MONTHLY REVIEW

March 2023

MAINLINE WEST

Mocking Jays & a Detroit Revisit:

As an investment manager, the past couple years have felt like we are nothing more than candidates from a District in an evil "financial markets hunger game" where a Game Maker randomly throws in new challenges to test investors' skills of survival. For example: fight a pandemic, fight the most aggressive Fed tightening ever, fight inflation, crypto corruption, and now a banking crisis? Can someone please pull the plug on this cruel game? Either way, munis are still standing and, in fact, being viewed as a safe place to invest. Combine this with the calmness of the market at month-end and supply/demand technicals getting stronger, MainLine sees munis providing investors a survival kit this summer. So, take that Mr. Game Maker, munis are your "Mocking Jay"!

Talking about lifelines and muni resurgence, nothing is more symbolic of that than the City of Detroit. While doing a recent review on muni credits, I came upon one on the city of Detroit. Yes, it still exists! MainLine thought this would be a good time to revisit what was once the mega motor city that ultimately became a wasteland. We were surprised to see what was going on and just how far the city over the last ten years. Other than no longer being "Hockeytown USA" (that belongs to Denver, Thank You!), Detroit is getting a little spring back in its stride, while not ***"catching fire"*** quite yet.

Muni Market Review:

Now what? Another banking crisis? What happened to inflation? What about a 6% Fed Funds rate? Does Crypto still exist? March has brought in a whole new set of market concerns and chaos, but seems to be finishing on a calm note. The performance of the muni market was encouraging. Instead of being treated as a "risk asset", it performed like a safe-haven, keeping pace with US Treasuries. The month-end calmness is just what the muni market needed, as the Bloomberg Composite Muni Index showed a 2.22% return for the month - the best March performance since 2008.

Highlights as follows:

- Muni yields were higher by 42 to 24 bps, as the curve flattened. Taxable yields were higher from 64 to 31 bps, as they also flattened.
- Munis are year-to-date positive on inflows at $6.2 billion, but only 4% of last year's outflows. They have been less consistently positive than forecasted, but as the markets calm down, expect the inflows to pick back up.
- Supply is still lagging 2022's pace and historical levels. Down over 25% year-to-date, 15% versus the five-year average, and not going up anytime soon. Analysts have finally cut their optimistic forecasts by 20%. A lot of this is refunding volume, which at the higher rates does not work for cost savings, but there is also a decrease in new money, which historically is not impacted by higher rates.

The market tone set during March, along with the cut in expected supply, is setting munis up for a solid summer ahead when supply and demand technicals will turn positive. Prospective buyers could be chasing after bonds and looking back at the value opportunity that 2022 and early-2023 provided and regret not getting invested.

Market News & Credit Update:

- **ETFs are becoming a much bigger player in the muni world.** Recent growth has their size exceeding closed-end funds at $100 billion versus $80 billion, but still smaller than open-ended funds at $750 billion. ETFs now make up 11% of the muni fund universe. Same-day liquidity, low cost, and ability to control tax consequences are all reasons for the growth versus open and closed ended mutual funds. This has had an impact on the muni bond market by creating increased liquidity in bonds held by the ETF's, and discounted prices on types of bonds not invested in by ETF's such as AMT bonds, healthcare, housing or charter schools. It has also increased rate volatility, as their liquidity creates easier access to buy and sell munis on a daily basis.
- **A sign of what is to come? The California Wealth and Exit Tax:** Introduced and unlikely to pass, it could be the first shot across the bow to the wealthy. Introduced was a 1% to 1.5% wealth tax on residents starting at $50 million in household wealth and also introduced was an "exit-tax", that would levy a fee on tax payers leaving the state. Think California is the only state looking into this? They may be the most extreme at the moment, but Hawaii and Washington have proposed "wealth taxes." Other states like New York and Massachusetts have other ideas such as "sur-tax" to get income from the ultra-rich.

Detroit Revisited

On July 18, 2013, the city of Detroit filed for bankruptcy and entered the world of Chapter 9. It was an unfortunate situation for the people who still lived there, but certainly not a surprise to municipal investors, as it was the culmination of a long, slow deteriorating demographic trend. The demise of Detroit provides the opportunity to learn what went wrong and if and when it can ever return as a place to live and invest in.

Background:

Entire books could be filled with a detailed analysis of everything that went wrong with the City of Detroit, but it takes only a brief examination of the Motor City to understand where things began to unravel. Most people would agree that, at one time, Detroit was considered the "place to be". It was a modern, booming city. Sixty years later, it was a prime example of a city in urban decay due to local government mismanagement and the mass exodus of people and industry.

In the 1950s, Detroit had over 2 million residents and was the fifth largest city in the U.S. thanks to a booming automotive industry. Yet, as early as 1961, Time Magazine ran a special report speculating on the "Demise of Detroit." Little did they know how big of a decline the City was about to see, and how long it would take. Since the 1950s, the City's population has declined 60% (now below 700,000) and is smaller than towns like El Paso and Oklahoma City. Detroit could no longer afford to provide the most essential of services to its residents and was strapped with the debt and bills once used to support a city 2.5 times its current size.

Bankruptcy Process

On July 18, 2013, Detroit filed the largest municipal bankruptcy in history, measured by debt estimated at $18 to $20 billion. The court approved the chapter 9 filing after a series of appeals on March 1, 2014, and the battle for funds began between bond holders, city creditors, and the pension fund.

The city put forth an adjustment plan to exit Chapter 9 in February 2014 and it was approved with some changes on November 7, 2014. The biggest issues facing the bankruptcy of Detroit were which assets belonged to the city and which belonged to the creditors. Remember, general obligation debt refers to "full faith and credit", what that truly means was debated and finally interpreted by the Judge. This was highlighted in the battle for the fate of the Detroit Institute of Arts (DIA), which owned 66,000 valuable pieces of which only 5% was actually bought by the city, the rest was donated. The grand bargain, after getting DIA to contribute $100 million, which was used to shore up more of the pension claims and not bond holders was as follows:

- Detroit city workers' pensions were cut by 4.5%, end to cost of living adjustments and reduced health insurance coverage.
- These pension cuts are in place for ten years, at which time if the system is healthy, reductions could be renegotiated.
- General obligation bonds, backed by an unlimited pledge (authorized by City, and voter approved) received 74 cents on the dollar, bonds backed by a limited pledge (city approved but not voter approved) received 34 cents on the dollar.
- Secured bondholders with a specific revenue stream assigned to the back bonds, such as Detroit Water and Sewer Department, were paid in full, and the revenue backing them left untouched.

Detroit 2022:

Yes the city still exists, Yes is still only one third its original size and yes it is still called the "Motor City". Economically, demographically, and financially the city is slowly coming back to life. It has realized a series of upgrades from B in 2012 to its current rating of Ba2 as of March 2022, reflecting its reemergence from decay, but it still remains a "junk bond" reflecting that its recovery is still in process.

Economy Rebuild:

The unemployment rate is falling and has gone from 22% in 2020 to 10% in 2021, and is now close to 8.7%, but it is still the highest amongst the nation's top 50 cities. Much of the gain is from construction, manufacturing, and service jobs. The city has also seen wage growth, faster than the state, but a bit inconsistent due to the nature of the jobs. The return of the auto industry with EV cars and a few new industries taking advantage of its international crossing with Canada are creating this life.

Society & Demographic Rebuild:

The city is providing young people and those with ideas to do a lot with just a little money. Real estate is cheap, plentiful, and ready for transformation. It provides young couples and individuals with a chance to build a middle class and be entrepreneurial in spirit. The city still lacks the safety and quality education needed to bring back the majority of people. Population growth has been 0% in 2022 and declined .25% in 2021. The key to population growth and recovery will be when families start returning to the city.

City Financial and Politics Rebuild:

What appears to be the biggest improvement in the Detroit story from a municipal investor's perspective? The leaders of the city and their budget management. The city has a balanced budget and the city is making good, clean decisions on planning and managing its new "world". What, no more corrupt politics –or- decisions for the common good and a plan that do not include political gain?

Rebuilt and Reborn?

This new "Motor City" does not appear to be the Detroit of our parents, even if the Detroit Lions appear to be the same. The city looks to be moving forward, and remains a great experiment, almost like the new "wild west". It is providing Americans a place that they can afford to chase their dreams, yet it seems like the return of Detroit as a place for the common American family remains years away. Detroit is not ready for a SWAN portfolio, but maybe in another 60 years it will be. Until then we can all continue to root for a great muni comeback story, and the success of the Mocking Jay!

SPECIALISTS IN MUNICIPAL BOND INVESTMENTS