MUNICIPAL OBSERVATIONS AND PORTFOLIO IMPLICATIONS

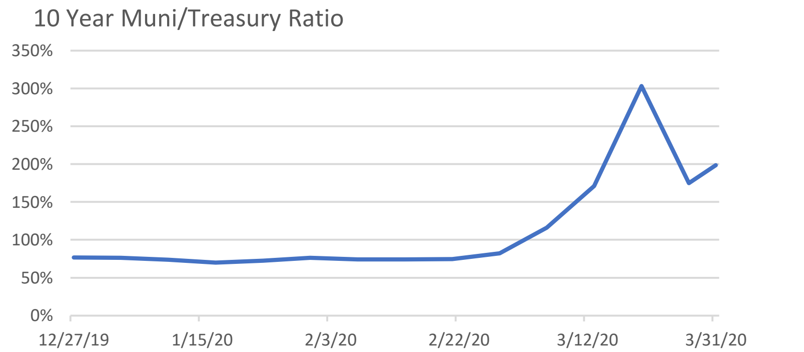
MARCH 31, 2020

Onset of Turbulence

- As the magnitude of the Coronavirus crisis and the economic impact of mitigation practices became increasingly evident, equities rapidly slid into bear territory, with the S&P 500 posting the fastest 30% drop in history.
- This sell-off was soon followed by a flight to quality that rattled the corporate and municipal bond markets. Tax-exempt bond funds incurred a record $25.9B of net outflows over the two weeks ended 3/25.[1]
- Investors quickly sought to raise cash and, as a result, higher quality, liquid assets such as municipals, commercial paper, Treasuries and agencies suddenly faced intense selling pressure.

The Markets React

- This contributed to extreme dislocation, with the 10Yr AAA muni curve jumping in yield from 0.81% on 3/9 to a peak of 2.88% on 3/23, before dramatically retracing to 1.33%.[2]
- The 10Yr AAA Muni/UST ratio rose from 93% at the end of February to a peak of 303% on 3/20, before settling back to 199%.[2]
- Investment grade corporate credit spreads widened to an extent not seen in at least 40 years on 3/19 prior to recently narrowing considerably.



Source: MMD and Bloomberg

The Federal Reserve Steps Up

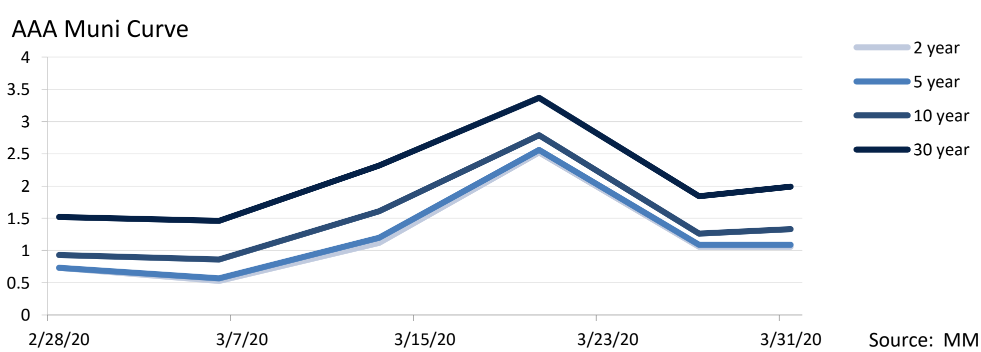
- Fiscal and monetary policy response has been dramatic - far larger and faster than during the Financial Crisis.
- The Fed authorized $450B in purchases of short-term municipals and investment grade corporates, pledging primary and secondary market support where stabilization is needed.
- The Fed is also taking other steps to stabilize short-term funding markets, including expansion of its Money Market Mutual Fund Liquidity Facility to include VRDNs.
- Wall Street estimates suggest there will be $4 trillion of Fed purchases during this round of QE, with as much expected in three months as during QE1, QE2 and QE3 combined.[3]

Congress Turns on a Fiscal Firehose

- A front-loaded $2 trillion Congressional fiscal package quickly followed, stimulus representing almost 10% of GDP, much more than was authorized during the Financial Crisis.[3] Another round is already being discussed.
- Congress is rushing tax cuts, direct payments, extended unemployment insurance, loans and guarantees to individuals, businesses and municipalities to help bridge the gap until the healthcare crisis abates and economic vitality returns.
- Sizeable sums are going to states and municipalities ($150B), hospitals ($100B), transportation systems ($25B), higher education ($14.5B), local school districts ($13.5B) and airports ($10B) to help offset Coronavirus-related economic impact. While hardly a panacea, these funds offer valuable assistance as tax-exempt entities adjust their revenue assumptions and budget plans.
- For states and municipalities, prospective additional stimulus could enhance fiscal flexibility in the face of reduced or delayed tax payments.
- The Federal Government is in an "act now" mode, as stabilizing the economy supersedes budgetary constraints. Deficits are expected to double from 5% to 10% of GDP in very short order[3], a risk that is being deferred to another day.

Signs of Stability

- Market conditions have significantly improved in recent days with municipal yields falling nearly 150 bps across the curve off their highest levels of March.
- 10Yr AAA yields now rest at 1.33% vs. 0.93% at the end of February.[2]



Source: MMD

APPLETON PARTNERS, INC.

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Signs of Stability

- Although still extremely elevated, the 5 and 10Yr AAA Muni/UST ratios are well off recent peak levels at 287% and 199% respectively.[2]
- Corporate bond prices are also firming, as Bloomberg Barclays IG Corporate Index option-adjusted spreads have fallen from a high of 373 to 272.[2]
- Equity risk appetite also appears to be returning, with the S&P 500 recently rallying 17.5% off its lows, the 2nd biggest 5-day rally in history.[3]
- VIX, the CBOE's volatility index, has declined 30 points after recently spiking to 83, another indication that capital market conditions have at least temporarily calmed.

Tax-Exempt Portfolio Strategy

Markets have trouble pricing uncertainty; and the path the Coronavirus Crisis and economy ultimately takes introduces unprecedented unknowns. That tends to produce sustained volatility. In this environment, we feel proprietary credit research and active management have never been more important. At Appleton, we are drawing on both as we seek to add value in client portfolios.

- Even after a welcome rally, municipal yields remain higher than a month ago, creating an ability to add considerable tax-advantaged income when deploying new cash flow.
- Differentiating value from vulnerability is critical and we are stress-testing issuer credit quality by conservatively modeling variables such as revenue decline scenarios, liquidity, and maximum debt service coverage.
- When we see creditworthy bonds trading at attractive levels relative to historical norms, our portfolio managers are selectively trying to put cash to work.
- We are also looking to sell certain names perceived to face greater credit risk as more attractive bids return to the market.
- Trading conditions remain challenging and we continue to emphasize avoiding unnecessary selling. Wide bid-ask spreads create severe penalties, particularly when transacting in odd lots and/or less liquid issues.
- Relative to very short maturities, we are adding credit approved VRDNs to appropriate portfolios when supply becomes available and yields are favorable. The VRDN market is technically sensitive right now and yield fluctuation can create income enhancement opportunities.
- Given sustained front-end relative value dislocation, we see benefit in swapping out Treasuries for short-term high-quality municipals in applicable Crossover accounts.

1. Refinitiv/Lipper
2. As of March 31, 2020
3. Strategas

Accessibility and communication are important in any environment, although these attributes are especially valuable during uncertain and volatile times. Appleton Partners is committed to sharing our market and portfolio management perspectives as developments unfold. We hope these briefs are helpful and also invite you to reach out to us directly and/or visit www.appletonpartners.com/Insights for additional commentary and insights.