MONTHLY REVIEW

November 2020

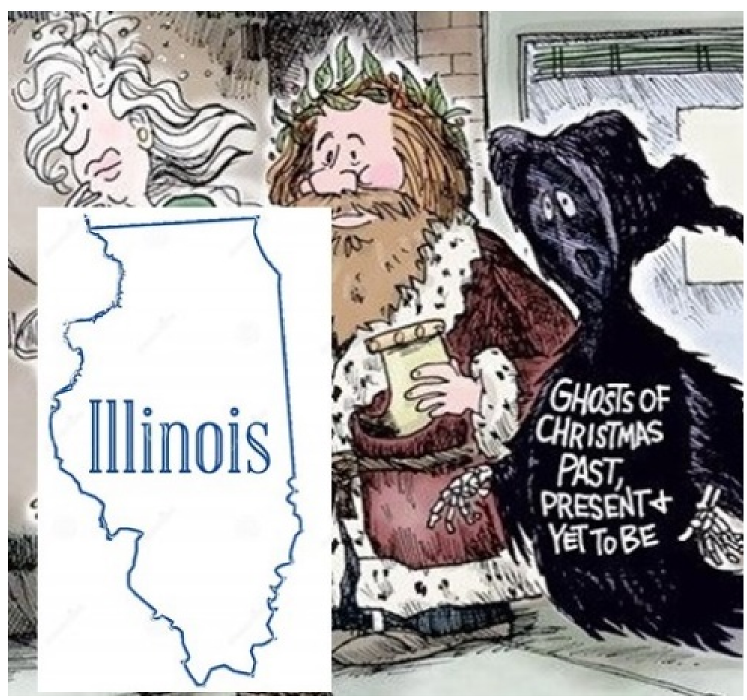
MAINLINE WEST

November 2020 – "The Fiscal Nightmare Also Known as Illinois"

November 2020 was quite a big month for munis. To say munis outperformed taxables is an understatement. For the month, general index yields were lower by 3 to 6 times more in basis points than taxables and ratios are getting very rich on the short-end. For bonds that are considered lower in credit quality or more volatile in trading liquidity, the drop in yield was much larger. ***For example, by mid-month, the New Jersey General Obligation deal effectively eliminated whatever value remained in muniland.*** From the initial pricing early in the week --> to the underwriting --> to the repricing --> to "free to trade" in the secondary market, yields on bonds decreased 70 to 80 bps (from 2.50%ish to 1.80%ish in 2032). Having lived there for seven years, I may be one of the few who appreciates New Jersey, but even that seemed like too much love to me. There is still Camden and Jersey City in that state! ***What this suggests is that most munis are in a good place for the next 30 to 90 days.*** Happy Holidays MainLine West investors!

In this month's Municipal Market review, we look at a state not in such a good place - the State of Illinois. The state is about to become the first state general obligation "junk bond". Rated BBB-/Baa3 and with roughly one-third of its tax revenues supporting "debt" obligations, it is only a matter of time before it is no longer considered an investment grade issuer.

This fiscal mess comes from a long history of neglect, misplaced priorities, and lack of political direction. Ghosts from the state's past, present and soon to be future haunt its credit worthiness. MainLine is not calling the state "blue" and we are not suggesting it should declare bankruptcy or receive a bailout. However, we are calling for bipartisan reforms beginning immediately, so it can add up over the next 30 years - saving it from a Detroit-style ending. ***MainLine's is comfortable with its existing holdings in Illinois GO paper, as it is our belief that the impact of the fiscal issues in Illinois will be realized over the long-term, while our investments are shorter-term in duration.***



Muni Market Review

The muni market crushed taxables, outperforming and taking the yield ratios lower by 20%. The market has all but made up for it lackluster performance this fall and yields are now getting close to the lows of mid-August. Credit spreads are tightening and COVID concerns seem to be cured. Highlights from November are as follows:

- Muni yields decreased from 7 to 30 bps, curve flattening, as taxable yields were lower by 2 to 5 bps.
- Muni to taxable yield ratios tightened dramatically: 5 year from 67% to 55%, 10 year from 105% to 85%, 15 year from 114% to 93% and 30 year from 129% to 110%. Munis on the short-end are now rich, 15 years and out they still show a little value.
- Credit default spreads continue to tighten, but remain a bit higher at roughly 105% to 140% versus one year ago.
- At $434 billion in new issuance, the muni market continues to bring new deals, and has now eclipsed the previous full year record issuance of $428 billion in 2016. More specifically:
    - Year-to-date issuance is higher by 18% versus 2019, and 15% versus the last five-year average.
    - New issuance for 2021 is forecast in a wide range from $375 to $550 billion. This shows the uncertainty regarding taxable refunding volumes. Stay tuned for our opinion in our 2021 Outlook due in January.

The MainLine Family of Funds are in a good place as we approach year-end. Fund V has returned all deleveraging capital, Fund VI is fully invested and Fund VI.5 is half invested, and are all showing good NAV appreciation. If you have any needs to invest cash, or better yet raise cash before year-end, MainLine advises you do so in the next two weeks. We are anticipating a quiet year-end, after such a wild ride.

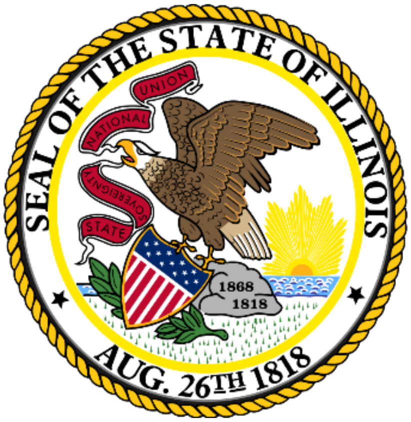
Market News and Credit Update

- The City of Chicago approved a $12.8 billion budget for 2021 that relies on higher property and fuel taxes along with savings from a large debt refinancing. More specifically, $94 million increase in revenue and $501 million in debt costs savings. The City is struggling with COVID revenue shortfall, costs associated with unfunded pension obligations and chronic budget imbalances.

- COVID is cured in the muni market. Issuers that caught the virus are now immune. For example, airport bonds, with the hope of a vaccine, have tightened back to spreads Before-COVID (BC). The tourist town of Gatlinburg, Tennessee – "Dollywood", has 60% of its revenue from tourism sold bonds at levels close to the high-grade scale.

- An update to the “Goodbye LIBOR, Hello SOFR” monthly review from October 2020. Recent news has the extension on the conversion of shorter indices (3-month) from late 2021 to possibly mid-2023. Once again, we anticipate no real impact on the muni market or on the MainLine West Family of Funds.

The Fiscal Nightmare Also Known as Illinois:



The State of Illinois currently rated BBB-/Baa3 and on negative outlook, is one downgrade away from becoming the first and only state to have a high-yield credit rating.

“A high-yield bond can also be referred to as, speculative or a junk bond. These bonds have a higher risk of default or other adverse credit events, but offer higher yields than better quality bonds in order to make them attractive to investors.”

How did one of the largest and (once considered) wealthiest states, with one of the largest cities that is a main pathway for trade and commerce in the USA, become such a fiscal mess? Here are some ugly truths:

- The State is on an amazing 14 straight downgrade run from the two rating agencies (S&P/Moody’s) over the last seven years.
- Illinois is the only state and one of two municipal issuers to access the municipal liquidity facility (MLF) for $1.2 billion and is considering borrowing another $2 billion. New York Metro Transportation Authority is the only other public entity to access the MLF, as 90% of its operations are shut down from the COVID.
- Illinois ranks as the worst financially managed state in the USA.
- Six Governors have been indicted and charged with corruption with four actually serving time.
- An Illinois family now owes more in unfunded pension payments ($76,000) than it earns in annual household income ($63,585).

This fiscal mess has come from neglect/fraud, misplaced priorities, and lack of political will power. These fiscal mistakes are now ghosts haunting the State from its past, present ghosts holding it back today, and on a path for more ghosts in the future.

The Ghost of Fiscal past - Pension Pollution. This long-term poison brought on from the past fiscal hiring favors, is slowly consuming the state's budget and ability to support operations. The State has had a generous public hiring policy, pension policy, pension funding neglect, and a long history of system abuse and fraud.

As of April 2020, the State has an underfunded pension balance of $4.5 billion, meeting roughly 60% of its liability. If you include the cost of the State's outstanding general obligation debt, these liabilities cost the State $31 for every $100 of tax revenue. *In other words, this debt service cost leaves the State with only two-thirds of its revenue available for day-to-day government operations.*

How did the pension funding go so bad? The source of this liability comes from the high priority the State has historically placed on paying government workers. For example, a local article said 110,000 public employees and retirees earn more than $100,000. There are educators, lawmakers, barbers at corrections institutions, police officers, small town administrators earning over $300,000 a year. Add to this the guidelines for pension payments that allow retirees to "game" the system to get more than they should through the public payroll.

On the asset side of the problem, the State has never put aside enough money to make the payments. The budget is a mess already, and the ability to fund more into the pension plan and keep State operations going, does not exist. This all adds up to a pension system that is broken, and one it continues to neglect.

The Ghost of Fiscal Present - Polluted Budget Practices. This current poison hinders the ability to easily start fixing any long-term financial issues today**.** The State's comptroller shows the State has not had a "true" balanced budget since 2001. For 2021, the gap is roughly 15% of the budget. Moreover, this is not without "budget gimmicks", so it is actually out of balance even more than 15%. Dysfunctional politics have left needed budget reforms from happening. State officials have used loopholes, debt, budget gimmicks such as paying bills late (currently at $7.2 billion unpaid balance), shifting funds between agencies, changing pension funding rules, to keep the "budget balanced" and allow for continuing with their misplaced priorities.

Corruption has been a constant throughout state history. The hiring of "friends" placed on the State's payroll for huge salaries, payments and budget projects to support union employment have created a cost structure the State can no longer afford. *This was highlighted earlier with 1/3 of the State's revenues spent on servicing pension and debt.*

Fiscal and operational reforms are needed for the pensions, government health care costs, and government spending on payrolls. Yet, State laws and practices do not give lawmakers many options. This is fine for them, as they prefer to keep kicking the fiscal can down the road. Heavy lifting and bipartisan effort are required to get past the challenges and make the needed changes.

On a positive note, debt service is running at roughly 2% to 3% of the outstanding debt a year for over the next ten years. This is very manageable and, for now, should keep a liquidity crisis from occurring and causing any repayment issues.

The Ghost of Fiscal Future - Polluted Economic and Demographic growth. Demographic and economic growth are starting to fade and will not be the remedy to fix problems, going forward. At this pace, the State will not be able to grow out of its fiscal problems, or even tread water with them. The resources are still there for increases in revenue for the State, but this will not work if the politicians cannot start to get along and make some tough budget decisions and policy changes first. The State's fiscal condition is finally effecting its economy and the willingness of people to want to live there. This is reflected in the following:

- Demographics are trending down (2019 numbers):
    - Unemployment rate of 4% is higher than the USA at 3.7%
    - Population estimated decline of 1.2% over the last 9 years.
- The State maintains good but fading economic activity and wealth levels (2019 numbers):
    - Per capita real GDP is high for the state at $61,713 versus the USA average of $58,197.
    - Personal Income per capita of $58,764 versus USA average $56,490.

Conclusion:

MainLine is not ready to predict the bankruptcy of the State of Illinois, but we are ready to sound the alarm for change to begin now. It took Detroit 60 years of demographic and economic decay to become a city with a 60% population decline, supporting debt and services 2 ½ times its tax base to finally declare bankruptcy. *This supports the justification of owning Illinois General Obligation bonds in the shorter-term.*

Illinois is just starting to see demographic weakness, and is now on the clock. It still has the resources to meet debt service & pension payments for years to come, but the State needs to start making some the unpopular decisions now:

- Time to address the 800-pound "favor" elephant in the room. Stop and correct the State's bloated public hiring practices and the inflated costs to do business.
- Re-address its current pension policies and explore ways to correct with buyouts and incentives. Then, take the cost to fund the liability a bit more seriously giving it higher priority.
- Identify new sources of revenue and explore selling or partnering with others to "liquidate" state assets.
- Set aside politics and work as a bipartisan unit on a balanced budget. Everyone should feel the pain in fixing this mess.
- Chicago and its economic attraction needs to be the center of a plan to re-stimulate growth. It has a lot to offer and is a magnet for the up and coming young working class.
- Lastly, get rid of the Chicago White Sox baseball team. Nobody knows they are there and they just hurt the city's image. LOL

MainLine has purchased general obligation bonds backed by the state for its various Opportunity Funds and some client accounts. ***We have kept these purchases to ten years and less in maturity to minimize the long-term credit risk exposure we see at this time.*** The State is at a critical point to change its financial course, and a little change today could make a big difference in 30 years. Come on Illinois! Set a new trend in politics and bipartisan cooperation. Exorcise those ghosts of the past, current and then (in 30 years) those of the future.