INDEPENDENT THINKING

A NEW PERSPECTIVE

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October 2020

GOT MUNIS? THE CASE FOR BONDS AS STATES ADJUST BUDGETS

Municipal bonds continue to play an integral role in a diversified investment portfolio, even as states experience significant financial stress in combating the effects of the pandemic. Careful credit analysis is key.

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THE NEW STANDARD IN WEALTH MANAGEMENT

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About Evercore Wealth Management
Evercore Wealth Management is the wealth management division of Evercore (NYSE: EVR) and is an investment adviser registered with the U.S. Securities and Exchange Commission. Founded in 2008, the firm has been named a leading registered investment advisor (RIA)[1] and now manages $9.1 billion (as of June 30, 2020) in assets for families, foundations, and endowments across the United States. Partners at the firm work directly with clients, providing a more personal and modern alternative to big banks and traditional trust companies. Please visit www.evercorewealthandtrust.com for further information or contact the Evercore Wealth Management office near you.

Overview

At Evercore Wealth Management, we believe that municipal bonds, as a defensive asset, remain an integral part of most clients' investment portfolios. In a diversified portfolio, they serve as a ballast to equity market volatility, as high-quality bonds most often move inversely to stocks. Most important, they also provide our clients with a consistent and dependable tax-free income stream. While it's hard to argue that yields are attractive from a historical perspective, municipal bonds are relatively attractive when compared to Treasuries and corporate bonds on an after-tax basis, and they remain the best risk-adjusted fixed income vehicle for clients in the highest tax brackets. It is important to consider the defensive asset nature of municipal bonds, even during the pandemic and the related – and unusual – stress felt by individual states. Even at these low rates, municipal bonds also offer total return potential beyond the current yield to maturity in the event that Federal Reserve policy moves interest rates negative on the short end or market expectations of longer-term deflation push market rates into negative territory. These are possibilities, albeit unlikely ones, and they would probably coincide with equity price volatility, furthering the case for bonds as a hedge for equities.

State Budget Shortfalls and Federal Help

If we needed any reminder that the U.S. states are almost as divided as they are united, their respective responses to COVID-19 will serve investors well. All have been affected by the shutdown of the U.S. economy in the spring and the subsequent slow – and erratic – reopening. And all rely on Washington, D.C. for adequate financial support, as they, not the federal government, are on the front lines in managing the pandemic. But the similarities in this regard pretty much end there. The differences in fiscal health at the state level are now extreme, even more so than during the 2008-2009 fiscal crisis.

The federal government has shouldered some of the pandemic-related burden, through direct cash payments to lower- and middle-income Americans, expanded unemployment benefits, and liquidity from the Federal Reserve Bank. This help has done much to calm the municipal bond market, which had experienced illiquidity and significant trading disruption in the early spring. And there is recognition in Washington, D.C. that more is needed to enable states and localities to respond to the immediate public health emergency, absorb increased program costs, and balance their budgets to avoid sharp spending cuts that would deepen and prolong a recession.[2]

However, there may be reasons to think that this particular recession may have a much more damaging effect. While projections of state budget shortfalls are based on the historical relationship between unemployment and state and tax revenues, no one yet knows the timeline for developing an effective vaccine, continuing social distancing and the pace of recovery. Nor do state authorities know if wealthy individuals will continue to generate substantial capital gains tax receipts, which many states depend on to help balance their budgets. For example, in New York State, profits from the sale of corporate stock, real estate and other investments contribute approximately 11% to New Yorkers' adjusted gross income for state tax purposes.[3] Significant stock market moves and/or relocations to low- or no-tax jurisdictions could wreak havoc with revenue models.

The state fiscal aid provisions in the Coronavirus Aid, Relief and Economic Security (CARES) Act of March 27, 2020 have provided additional support, but are somewhat restricted as to use. The Act primarily dealt with liquidity issues, but did not entirely cover the costs of lost revenues. Specifically, $150 billion in direct aid to states and populous cities and counties must be spent before the end of calendar year 2020. There is also a $30 billion education stabilization fund in the Act, which could provide some fiscal relief. Other provisions in the CARES Act, such as additional funding for transit agencies and airports, will not provide much direct state budget support.

In addition to support from the CARES Act, states will benefit from a temporary increase of 6.2% in federal funding for Medicaid (Federal Medicaid Assistance Percentage or FMAP) under the previously passed Families First Coronavirus Response Act – March 18, 2020.

Still, direct fiscal aid for states so far significantly lags that provided in the last recession under the American Recovery and Reinvestment Act – nor does the CARES Act provide as much flexibility as to use. At the same time, unemployment remains high at 7.9%[4], albeit down from the 14.7% peak recorded in April and from the Great Recession high of 10.0% in October 2009.[5] And increasing numbers of people are reporting that they have lost their jobs permanently, rather than being temporarily laid off or furloughed – a sign that the crisis is causing lasting damage.[6]

Employment figures will eventually be reflected in state revenue. Estimates of projected revenue declines have varied, with year-to-date average decline of 2.9% - 5.5%, compared to the corresponding period in 2019.[7] However, this decline can vary widely between states, based on a number of factors:

- **State Unemployment Rates:** Western, northeastern and some southern states have seen relatively high unemployment rates.

- **Cost of Living:** Many northeast and western states have a higher cost of living index, including rent, food, utilities and other expenses. Consuming these essential items detracts from using unemployment insurance and federal stimulus checks on non-essential goods, thus driving down sales tax collections.

- **Spikes in COVID-19 Cases:** High infection rates in many densely populated areas in western and northeastern states, as well as in the south, have prompted stricter/longer lockdown measures, leading to declines in economic activity versus the more rural states.
- **Tourism:** States that derive more income from tourism/business travel have suffered disproportionately, notably those more dependent on air versus automobile travel.

Taken from a different perspective, Moody's Analytics[8] estimates that state governments alone would see revenue shortfalls of almost $200 billion over the three-year fiscal period from 2020 to 2022. This is compared to a flat baseline, growing revenues out solely by the rate of inflation. In terms of spending, states would see Medicaid needs increase by more than $80 billion versus a pre-pandemic baseline, as millions of Americans remain unemployed. To put this three-year amount in perspective, annual own-source government revenues were estimated to be a total of $1.2 trillion for the entire year. Year-end balances and Rainy Day funds were estimated to be approximately $90 billion for FY 2020.[9]

Other Federal Programs and Proposals

Other federal programs and proposals to alleviate the stress on states and its citizens include the following:

- **The President's Executive Order of August 8** to extend unemployment benefits per week from the Department of Homeland Security's Disaster Relief Fund could face constitutionality challenges.[10] The order invokes the President's power under the Stafford Disaster Relief and Emergency Assistance Act. Without specific authorization from Congress, it's not clear that this law can be used to fund unemployment benefits.

- **Federal Loans to States:** The CARES Act provides $454 billion to the Federal Reserve System to buy public and private debt, which for the first time includes short-term maturities (maturing within three years) issued by states and certain localities, through a municipal liquidity facility. These loans are an important way to help states address immediate revenue declines while they look for longer-term solutions. It should also be noted that some states have limits to short- and long-term borrowing based on their own constitutional and statutory requirements, and may not be able to take advantage of this new program.

- **Legislation Allowing States to File for Bankruptcy:** Allowing states to declare bankruptcy has been suggested as an option to deal with their current financial situation. This seems unlikely for three reasons: 1) declaring bankruptcy means failing a solvency test, so even if bankruptcy were an option, it would not mean it would be exercised; 2) permission for a state to declare bankruptcy would require a change in law that needs agreement in the House of Representatives plus a filibuster-proof majority in the Senate; and 3) there will be legal changes under Article 1, Section 10 of the U.S. Constitution that prohibits states from impairing the obligation of contracts. Comments about exploring a state bankruptcy option are probably less about setting policy and more about setting the debate over future state aid.

Differences Among States

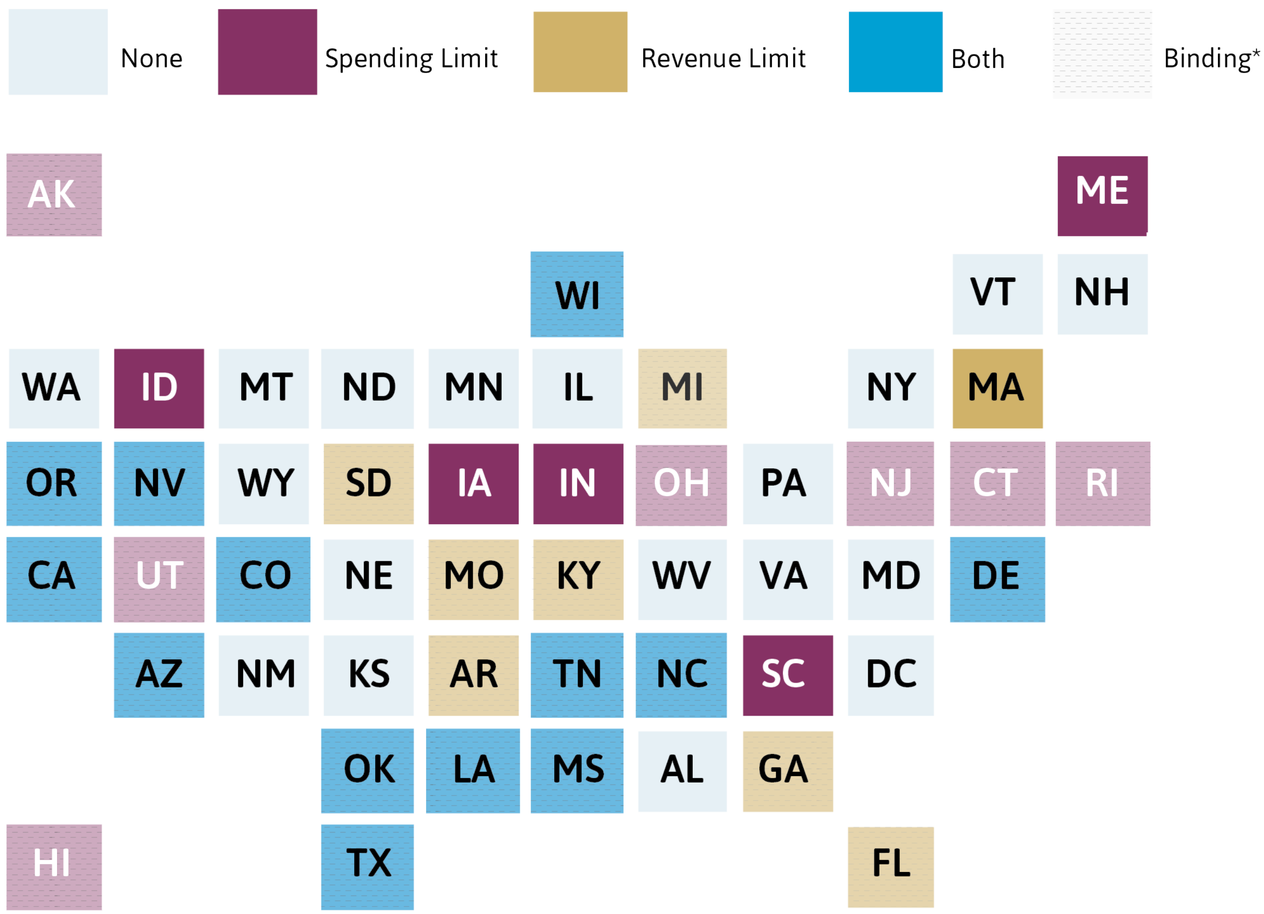
The effects on states will vary based on their economic and revenue structures and poverty rates. States with low economic volatility and those willing and able to adjust tax rates are likely to suffer less severe impacts than those with less diversified economies or a high dependence on the most volatile taxes, such as very progressive personal income and capital gains taxes.

In the past, states have been willing to make significant cuts to balance their budgets. In the aftermath of the 2008 financial crisis, states on average reduced general fund spending on a nominal basis by 3.8% in fiscal year 2009 and 5.7% in FY 2010.[11] These reductions would have been much larger had there not been offsetting revenue increases and other actions taken by states, including shifting burdens to local governments. Some states have already begun to reduce staff levels, or at least not fill vacant positions. However, there needs to be a cohesive strategy about programmatic cuts, so as not to exacerbate the pandemic while protecting more vulnerable citizens.

There are also state-specific constraints to actually passing tax legislation. New Jersey, through a simple legislative and gubernatorial budget approval, recently raised the state income tax from 8.97% to 10.75% for people earning between $1 million - $5 million in order to match the $5 million+ state income tax rate. In California, a two-thirds majority vote in each house of the legislature is required to raise taxes, or a direct voter referendum through the state's proposition system. Furthermore, any tax increase may weigh on the speed of the economic recovery. The recently enacted Tax Cuts and Jobs Act of 2017 implemented a cap on state and local tax (SALT) deductions, adding to the tax burden of many state residents.

Tax and Expenditure Limits by State

2020



Source: Urban-Brookings Tax Policy Center analysis of literature, including Kallen (2017), Lee (2018), NASBO (2015), and Waisanen (2010); as well as independent review of state statutes, constitutional provisions, and state sources.

Notes: Binding limits require either a vote of the people or legislative supermajority vote to override. Legislative supermajority requirements to raise new taxes or revenues are counted among binding expenditure limits. Four states (Georgia, North Carolina, Texas, and Nevada) constitutionally cap or ban state income taxes. These are classified above as binding revenue limits, since they require a supermajority vote of the legislature to amend. Nebraska constitution prohibits a state property tax, but we do not count this as a revenue limit, since property taxes do not generally constitute a large share of state revenue. States with both a spending and revenue limit are classified as binding if either of their limits meets the above criteria.

Other Vulnerabilities

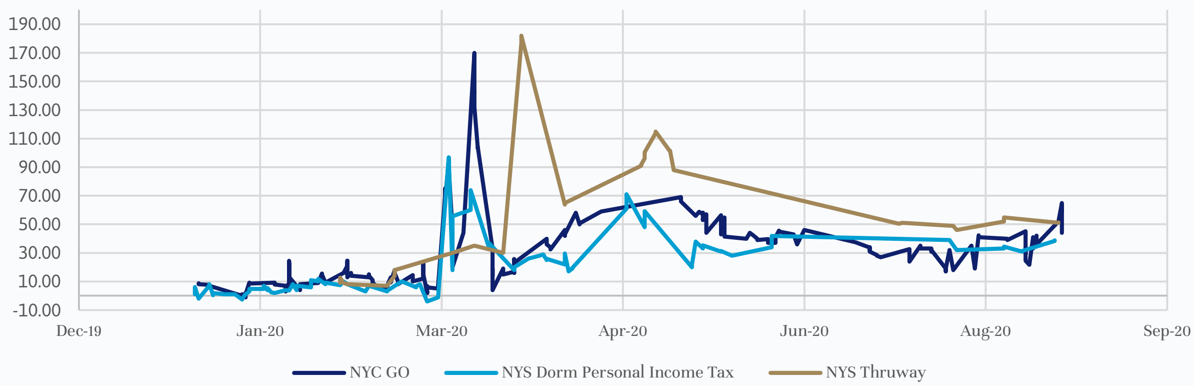
The Wealth Gap: As the pandemic progresses, increasing attention is being paid to the fact that minority and less affluent communities are especially hard hit. That's in part because a higher percentage of this cohort cannot work from home due to the nature of the many – and essential – service sector jobs, and they must therefore engage in risky activities such as riding public transportation. Availability of health insurance and Medicaid benefits in states also needs to be analyzed, both in addressing the pandemic as well as generating an economic recovery. Also, affordable housing shortages have forced high percentages of lower-income populations to live in overcrowded housing, increasing their susceptibility to the virus. This puts an additional strain on urban areas and the states that rely on these areas for a major portion of their revenues.[12]

Remote Working and Implications for a Municipal Tax Base: The longer the pandemic lasts, the more likely behavioral or societal changes become entrenched, including increased health precautions, remote working, and demands on governments at various levels to meet societal needs and address inequities. Increased adoption of remote working might modestly reduce demand for housing, office space and retail sales in major urban locations, while increasing it in other suburban and rural areas. However, there are factors that will limit the effects or spread them out over time. This is based on employment in many industries and job categories that are inherently unsuited to remote working or long-term remote working. Some business leaders have indicated skepticism about the benefits of remote workforces and many remote-working employees may still be required or encouraged to visit with coworkers or clients, keeping them tied to particular markets. We will continue to monitor these trends and their impact on tax bases and municipal finances, while assuming there will be some medium-term revenue impact for urban centers that could impact credit ratings, but would not present default risk for the credits we cover.

Market Considerations

In March, when New York City was the U.S. epicenter of the pandemic, all New York state credits widened out relative to the rest of the country, presenting an investment opportunity (see chart 1). We began buying quality but hard-hit New York credits for our New York clients, as well as for our general market accounts for residents of Florida or other low- or no-tax states. Shortly after, when the New York credits came back in line, transportation credits such as airports remained attractive. Most investment grade issuers have since rallied back to their pre-COVID levels, and in early August, much of the 10-year AAA scale was at record low yields.

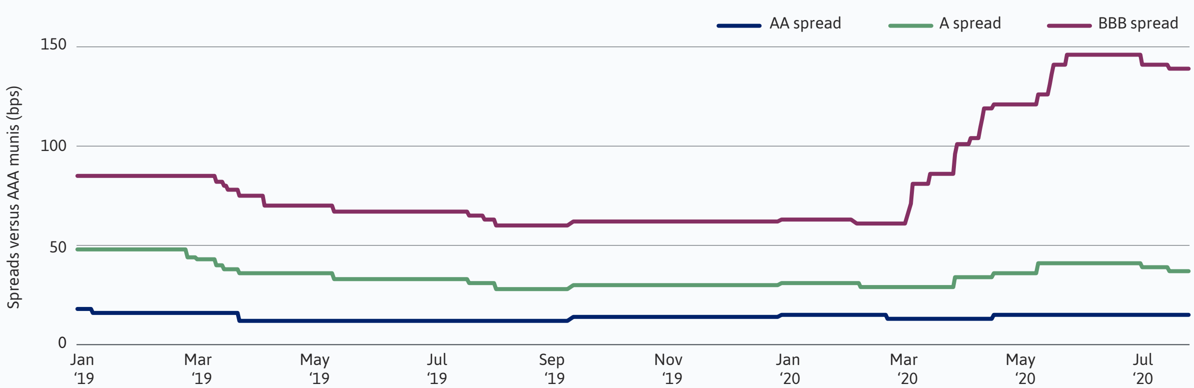
Chart 1: New York Bond Spreads to the AAA Scale



Source: Loop Capital markets, LLC.

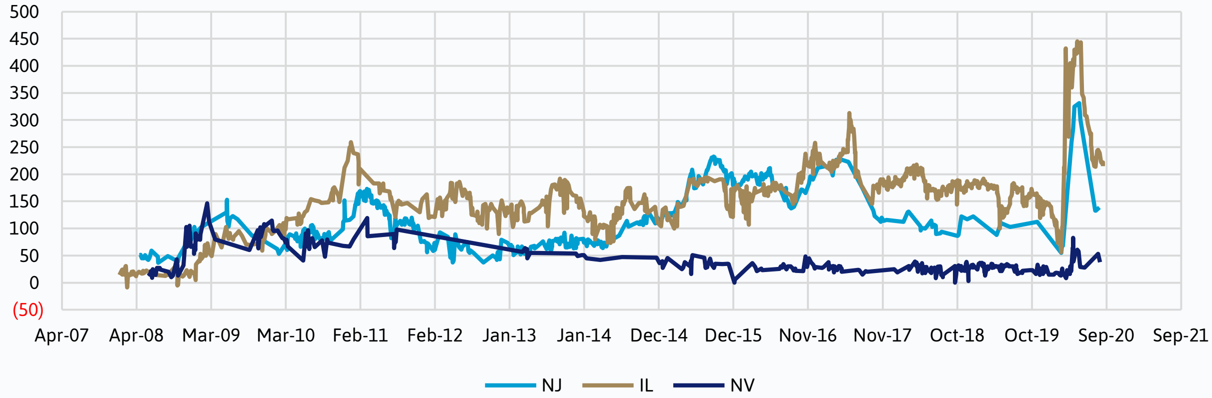
Chart 2: Rating Spreads Scale

Uninsured, Baa1/BBB+/BBB+ 5.00% Coupon, 5 to 10-Yr Maturity, Non-callable
Municipal yield spreads remain wide farther down the credit spectrum



Source: Thomson Reuters as of 31 July 2020

Chart 3: State Bond Spreads



Source: Loop Capital markets, LLC.

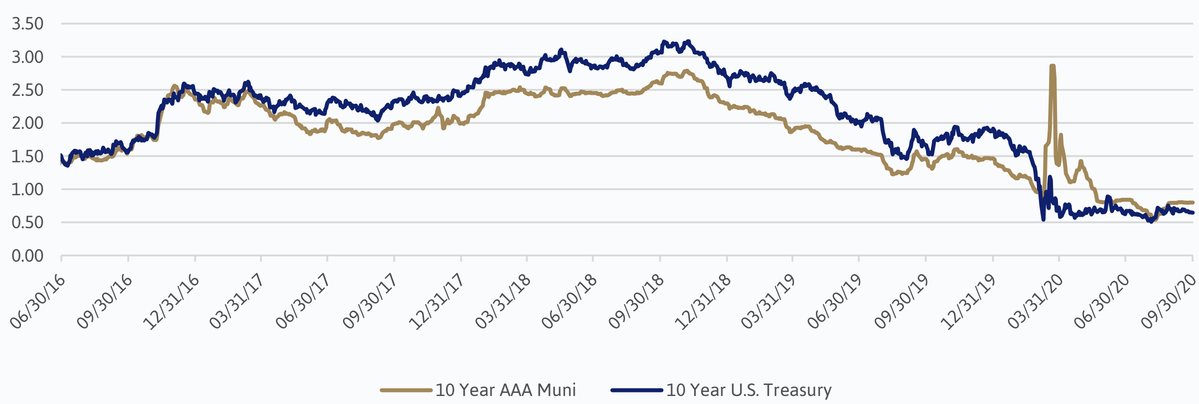
The same cannot be said for non-investment grade issuers, as illustrated in chart 2. While most investment grade credits have bounced back to or below their pre-COVID spreads to the AAA municipal scale, BBB rated issuers on the whole have not. This is especially true for credits related to transportation, healthcare and tourism, and those from low-funded pension states such as New Jersey and Illinois. These wider spreads imply that the market has placed a premium on risk that did not exist before all the pandemic-related uncertainties.

As a further example of the municipal market's behavior during both the last recession and the pandemic, chart 3 compares the spread of three large and challenged issuers: State of Illinois general obligation bonds, State of New Jersey appropriation bonds, and Clark County, Nevada (home of Las Vegas) Limited Tax General Obligation Bonds. While all three credits have rallied back from their widest and most distressed levels, they remain elevated in terms of spread to their longer-term averages. All three examples represent the inherent risks and opportunities to be found in the municipal bond market and, in our view, the need for professional management and independent credit research.

Today, municipals remain relatively attractive to Treasuries and corporate bonds. Ten-year AAA rated munis trade at over 100% of Treasuries before tax considerations, and historically they have traded below that (see chart 4). One reason for this is that the Fed has been buying virtually all the Treasuries issued and has directly purchased over $3 billion in corporate and mortgage securities since March. Not only has the Fed stated that it plans to keep the funds rate at zero for the next few years, but it has the ammunition to control the absolute level of yields as well as perhaps the shape of the yield curve. In addition, the Fed has recently changed its stance on inflation and is willing to let it go higher than the stated 2% target, to maintain economic growth and encourage employment. All of this supports the Fed's "lower for longer" policy and keeps a bit of a ceiling on all bond market yields, until the time when inflation or inflation expectations move materially higher, which we do not anticipate in the near term.

The pandemic brought on mostly disinflationary forces, and while it is not our base case expectation, zero or negative interest rates are a real possibility. While we believe that disinflationary forces are more of an immediate concern, especially if reopening the economy experiences a setback, **we remain cognizant of the expanding deficits** and what inflation can do to bond prices in a rising rate scenario as well. If higher interest rates or inflation does transpire, actively managed bond portfolios can mitigate the negative impact on bond prices by keeping the duration risk shorter than the benchmark; by investing in high coupon bonds, often pricing to shorter call dates, that return income more quickly, which also shortens duration and mitigates price volatility; and by reinvesting principal from maturing bonds and semi-annual income at higher rates.

Chart 4: AAA Muni vs. Treasuries



Source: TM3/MMD & Bloomberg LP

Conclusion

State and local governments, which have historically proven their resiliency during difficult economic times, face challenges without additional aid. Other hurdles to recovery include the decline in oil prices on energy-dependent state economies, market volatility that will have an impact upon pension fund investments, and overall uncertainty about the duration of the economic crisis. As a result, state and local governments are likely to operate with structural imbalances. For some, it could take years to recover and return to the revenue baseline. However, municipalities are resilient, meaning that they have many **more levers to pull to ride out the rough patches** than similarly rated corporations do. And with a historical default rate of just 0.08% of all investment grade municipalities, they have historically been considerably safer as well.

We believe that the carefully researched bonds within our separately managed portfolios, while subject to some rating downgrade risk, will not default. This belief is based on the underlying economic viability of the entities, the statutory strength of the associated bond documents that prevent overleveraging, and more than adequate liquidity[13] of the issuers to see them through this disruptive short-term period. For risk-averse investors, there are bonds that carry many favorable, court-tested legal protections that ensure revenues pledged for bond repayment cannot be diverted to other needs.

Our fixed income portfolio managers are making changes to the portfolios as needed to meet individual client goals. This can entail upgrading credits where possible, as well as the opportunistic purchase of misunderstood and mispriced municipal bonds. Regardless of the rate environment going forward, we feel confident that we have the experience to navigate our clients through this challenging credit environment, and we expect all of our client holdings to pay timely interest and principal.

Notes

[1] *Barron's* 2020 Top Independent Advisors; The *Financial Times* 2020 Top 300 Registered Investment Advisors; *Financial Advisor* 2020 RIA Ranking

[2] "Economists Announce The U.S. Economy is Officially in a Recession" National Public Radio, All Things Considered, June 8, 2020.

[3] "NY's Coming Capital Gains Crash," Empire Center, March 23, 2020.

[4] US Bureau of Labor Statistics Employment Situation Summary, September 2020.

[5] Bureau of Labor Statistics Spotlight on Statistics, "The Recession of 2007-09," February 2012.

[6] "Job Gains Shrink, Showing Frailty of U.S. Recovery," The *New York Times*, September 5, 2020.

[7] "Year-to-Date Total Tax Revenue for 49 States," J.P. Morgan Municipal Markets Weekly, September 11, 2020, "Handful of States Will Bear Brunt of Coronavirus-Induced Tax Revenue Declines" Moody's Investors Service, 9/25/20 and "States Take in More Taxes Than Expected" Pew Stateline Update, September 22, 2020.

[8] "U.S. State and Local Government Shortfall Update," Moody's Analytics, 9/21/20.

[9] Tax Foundation, "State Rainy Day Funds and the COVID-19 Crisis," April 2020.

[10] Unemployment Insurance (UI) Trust Fund: The CARES Act expands states' ability to provide unemployment insurance for workers. This includes having states provide 13 additional weeks of federally funded benefits beyond the states' maximum period. Also, there was a temporary boost of $600 in workers' weekly unemployment benefits until July 31, as well as expanding UI to individuals that don't usually qualify, such as self-employed and contractors, until December 31. States also have the ability to borrow from the federal government to help pay soaring unemployment claims during any recessionary period. These federal loans are repaid from federal assessments on employers after the economy begins to recover and, as such, do not put an additional burden on state operating funds.
In an executive order on August 8, unemployment benefits will continue at $400 per week at least until a new law provides supplemental federal unemployment compensation. Specifically,[10] the order directs the Federal Emergency Management Agency (FEMA), to pay the $400 per week from the Department of Homeland Security's Disaster Relief Fund (DRF). The enhanced unemployment benefits are retroactive to August 1, 2020, and will continue until December 6, 2020. They may end sooner if the DRF balances drops to $25 billion (it currently has $70 billion). Importantly, the federal government will cover 75% of the payment (i.e., $300 of the $400). States will need to pick up the additional $100 per week from funds allocated to them via the Coronavirus Relief Fund under the CARES Act. But most states claim they don't want the additional $100 burden. As a result, depending on the state, recipients will be getting just the extra $300 on top of whatever unemployment payment they're already eligible for in their state. Also worth noting is that the August jobs data was collected early in the month, and might not reflect the full impact of the loss of benefits.

[11] Moody's Investors Service, "Revenue Recovery from Coronavirus Hit Will Lag GDP Revival, Prolonging Budget Woes," April 2020.

[12] On the city level, academic papers have begun to explore revenue losses. In "The Fiscal Effects of the COVID-19 Pandemic on Cities: An Initial Assessment," September 2020, it is estimated an average shortfall in city revenues between 5.5% - 9% with variations driven by declines in dependence upon own-source revenue from taxes and charges, state aid to local governments, and changes in federal government direct and indirect assistance to city governments.

[13] Liquidity can include a strong "days cash on hand" position as well as covenant requirements for a debt service reserve fund providing up to one year's debt service payments.

About the Authors

Jim Holihan is a Partner and Portfolio Manager at Evercore Wealth Management. He has over 25 years of experience in managing fixed-income investment strategies.

Prior to joining Evercore in 2008, Jim was a managing director and portfolio manager at U.S. Trust, where he managed fixed-income portfolios for high-net-worth individuals. Following Bank of America's acquisition of U.S. Trust, Jim was a managing director and fixed income specialist with Columbia Management where he was part of a team with investment management responsibility for $6 billion.

Jim was earlier the head of the Fixed Income Management Department at Glickenhaus & Co., a managing director and municipal bond trader at Lebenthal & Co., and an assistant vice president and municipal bond trader at Oppenheimer & Co., where he focused primarily on securities from the states of New York, New Jersey, and Connecticut.

Jim received his B.A. in Economics from Hobart College. He is a member of the Municipal Bond Club of New York and the Executive Director and Founder of the Harborfields Lacrosse Club, a not-for-profit youth sports organization.

Howard Cure is the Director of Municipal Bond Research for Evercore Wealth Management. He has over 30 years of experience in analyzing municipal securities.

Prior to joining Evercore in 2009, he was for 11 years a director at the Public Finance Department of Financial Guaranty Insurance Company. He previously was a vice president with the investment banking firm of Prager, Sealy & Co. and, earlier, a vice president at Moody's Investors Service. He began his career as an economist with the New York State Senate Finance Committee in Albany, New York.

Howard is widely quoted in the media, including in *The Wall Street Journal*, *Bloomberg News/Business Week*, *Barron's*, *Reuters*, *The Financial Times* and *The Bond Buyer* and has appeared on CNBC, National Public Radio and Bloomberg News.

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