and New York in particular. Thus the potential removal of this $10k cap as has been discussed, could pressure spreads for credits within these states.

Uncertain Market Impact

Infrastructure Bill

Infrastructure investment has generated some bipartisan support, but progress has been minimal. The municipal market has the potential to play a key role in infrastructure reform, which could influence future tax-exempt and taxable supply.

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Taking Credit in 2021

Selective exposure to mid-grade and high-yield municipal credit may yield opportunities.

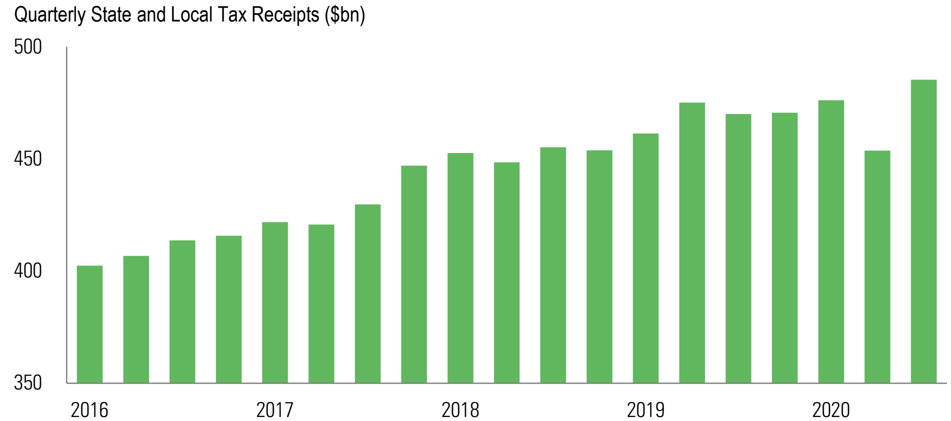
State and local revenues generally fared better than expected during the most impacted quarter in fiscal 2020 and for the year overall. For the second quarter ended June 30, revenues were down a manageable 4.4%. While states and local governments benefitted from the CARES Act, we also believe the majority of municipalities were well positioned even without the additional federal stimulus. The Federal Reserve's Municipal Liquidity Facility (MLF) may have shored up confidence in the muni market, but only two issuers actually used it, illustrating the stability of high-grade municipal bonds.

As of the third-quarter of 2020, revenue numbers were 3.2% higher than they were during the same quarter in 2019 (Exhibit 3). We expect those revenues to continue to drift back to normal. Goldman Sachs Chief Economist Jan Hatzius expects 5.9% US GDP growth in 2021 and historically data suggests that state and local revenue tends to be closely correlated with US GDP growth (Exhibit 4). That bodes well for municipal credit broadly; even in the darkest days of the pandemic, municipal ratings volatility was limited, and we expect further credit strengthening in 2021.

We do not anticipate a significant rise in high-yield municipal defaults either, as most issuers were not directly affected by Covid-19. Some issuers, however, in sectors such as retail sales, proton therapy and waste disposal/recycling that were under stress before the pandemic hit will likely remain so. Some project finance issuance, boosted by the low-rate environment in recent years, may also struggle as they reach the critical final development and start-up stages. On a positive note, healthcare, small university and student housing sectors may start to improve as Covid-19 vaccines are more readily available.

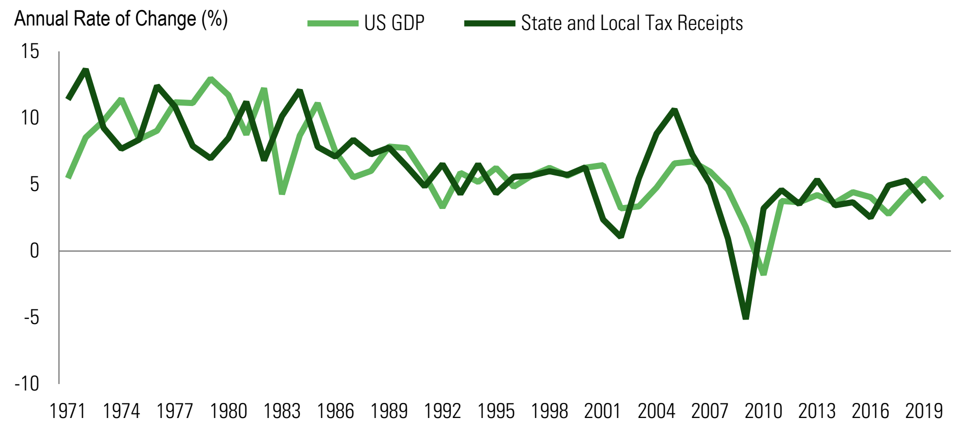
Overall, we see opportunities across the credit spectrum that may improve portfolio yields. However, research is key. Credit quality varies widely across issuers, and some segments of the market are highly idiosyncratic. Determining the risk/reward tradeoff requires careful credit analysis.

Exhibit 4: State and Local Tax Receipts Are Expected to Normalize as the Economy Recovers



Source: GSAM, Bureau of Economic Analysis. Quarterly data. As of September 30, 2020.

Exhibit 5: State and Local Tax Receipts are Highly Correlated to US GDP Growth



Source: GSAM, Bureau of Economic Analysis. Annual data. As of December 31, 2019.

The Strategy for 2021:
Be Flexible, and Stay Active

The municipal bond market showed its resilience last year, and we expect that to continue in 2021, particularly as the US economy recovers. Another year of heavy supply—much of it taxable—and the potential for policy changes could create opportunity, and we think active managers who can be flexible and selective are best positioned to navigate the twists and turns that may lie ahead and to seize opportunities to boost income in a today's low-yield environment.

Supply Surge

Taxable muni issuance may unlock new after-tax opportunities but increase scarcity of attractive tax-exempt municipals.

Eye on Fiscal Policy

Policy may be front and center in 2021, with stimulus for states, tax rates and even infrastructure spending potentially on the agenda.

Municipal Credit

Economic recovery should create opportunities in sectors hurt by Covid-19, but selectivity is key, particularly with regard to project-finance related deals.

Source: GSAM.

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