## BPG Fixed Income

# Top 5 Reasons Why Muni Issuance Can Surprise to the Upside in 2017

As 2017 unfolds, we are focusing on supply and demand factors driving forward tax-exempt bond valuations rather than traditional credit fundamentals. During the final months of last year, the municipal market was ravaged by rising interest rates, a spike in issuance supply, and tax loss selling which created a rout in investor demand. The result pushed tax-exempt yields well above that magical 100% of U.S. Treasuries in many maturities. While investor demand has returned, we are vigilantly watching for an uptick in new money supply. Several factors are coming together to set a new course in the municipal markets transition from years of refinancing to fresh purpose borrowing. While many market participants expect a decline in overall tax-exempt bond supply, we believe things could turn out unexpectedly different. Below we listed the top five reasons why municipal bond supply may surprise to the upside.

## 1) The Condition of U.S. Infrastructure is in Terrible Shape

Today, the urgency to invest in infrastructure has risen beyond a critical level. Decades of chronic underinvestment in areas such as transportation, water treatment, airports, power grids, and schools have left a big hole. According to the American Society of Civil Engineers, the nation's infrastructure is graded 'D+'. At this point, the investment needed to bring it back to a state of good repair requires substantial investment. The estimated funding shortfall totals $1.6 trillion over an eight year period or $201 billion annually. In many cases upgrades can no longer be deferred. The most critical needs don't involve just building new green field projects, but replacing existing infrastructure built over 50 years ago or longer. We expect the involvement of state and local governments through the issuance of municipal debt to be integral in this effort.

## 2) Federal Support for Infrastructure Spending the Strongest in Recent Memory

Long an afterthought in the grinding process of the Federal government, infrastructure spending is now being viewed as a critical component to the nation's health. Both Presidential candidates in the last election agreed fixing the nation's crumbling infrastructure is a top priority. We believe there is strong bipartisan support throughout Congress to promote investment. While details of the plan are evolving, President Trump speaks of investing up to $1 trillion for infrastructure projects over 10 years. It is not clear how much funding will be primed from direct federal spending (in other words public funds). What is clear is the focus on leveraging private capital. There is an invigorated emphasis on public-private-partnerships or P3 financing structures, which leverage private expertise/funding to develop, construct, and manage new public infrastructure projects.

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Some argue the involvement of more private capital will reduce the need for borrowers to issue debt in the traditional municipal space. We disagree. Municipal debt will still play a lead role as the cheapest form and quickest established method of financing for public projects. Simply put, we believe federal and private capital just won't be enough to bridge the funding gap. We see municipal debt, and to a lesser extent combined with federal funding, and private capital could actually be the impetus that drives infrastructure projects from concept stage to actual construction.

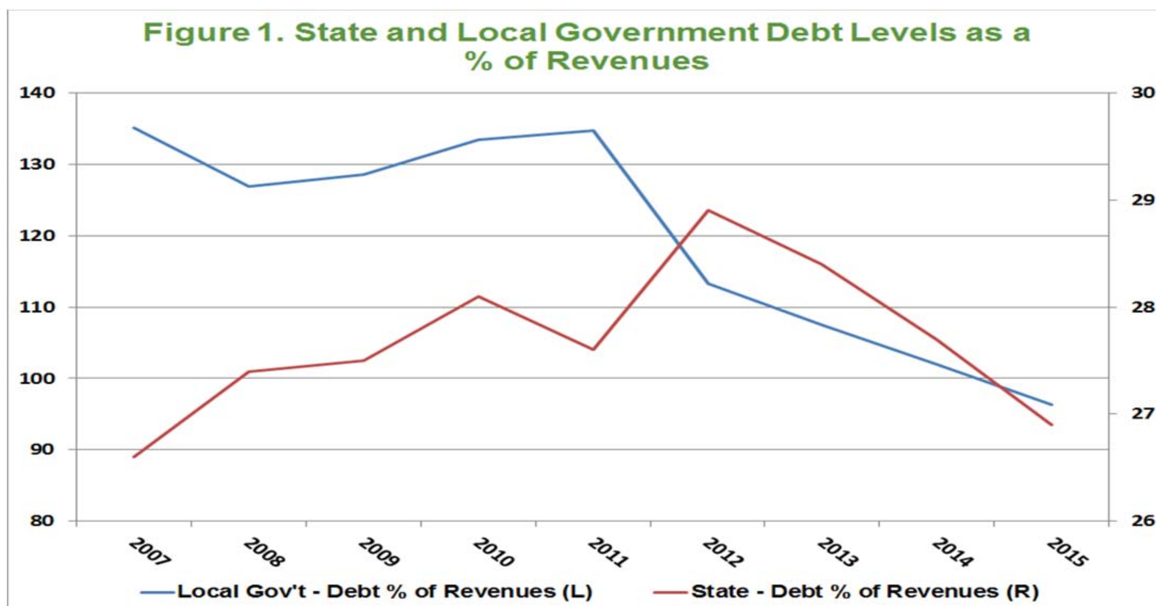
## 3) State and Local Government Finances are Stable

Contrary to popular belief, the majority of infrastructure projects are actually decided and accomplished at the state and local level. As a result, strong credit fundamentals are essential for government decision makers to have the confidence to take on new debt to fund a road or bridge. News headlines paint a bleak picture. In Illinois, political disagreement is preventing a state budget from being passed, which is nearly two years late. While unfunded pension liabilities are putting stress to many major cities. Take for example Dallas, Texas. Through a series of well-meaning but ill-conceived decisions, the city's pension burden has grown to become the 2nd worst for a major city following Chicago. The Mayor of Dallas has gone as far as publicly stating the city may need to file for bankruptcy without state intervention.

Despite the noise, we feel these are isolated cases representing the exception rather than the norm. In fact, municipal credit fundamentals remain healthy. State tax revenues continue to trend higher, near the highest levels on record, and rainy day reserves have been replenished. For the 2nd straight year, the number of rating upgrades to downgrades for municipal credits are back to even after six years in the negative (Source: Moody's Rating Actions as of 9/30/16). While unfunded pensions are a challenge for some state and local municipalities, the vast majority remain manageable. In our financial database of over 1,200 municipalities, we calculated the average unfunded pension liability was 1.2x of annual tax revenues, nowhere near the likes of Chicago and Dallas a whopping 8.6x and 9.7x, respectively.

## 4) Leverage for State and Local Governments Lagging Capital Needs

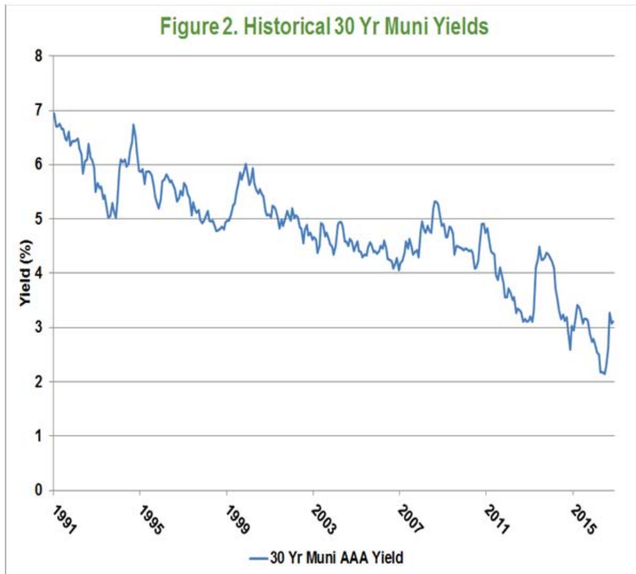
Despite the critical need for infrastructure spending, states and municipalities have significantly cut back on capital expenditures to shore up their balance sheet. As a result, leverage, as measured by debt as a % of revenues, declined to the lowest point since the financial crisis (Figure 1). Today, municipal governments financially have a better ability than any point over the past nine years to fund capital needs. Many have the capability to borrow the funds with a secure balance sheet to support their public long-term goals.

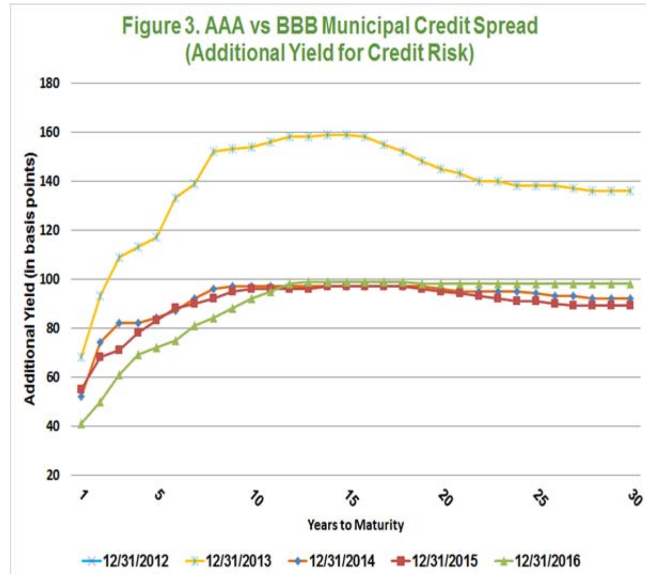



Source: Ziegler BPG Group; Merritt Research Services.

## 5) Cost of Debt Remains Cheap

In today's market the cost of issuing long-term debt for municipal borrowers remains historically cheap with ample demand. Even after the recent rise in rates, the 30 year AAA municipal bond was 3.1% at the end of January. This remains low from a historical standpoint (Figure 2). Credit spreads are also near the lowest point in the past five years (Figure 3). The combination provides a strong tail wind for project finance. In fact, we are seeing a trend developing already. Last year was a record for issuance with close to $450 billion of municipal bonds brought to market. This included new money issuance increasing by a strong 11.9% for the year, the fastest growth in seven years. 2017 is starting even stronger with new money issuance increasing 47.5% for the month of January versus the same period last year. Low cost of funding and a generally healthy fundamental credit outlook will spur municipal borrowers to issue debt to begin investing again in the building of essential development necessary for improved economic infrastructure.




Source: Ziegler BPG Group; Bloomberg; TM3 Thomson Reuters.

## Conclusion

The current environment appears ripe for municipal borrowers to ramp up their capital spending. Deferring capital spending is no longer an option. We believe the municipal market is underestimating the forces leading to a surge in new project financing. All five factors appear to be converging to boost supply in 2017. Of course the other side of new supply in tax-exempt bonds is demand. As you know, President Trump has indicated plans to overhaul the tax system. It is still unclear how this will impact the value tax-exempt municipal bonds. However, with municipal bonds funding 75% of the nation's infrastructure needs, we think it would be shortsighted to endanger a prime funding vehicle for infrastructure revitalization and development. Ultimately, we view municipal bonds as the primary financing work horse that is a critical element in moving toward the goal of restoring the nation's infrastructure health and builds opportunity into the future. Expanded issuance brings opportunity for investors to obtain attractive return and invest in the U.S.A.

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