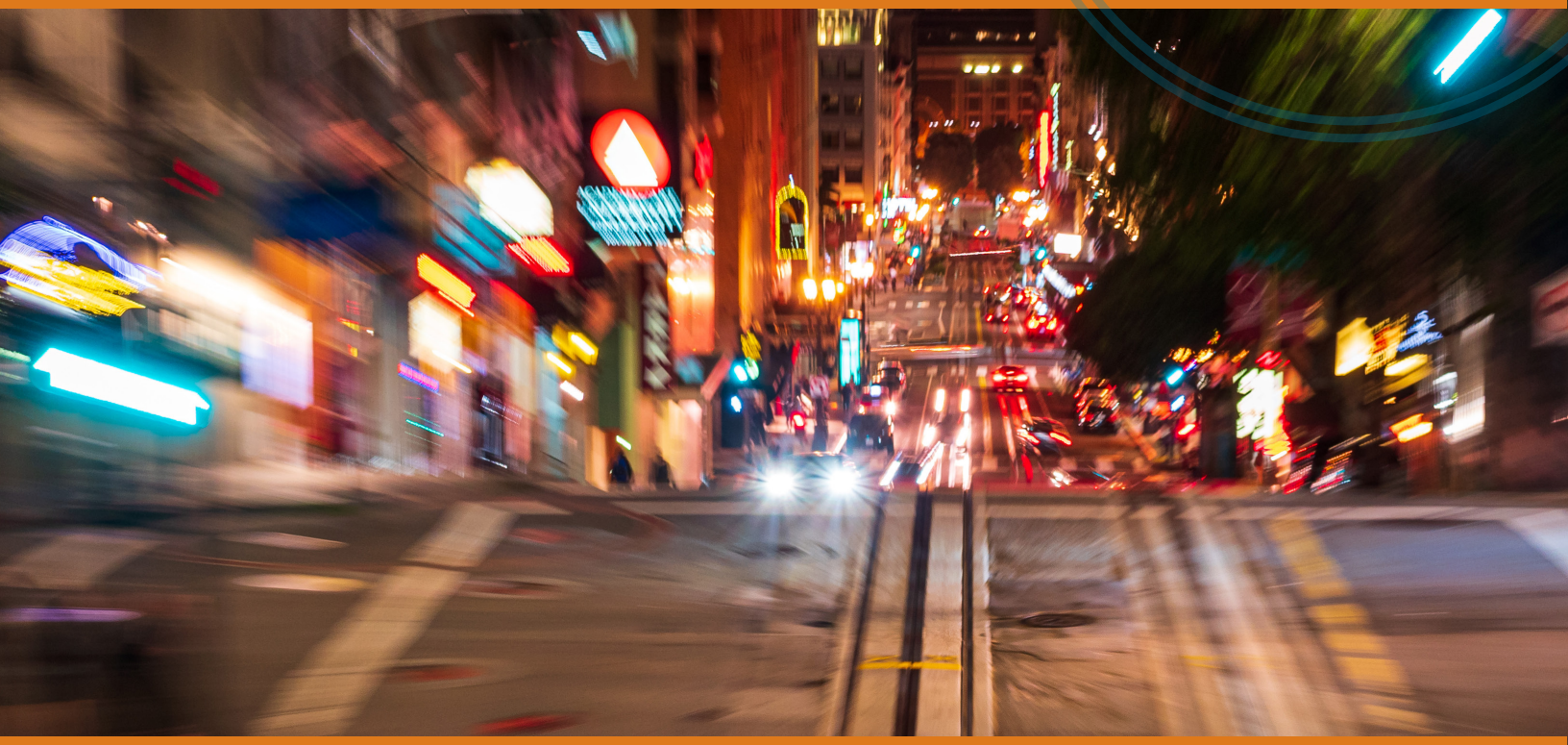
May 2020

MUNIWATCH

FIXED INCOME RESEARCH



After experiencing unprecedented stress in March due to the effects of the coronavirus, the municipal bond market has returned to more of a sense of normalcy as the new issue market begins to open and trade activity stabilizes. The AAA Municipal curve steepened for the month, with short-term yields falling and long-term yields rising. Absolute yields on high-grade munis are actually higher than comparable corporates, presenting a great opportunity to invest in munis.

The market has been tested, successfully absorbing multiple $1bn+ new issues as well as deals for hard hit sectors such as hospitals and airports. While economic data and political commentary continues to fuel credit concerns, the Federal Reserve (Fed)'s Municipal Liquidity Facility will help issuers through a potential liquidity crunch and we do not anticipate any issues for traditional muni issuers. As the market reevaluates and reprices credit risk based on the effects of the coronavirus, careful sector and individual credit selection is of utmost importance.

AA Munis Out-Yield AA Corporates

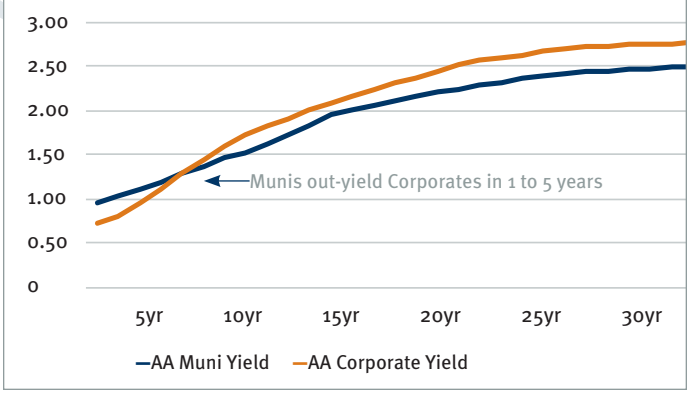
While the Fed has detailed its support for the corporate market, its support for the muni market remains undefined. As a result, corporate yields have fallen and muni yields have risen. As of April 30, the absolute yield on AA munis is higher than that of AA corporates in the 1 to 5 year area of the curve. We view this as a great opportunity to invest in the muni market and don't believe this opportunity will last as traditional corporate bond buyers have been moving into the tax exempt market over the past few weeks (see bottom left chart showing AA muni and AA corp curves).

BBB Muni Spreads Widen

Given the uncertainty surrounding the economic impact of the coronavirus, spreads on lower-rated munis continued to widen in April. Spreads on higher quality credits are improving but harder hit sectors such as senior living centers, hospitals, transportation/public transit, and airports have yet to recover. On a positive note, the New York City MTA came to market just this week, issuing 25, 30, and 35 year bonds. The deal received robust demand and was actually upsized to $1.375bn, to become one of the largest new issue transactions so far this year. As the overall reaction to new issue deals over the past few weeks has been positive and met with healthy demand, including those for lower-rated issuers, we expect these spreads to begin to narrow (see bottom right chart showing m/m spread curves).

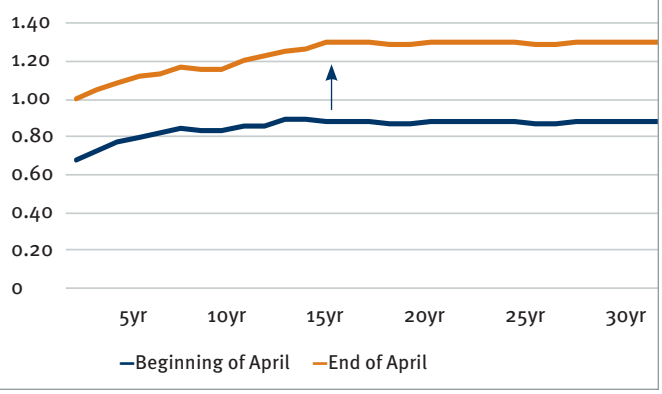
AA MUNI YIELD CURVE VS. AA CORPORATE YIELD CURVE

Source: Thomson Reuters, Bloomberg. Data as of April 30, 2020.



BBB MUNI — AAA MUNI SPREADS WIDEN

Source: Thomson Reuters. Data as of April 30, 2020.



POLITICAL LANDSCAPE

As mentioned on page 1, the municipal market has achieved some semblance of normalcy, but not without a big bump in the road. Senate Majority Leader Mitch McConnell's comments of support for allowing states to go bankrupt certainly roiled the market and caused an uproar among governors from both parties, despite the near certainty that such a step would never pass the Democrat-led House of Representatives. McConnell has since pulled back dramatically on his comments, even going as far as saying he doesn't favor the idea. McConnell has not pursued the idea and does not have bankruptcy legislation in mind, according to University of Pennsylvania, Carey Law School professor David Skeel. The apparent purpose served by his remarks was to establish that his tolerance for aid to states has limits and that he will be resisting any effort to exploit the crisis to secure a general bailout for poorly managed states.

Beyond the posturing, there are several insurmountable legislative and constitutional challenges that preclude states from filing bankruptcy, number one of which is that it is illegal! States are not allowed to file for bankruptcy. Congress would need to amend the federal bankruptcy code. States would need to amend their own laws to authorize application. The U.S. Supreme Court would need to rule on whether it violates the contracts clause of Article I, Section 10 of the US Constitution. The Sovereignty of states becomes an issue also. Congress cannot rule on the potential bankruptcy of a state — a federal court would be the only body allowed to do so, and they would have to create a separate federal court entity to handle this. Federal bankruptcy code also requires a party to prove they are "insolvent" and have no other access to liquidity, which would be extremely difficult if not impossible for a state to prove. Bankruptcy is an inability to repay debts, which is not the situation states currently find themselves in. States are facing a temporary gap between revenues and expenses to potentially fund essential services.

Coronavirus Aid, Relief, and Economic Security Act

The $2.2 trillion Coronavirus Aid, Relief, and Economic Security Act (CARES), signed into law March 27, will help state and local municipalities (including transit agencies like MTA) cover their immediate costs associated with treating the COVID-19 virus and related lost revenue. The Act was viewed favorably by S&P Global, which stated that the $25 billion in federal aid allocated to transit agencies "has alleviated immediate liquidity pressures for many systems." Most municipalities were in much better shape going into this pandemic than they were during the financial crisis of 2008-2009, with larger reserves and rainy day funds. A PIMCO report notes, that states entered this crisis with rainy day funds equal to $75 billion, or 7.7% of spending, more than 1.6 times greater than what states had entering the global financial crisis.

According to a Citibank report (April 27, 2020), "One common misconception is that a state which has a fiscal deficit and does not have a rainy day fund is facing insolvency. That is not the case and the cash balances in a state's operating fund and various non-operating funds are more reliable indicators of solvency and even both Illinois and New Jersey have sufficient cash in their non-operating funds to weather the storm." States also have many options to balance budgets, including the ability to draw on reserves, sweep cash from additional funds, cut spending, raise taxes and extend payments.

Municipal Liquidity Facility

The Federal Reserve also just considerably broadened their guidelines and extended the scope and duration of the $500 billion Municipal Liquidity Facility (MLF), allowing many more municipalities to participate. Although, as of the date of this writing, the Fed has yet to actually purchase any municipal securities. This will nevertheless help municipalities bridge this temporary gap and spread out the time period needed to deal with these issues. As it relates to Illinois, New Jersey and Connecticut, from a JPMorgan report from last week, "Looking at three lower rated states, Illinois, New Jersey, and Connecticut, we find that state estimated revenue shortfalls, should be sufficiently covered by MLF capacity if capital markets and traditional avenues of credit seizes up, after accounting for reserves and $150bn allocation in the CARES Act. Further, we find that each state also has ample GO issuance capacity, meaning that they have room to issue short-term notes to bridge any funding and budget gaps. The Fed support would also mean that the states can take advantage of notes out to three years, lowering liquidity and non-payment risk, given that one of the eligible use of proceeds of Fed purchased notes, is to pay debt service on existing obligations."

Conclusion

When state bankruptcy was last raised in 2011, after the financial crisis, it died a quick death after just a single hearing in the U.S. House of Representatives. It's highly unlikely the topic will even get that far now. States are not in favor of a bankruptcy option, as they've previously voiced, as it could lead to additional/higher borrowing costs for municipalities and they can find other means of addressing their budget gaps. And, as mentioned above, the "traditional avenues of credit" — the municipal markets, have not seized up and in fact are functioning quite well in distributing new issue municipal product, even from some of the harder hit sectors like airports and hospitals. There is also no doubt that more aid will be forthcoming from both the Fed and Congress, as both parties agree on the need, we might just need to wade through more political posturing, of which we've certainly had a good couple years' worth, regardless of the political party you may favor.

SEPARATELY MANAGED ACCOUNTS
PROFESSIONAL PORTFOLIO MANAGEMENT

Washington Crossing Advisors' separately managed account programs provide investors with access to the management team who for the past 20 years have worked together as market strategists and portfolio managers.

In addition, since these programs are offered only through investment professionals, financial advisors can provide individualized monitoring of portfolio manager performance.

Portfolio Customization

Separate accounts can be tailored to address individual investors' needs — focusing on risk tolerance and long-term investment objectives. Investors can specify certain parameters to customize their accounts, such as excluding certain securities or sectors, due to social, political or environmental concerns, and managing the portfolio to help reduce tax liabilities.

Individual Security Ownership

Ownership has its privileges: investors own each individual security held in a separate account. Sell decisions are made by portfolio management based on the investment portfolio and are not affected by the redemption needs of anyone except the individual account owner.

Tax Advantages

When investing through a separately managed account, investors pay taxes only on the capital gains that they actually realize. Individual securities in the account are owned directly, allowing investors to work with their tax advisor and financial advisor to implement tax-efficient investing strategies.

FEATURED STRATEGY

1-10 Year Municipal Ladder
BPG Core Muni Portfolio (BPGCMT)

The Washington Crossing Advisors' Laddered Municipal Bond SMA Portfolio offers investors better control over exposure to interest rate risk, predictable cash flow, and the opportunity to help manage an everchanging interest rate environment.

Philosophy

We believe that stable long-term returns are achieved through bottom-up credit research and issuer diversification.

Process

The securities chosen for the Washington Crossing Advisors' Laddered Municipal Bond SMA Portfolio undergo a thorough selection process. The portfolio management team emphasizes fundamental analysis and employs a disciplined review process that focuses on a comprehensive analysis of the issuer's creditworthiness, valuation, liquidity, and each bond's unique factor footprint.

Buy/Sell Discipline

Positions are sold if our evaluation of credit quality deteriorates and/or the risk of a potential rating downgrade increases.

Construction

The Washington Crossing Advisors' Laddered Municipal Bond SMA Portfolio will invest in investment grade municipal fixed-income securities laddered across consecutive maturities from one to ten years. When a bond matures, it will be replaced with a bond having the longest maturity in the strategy's range. The portfolio may invest in callable bonds, which if called prior to maturity, will generate a need to reinvest in a manner that will maintain the composition and risk profile of the portfolio.

About Washington Crossing Advisors | Washington Crossing Advisors is a registered investment advisor and wholly-owned subsidiary of Stifel Financial Corp. WCA helps supervise and manage over $3 billion in discretionary assets for individuals and institutions. Proprietary strategies include equity, fixed income, balanced, and asset allocation.

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