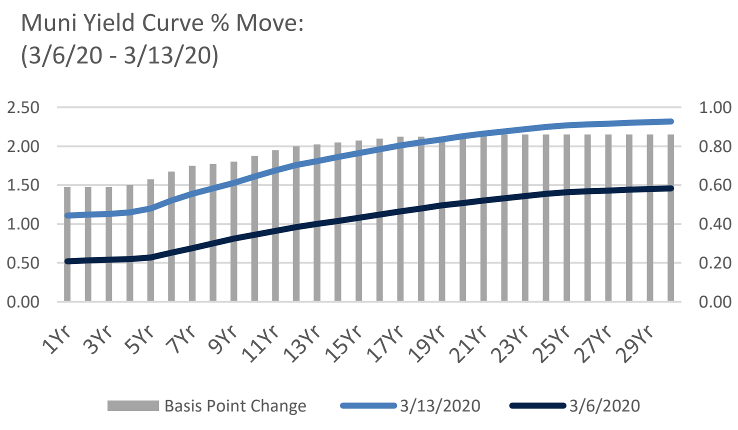
CORONAVIRUS CRISIS & THE MUNICIPAL MARKETS

MARCH 16, 2020

Capital Markets Turbulence Reaches Municipals

The tax-exempt markets were jolted on March 12 by a rapidly growing global healthcare crisis, experiencing extreme retail selling pressure. The 10Yr AAA municipal curve was off 42 basis points and market strains continued into the week of March 16. This followed two weeks in which municipals had performed well as volatile equity markets sold off.

What is occurring is unnerving and we recognize that investors are concerned, particularly given that tax-exempt portfolios generally serve as a source of stability. While every situation is unique, the fixed income markets have weathered past dislocations, including 9/11, the Financial Crisis, and the "Taper Tantrum." At Appleton, we have been through these crisis situations before, and this experience helps inform our thinking as portfolio managers.



Source: MMD

Roots of Dislocation

Pandemic fears accelerated what had already become a "risk-off" environment that produced the most rapid bear equity market in history. It only took 21 days for the S&P 500 to decline by more than 20% (BofA Global Research). A corresponding flight to quality quickly depressed Treasury yields, driving the 10Yr down to 0.82% in mid-day trading on March 16.

In our view, an extreme technical reversal, not credit stress, caused municipal yields to rapidly gap out last week. Fixed income investors had already begun reacting to public health and associated economic fears by withdrawing $14.3 billion from investment-grade, high-yield and leveraged loan mutual funds during a one-week period ended March 11, exceeding the prior week's record $12.2 billion. These figures preceded even larger net outflows on March 12.[1]

This acute stress quickly bled into the municipal markets where a long period of strong retail demand was abruptly reversed. Mutual funds incurred $1.4 billion in net outflows during the weekly period ended March 11, with high yield and long-term funds leading the selling. An additional $1.76 billion of net outflows exited tax-exempt funds on March 12 (Refinitiv Lipper).

A Supply and Demand Driven Shock

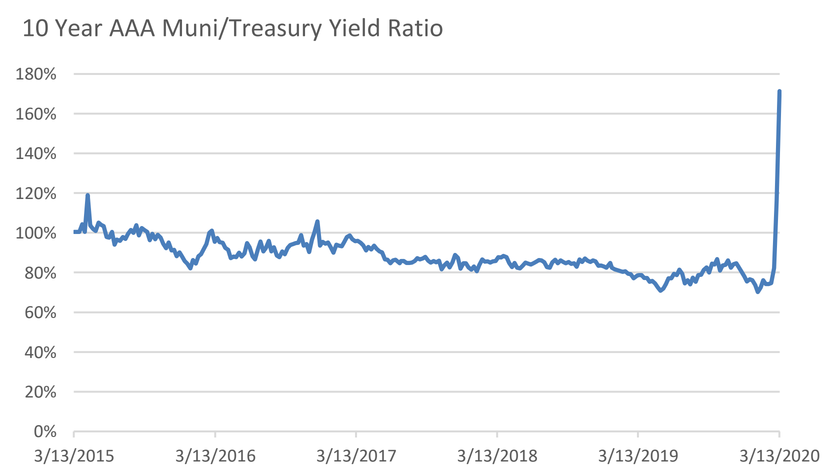
These redemptions forced mutual fund managers to sell into markets with a scarcity of buyers. Extreme technical weakness is creating illiquidity as bid lists meet with limited demand and dealers appear averse to carrying bond inventory. The cost to trade investment grade municipal issues has soared, widening bid-ask spreads. The result has been a sharp and sudden spike in yields across the municipal curve. As is often the case, lower quality, less liquid sectors fared worst, with the Bloomberg Barclays High-Yield Municipal Bond Index losing 4.1% on March 12 alone.

Against this backdrop, AAA Muni/Treasury ratios have dramatically repriced. The 10Yr AAA ratio stood at an extremely elevated level of 209% as markets traded on March 16. 10Yr AAA municipal yields of 1.72% compare to 0.95% only a week prior.

Circumstances differ, but today's trading fits past crisis patterns. Very attractive values attract opportunistic capital as signs of stability emerge, a cycle that ultimately leads to recovery.

The Federal Reserve is acting quickly and with urgency to help restore liquidity and a degree of confidence, announcing an emergency cut in the Fed Funds rate to a target range of 0 – 0.25%, while also launching a massive $700 billion quantitative easing program. Sizeable repo operations previously announced by the NY Fed are expected to continue weekly for at least a month.

Our perspectives concerning the nature of today's markets, municipal credit quality, and ways in which we are seeking to add value in client portfolios follow.



Source: Bloomberg

1. Refinitiv Lipper reports weekly flows after the close of business each Wednesday.

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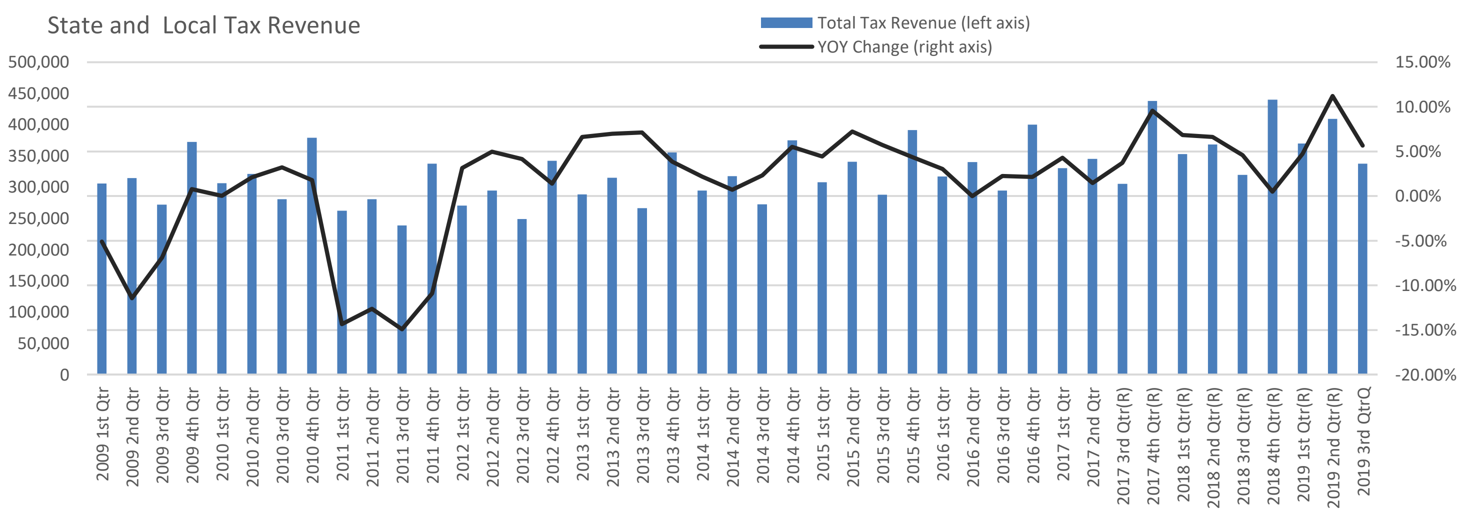
Credit Strength Backstops Quality Issuers

While Q1 and Q2 will be weak economically, most investment grade municipal issuers are entering this period with considerable credit strength. We are dealing with a dynamic, uncertain environment, but our belief is that stronger, more economically diversified issuers will retain their credit quality. Provided this proves to be the case, bond prices should gravitate back towards fair value.

Our longstanding preference for large, high quality municipal issuers is fundamentally rooted in preparing for challenging environments. Issuer characteristics we seek include economic breadth, diverse revenue sources, prudent management, and deep financial resources. As we have seen in past downturns, these characteristics create far more flexibility to deal with difficult economic periods than is available to smaller, more economically constrained entities.

From a credit perspective, we feel most of the municipal market is on solid ground. State and local government tax revenues collectively increased 35 of the last 40 reported quarters (US Census Bureau), while fiscal YTD state tax revenues are up more than 6%. Sustained growth has allowed municipalities to fortify their reserves. In fact, the median level of state rainy-day funds increased to 7.5% of expenses in 2019, up from only 1.9% in 2011, while local rainy-day funds exceed 20% of expenses. Balance sheets have also been rebuilt over the past decade, with aggregate state debt only increasing 4.8% since 2011.



Source: U.S. Census Bureau

Delving more deeply into municipal sectors, we believe essential service providers should perform better than smaller entities and less essential service providers. **Senior living, charter schools, and narrow project finance bond issues introduce considerably greater risk. Appleton has no exposure to any of these sectors.**

Last November we published "[Differentiating Credit Vigilance from Complacency]", a paper that discussed the importance of margin of safety and other risk management characteristics of our investment process. **While the current economic outlook is of concern, we are confident the high-quality tax-exempt bonds owned in Appleton portfolios will come through this period well.**

Portfolio Management Implications

Client objectives and guidelines differ and there are no simple "one-size-fits-all" solutions. Nonetheless, our fixed income team is looking at potential investment opportunities created by today's dislocation.

Municipal bid lists have been growing led by forced selling from some of the large mutual fund complexes. **We are drawing upon our proprietary research to try and find quality bonds at compelling prices.** However, trading is challenging given wide bid-ask spreads and dealer reluctance to step up.

In Strategic Municipal Crossover and other accounts with requisite guideline flexibility, we will look to selectively swap out of Treasuries into high quality municipals. We expect to see municipal/Treasury ratios normalize over time. How quickly this happens remains to be seen, as Treasuries may not move a great deal until the ultimate severity of Coronavirus and the efficacy of Federal response is better understood.

On the front-end, commercial paper, money market instruments and VRDNs have seen yields jump as investors sell liquid holdings. This too is not surprising, and we are looking for opportunities to benefit clients.

Partnership Matters

The value of professional advice may be greatest during turbulent times, and we greatly appreciate the trust clients have placed in us for so many years. We will regularly prepare short market notes and observations in the days ahead, and also encourage clients to reach out to our relationship management team with questions.