MONTHLY REVIEW

October 2020

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October 2020 – "Goodbye LIBOR, Hello SOFR"

For the third straight month, yields increased in muniland. A rise in US Treasury rates and a one-month record new issuance of $70 billion put value back into munis. October's record issuance levels are attributed to issuers' desire to sell bonds before the Presidential election and avoid uncertainties with the results and their potential impacts. This created wider yield concessions than normal and good one-off opportunities. ***Going forward, MainLine sees a return of volatility to the muni market, good and bad, depending on the market's reaction over the next 30 to 60 days to the election fallout.***

A mainstay of the investment world is schedule to be terminated by the end of 2021. The $350 trillion LIBOR index base market will need to find a new guideline. ***There is no need to get overly concerned, even the least desirable option is better than the current one, which has been manipulated and is not based on market transactions.*** The initial replacement looks to be SOFR, a secured overnight rate used for Treasury Repo transactions. We will review the LIBOR market, SOFR, and the impact on the muni market and MainLine West Family of Funds in this month's credit review.

Muni Market Review

Yields continued to increase for the third month in a row, but the muni market continued to outperform the taxable market. This is a bit deceptive as it just represents the "index curve". The record 30-day issuance and COVID concerns have caused certain issuers and deals to be sold at wider concessions to the index curve than historically. Highlights from October are as follows:

- Muni yields increased from 4 to 9 bps, curve slightly steeper. Over the last 3 months, yields have risen 30 to 35 bps.
- Taxable yields increased from up 10 to 19 bps, curve also steeper. Over the last 3 months, yields have risen 30 to 40 bps.
- The market digested record issuance for a month at $70 billon. This is a bit higher than the December 2017 record of $69.6 billion, when issuers rushed to market before tax reforms took effect. More specifically:
    - October's record level is due to issuers wanting to get bonds sold before the Presidential election. Uncertainties with the results and how they are accepted caused municipalities to issue now.
    - YTD taxable issuance is at 30% of the total amount, versus 14% in 2019, or an extra $79 billion of bonds. This represents 86% of the increase in total issuance.

As we expected, the soft market occurred, as issuance weighed on the market and spreads widened and deals were priced to move. A market meltdown has been avoided for the time being, as cash continues to come into the municipal mutual funds. At MainLine, we were able to get investors cash reinvested and the Funds were very active. Fund VI is close to 90% invested, and Fund VI-5 is 50% invested. ***The next 30 to 60 days could be volatile either way, as the fallout from the election and a pick-up in COVID cases will affect the financial markets.***

Market News and Credit Update

- A movement that began in 1972 by a team of MIT researchers is finally getting some media attention. *The term "De-growth" is the focus on improving human well-being rather than economic growth by a country.* The idea means a nation would accept lower to zero GDP growth in exchange for slowing climate change and the loss of biodiversity, while focusing on making humans healthier and happier. COVID-19, record destructive fires, frequent super-hurricanes, and increased economic/wealth disparity make the concept of de-growth more interesting to people.
- Some interesting economic stats, year-to date versus BC (Before COVID):
    - Job losses to-date: Workers with income levels over $60,000 a year 1%, $40,000 to $60,000 a year 5.4%, less than $40,000 a year 17.5%
    - Percentage that work from home is up from 10% to 25%. Most high-income workers are able to work from home, while most low-income workers cannot.
    - Home prices up 10%.
- Airline travel, 2.5 million YTD 2019 vs 1.0 million in 2020.
- The divide in credit ratings between Moody's and S&P has grown during COVID-19, showing the current challenges analysts face in muni research.

% The Same	Same Rating	One Rating Difference	Two Rating Difference
Before COVID(BC)	58%	35%	7%
After COVID (AC)	43%	51%	6%

Goodbye LIBOR, Hello SOFR!

This is an update to a review we wrote in April 2018. MainLine felt the timing was good to review the demise of LIBOR as a benchmark rate as $80 trillion successfully switched to SOFR as its new overnight discounting rate over the weekend of October 16 to 18th. SOFR is the proposed index to replace LIBOR. How do we think this will affect the muni market and the MainLine West tax-advantaged opportunity funds?

Why the demise of LIBOR?

LIBOR (Intercontinental Exchange London Interbank Offered Rate) is a benchmark rate set by the world's leading banks for a $350 trillion market. The rate is used to charge each other for unsecured short-term loans. LIBOR is also used for many other costs, such as student loans, mortgages, floating rate corporate and municipal bonds, swap and other derivative payments. In 2012, a criminal investigation revealed that several banks were involved in fraud and collusion when setting LIBOR (They were setting them higher or lower than they should be to help them increase their profits on trades.) Since this scandal, along with the decline in the use of unsecured short-term loans being made by banks these days, the various regulators around the world have been looking for a new way to calculate the cost to borrow between banks.

The Answer:

The USA, led by the Federal Reserve put forth *SOFR (Secured Overnight Financing Rate*) as a LIBOR replacement and it is now moving forward with this change. It is a broad measure of the cost to borrow cash overnight on loans that are collateralized by Treasury securities. In other words, this is also called the US Treasury REPO market. The rate will be calculated from actual market transactions in what is roughly a $700 billion a day traded market. The current transition is only with overnight investments. There is to be a slow transition out the curve over the next year.

The potential problems with SOFR:

- It is more volatile and is influenced by T-bill issuance. It also has monthly, quarterly and end of year cyclicals due to cash movements.
- It is a rate based on US Treasury credit, which will be used by non-treasury counterparties. There will likely be some credit spread added depending on the borrower.
- Once again, the major banks will most likely control the market, as they are the big players.
- Historical data is unavailable. We do not know what the rate was years ago.

Impact on the Municipal Market:

LIBOR is used for several different investment products, but we feel its loss to the muni market will be minimal.

- There are floating rate bonds that trade off the LIBOR rate. These bonds will need to have a new index to price off. We are not sure how this will be legally changed for all these deals, but the LIBOR replacement will most likely be used.
- The 7-day VRDO rate is based off one month LIBOR. Once again, this will probably change to the SOFR rate once a weekly index is created. The MainLine West Tax Advantaged Opportunity Funds pay this same rate to the money market Fund.

Updated Impact on the MainLine West Tax Advantaged Opportunity Funds:

- The Funds receive a 3-month floating rate based on LIBOR. At this time, only overnight LIBOR is being converted, term length SOFR will be developed next.
- It is anticipated by the end of 2021, there could be a SOFR replacement for 3 month LIBOR.
- As discussed above, the 7-day rate the trusts are funded at are based on 1-month LIBOR. At this time, there are no conversations planned, but we feel just like the swap 3 month LIBOR rate, this will be addressed as we near year-end 2021. The money market funds have expressed no concerns.

Conclusions:

The impact on the municipal market, and the Family of MainLine West funds should be minimal. A year-to-date comparison for overnight LIBOR and SOFR is 1 bps. SOFR has averaged in 2020 1 bps higher at 45 bps versus 44 bps. Currently overnight SOFR is at 8 bps, and LIBOR is at 9 bps.

Ultimately, this seems like a whole lot of nothing for MainLine West and its investment strategies. ***We will continue to monitor the transition and we do have other options in the event it doesn't meet our comfort level.***

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