MONTHLY REVIEW

July 2019

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July 2019 Muni Market Monthly Review – "The Illinois Agenda"

Once again, munis experienced steady, positive performance during the month of July. . MMA total return indices are up YTD roughly 8.3% for 15 to 30 year munis and 4.5% for five-year maturities. Muni inflows remain positive, and supply below historical levels. This (combined with a Treasury market anticipating Fed rate cuts and investors seeing only the good in muni credit news) keeps munis moving forward with price gains.

On the surface, recent credit news from Illinois does not alter our opinion about the State. Underneath the lawsuit, which we have named ***"The Illinois Agenda"***, we see a trend that could cause some concern in muni-land. MainLine sees politics and agendas becoming more prevalent and scaring some investors away from certain issuers and bonds. Now, it is our job to take advantage of any opportunities the noise could make, while continuing to ensure our investors are in the right type of bonds.

Muni Market Review

The muni market had a good July, slightly outperforming taxables led by the seasonal supply and demand imbalance. Munis remain in demand, with additional inflows (now 29 weeks in a row) even at these low yield levels. The relative value of munis is rich from 10 years and shorter, with 15 years and longer still considered "cheap" to taxables. July highlights include:

- Muni yields were down 21 to 10 bps, with the curve steepening.
- According to MMA, Muni YTD total annualize returns range from 4.5% for five-year maturities and roughly 8.3% for 15 to 30 year maturities.
- Taxable yields were mixed, + 2 bps to -5 bps with the curve slightly flattening.
- Year-to-date, muni issuance has finally picked up and it looks like this will continue:
  - 2019 is up 3.1% versus 2018.
  - 2019 is down 27.7% versus the last 5 years' average.

Credit news from Puerto Rico and Illinois has turned a bit negative for the overall muni market, but the investors have chosen to ignore it. We discuss the possible repercussions of these recent developments for munis, going forward, in this month's credit review.

Market News and Credit Update

Munis have experienced 29 straight weeks of inflows. We estimate roughly $54 billion in new monies have flowed into munis YTD. It appears this money is going to roughly five big firms:

- Vanguard 32.4%
- Nuveen 15.9%
- Goldman Sachs 11.9%
- BlackRock 11.9%
- NY Life (Mackay) 6.8%
- Everyone else 21.1%

- The muni industry lost one of its best analyst's and spokesperson at the end of July, when Phil Fischer retired from Bank of America/Merrill Lynch. Nobody understood, could explain, or tell stories about munis better than Phil. You could call him the **"Grandpa of Munis**"! I had the pleasure of knowing him for a long time, and doing some "research" together on Bourbon Street over 20 years ago.

- The Governor of Puerto Rico, after initially refusing, changed course and decided to resign at the end of July. The Commonwealth is in the middle of working through its bankruptcy, and a changing of the guard to a relatively unknown individual creates unknown credit concerns for those who are still invested in PR.

The Illinois Agenda

Introduction:

It is no secret that municipalities have found loopholes and stretched legal definitions to issue debt for projects that politicians felt were "important" and "essential". In many instances, politicians do not think their judgement of the "essential nature" of the project will or should be questioned by its voting residents. What if the residents decide to challenge the fiscal responsibility and essentiality of the project - say a golf course, ice rink, or shopping center? Now, assume the deal was financed by tax dollars that are "morally" designated to pay it off, and needs approval by the municipality on an annual basis? *"Houston, do we have a problem?*"

Simply put, municipal finance is not an exact science; there are broad brush strokes involved and, if someone wants to start looking closely, they can find "unpainted corners". When they do, then they can invite politics and local judges' opinions into decisions that may affect the principal value of the bondholders. I call this ugly side of muni finance as "**The Illinois Agenda"** after a recent lawsuit.

Background:

Politics and legal interpretations are the basis for a recent lawsuit filed against the state of Illinois. A special interest group in combination with a hedge fund believe some covenants were broken when Illinois issued bonds to pay a backlog of bills in 2017 and to fund its pension plan in 2003. ***They claim both issues were deficit financings that are prohibited by the State's constitution.*** The State's constitution allows bonds to be sold for "specific purposes". The lawsuit says funding a pension plan or past due bills are not specific. They want the state to be more fiscally responsible and want to make its political leaders accountable for the fiscal ills of Illinois.

The essentiality and importance of the use of proceeds by the State of Illinois is not in question in the lawsuit, and is not the basis for the "The Illinois Muni Agenda". This "agenda" is referring to the politics and legal interpretations that are ramping up in muni land and trying to scare investors from municipalities that have "enemies". *The moral pledge highlighted above, and the Illinois case are both examples of broad painting strokes, that are allowing the use of proceeds and the legal ability to pay off bond holders with tax dollars to be questioned by individuals with an agenda.*

This lawsuit comes two months after the Federal board overseeing the Puerto Rico bankruptcy sought to have $6 billion in bonds declared null and void, saying the island had already breeched its debt limits and was not allowed to issue any more debt.

What Is a General Obligation Bond? (Wikipedia):

A general obligation bond (GO) is a municipal bond backed by the credit and taxing power of the issuing jurisdiction, rather than the revenue from a given project. General obligation bonds are issued with the belief that a municipality will be able to repay its debt obligation through taxation or revenue from projects. No assets are used as collateral.

MainLine is not worried about the case against the Illinois bonds and its ability to continue to support their repayment. ***First, we believe the State, even if these bonds were found to be "illegal" by the courts would still pay them off by whatever means.*** We do not think the lawsuit has any legal merit to it and would be surprised if this issue ever makes it to the courts. We see "specific purposes" in the issuance of the bonds as follows:

- Past due bills were used for some sort of purpose by the State; they just were not paid for at the time of the service.
- Pension payments are owed to employees who worked for the State. This money is needed to make these State owed liability payments. Is this not a specific and an important purpose?
- We have no concerns with the Illinois debt other than it is the "hotbed" for politics.

MainLine sees the agenda in Illinois to be nothing more than politics and noise. Yet, we do see an underlying theme that also fits with Puerto Rico, Detroit and the Platte Valley bankruptcies. ***It also rhymes with our concern of the decline in the gold standard of general obligation bonds and its claim on the first liens on revenues, politically altered and inconsistent court legal interpretations.***

So Why Concerns?

It is not the ability of issuers to find a way to pay off the debt that worries us, not Illinois fiscal challenges, but it is more about political will. ***It is the concern that special interest groups, residents and other entities challenge the use of debt, the politicians then decide not to fight it, and the courts see the "broad strokes" and allow the municipality to walk away from their obligation.***

Moral obligation bonds (backed by the promise to repay with revenues, no-specific lien or source) and lease revenue bonds (bonds repaid by appropriations from the general fund) are a bigger concern then unlimited general obligation bonds. MainLine feels there are different levels of concern for all types of debt. Essentiality of the project, demographics, general fund budget management and politics are all variables that can elevate or alleviate concerns. ***For the most part, bond deals are done properly and there is no ability to question the use of proceeds and repayment.***

Going forward, we are worried that other special interest groups with an agenda will copycat the type of lawsuit occurring in Illinois. This seems to be the new way of politics, given the events in DC over recent years. It does not seem too far-fetched for munis to be caught up in it.

Conclusion:

MainLine feels the right type of bonds, used for essential services, backed by the right type of revenue, with the right type of indentures will not be questioned or be of concern. The fundamentals of the muni market should not be in question, and we do not see an increase in defaults. We do see politics and agendas becoming more prevalent in muniland scaring some investors away from certain issuers and bonds. Now, it is our job to take advantage of any opportunities this noise will make, and continue to make sure our investors are in the right type of bonds.