# Bi-Weekly Update

June 1, 2020

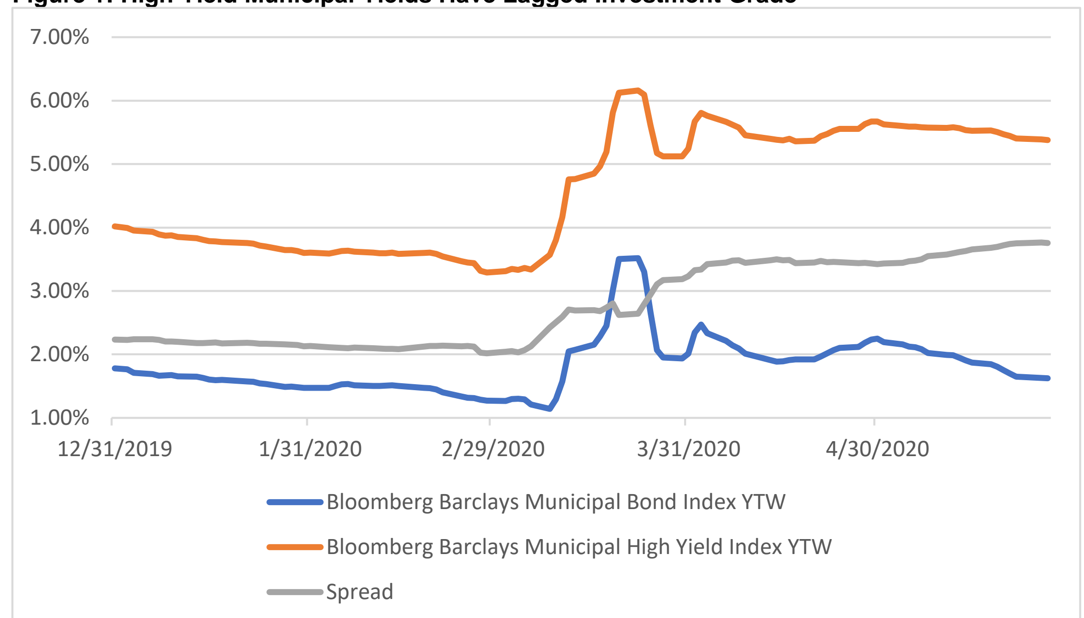
# Invesco Fixed Income

## US Municipals: A Tale of Two Markets and a Knight in Shining Armor

The municipal bond market has seen a nice recovery in investment grade names over the last few weeks. The new issue calendar remains light, with the big coupon reinvestment and maturity months of June and July right around the corner. The few large new issues that have come to market (a USD800 million state of Illinois General Obligation bond and a roughly USD2 billion state of New York Metropolitan Transit Authority issue) have been well oversubscribed. The high yield segment of the market is still lagging, but demand appears to be picking up recently.

Yields on investment grade municipal bonds (as represented by the Bloomberg Barclays Municipal Bond Index), have recovered to roughly where they started the year, though they are still above the lows reached prior to the pandemic in early March (Figure 1). However, yields represented by the Barclays Bloomberg Municipal High Yield Index are still well above the levels reached at the beginning of the year and the lows set before the pandemic. Accordingly, the spread, or difference between the two yields, has steadily increased since March. We believe this presents an opportunity to be taken advantage of by active managers. Many names in the high yield or BBB space have been guilty by association – we believe careful credit work can be advantageous and help position portfolios to benefit from this spread going forward.

**Figure 1: High Yield Municipal Yields Have Lagged Investment Grade**




Source: Bloomberg L.P., data from Dec. 31, 2019 to May 27, 2020. YTW is yield to worst.

A concern on the minds of many market participants is the potential for defaults in the municipal market, which we do not anticipate. To be sure, there will probably be a few defaults that make splashy headlines, but we believe the vast majority of municipal bonds will continue to pay coupons and principal as they come due. What makes us confident in stating this? The federal government has taken decisive action, arriving like a knight in shining armor with financial support (Figure 2). The Municipal Liquidity Facility (MLF) was established to provide market access for states, large cities and large counties and is almost up and running. The mere establishment of the MLF has provided comfort and stability to the municipal market and we believe it will likely help troubled borrowers the most. This support comes on top of the liquidity that the federal government provided in late March to stabilize the ultra-short segment of the municipal market.

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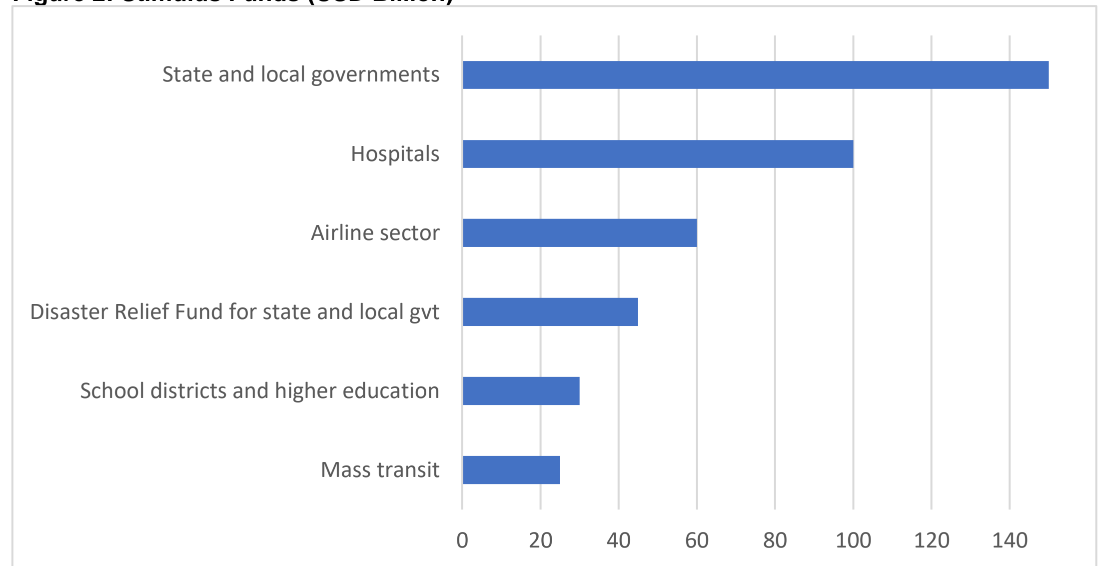
**Figure 2: Stimulus Funds (USD Billion)**




Source: US Department of the Treasury, March 27, 2020.

The economy had experienced an unprecedented period of growth prior to the global pandemic, resulting in strong balance sheets and ample cash on hand among many municipal issuers. We believe now is the time for active managers to sift through the noise, headlines and speculation to find the diamonds in the rough. As the US Congress debates additional stimulus to aid municipal issuers, we can't help but think of who will pay the resulting bill. Much of the burden will potentially fall onto taxpayers, which makes the tax exemption provided by municipal bonds that much more attractive.

# Municipal Sector Focus

**Senior Living**

The pandemic has shifted media focus onto the senior living sector, and rightfully so. Unfortunately, the coronavirus has hit our elderly population and senior living facilities the hardest. However, not all senior living facilities are the same. Because nursing homes provide the highest level of medical care for older adults outside of a hospital, this specialization makes them different from other senior housing facilities. Licensed physicians supervise each patient's care and other medical professionals are almost always on the premises. Skilled nursing care is available on site, usually 24 hours a day. There are approximately 15,600 nursing homes in the US with 1.4 million patients and nearly 70% are for-profit.[1] These facilities tend to be used by elderly patients in the last stages of their lives.

At Invesco Fixed Income, we focus on Continuing Care Retirement Communities (CCRC). There are approximately 2,000 CCRCs in the US with around 80% considered not-for-profit.[2] A CCRC, which is also referred to as a Life Plan Community, is a facility where a resident has access to multiple levels of care on a single campus. The benefit of this continuum of care is that residents can age in one place as their health changes over the years. Typically, a CCRC offers a combination of independent living, assisted living and/or nursing care. Roughly half of outstanding CCRC debt is non-rated, making credit research and analysis vitally important when investing in these bonds. With over 10,000 baby boomers turning 65 daily, we continue to believe there will be strong demand for this sector, especially post-pandemic.[3]

One of the many under-appreciated features of a CCRC is the sense of community these facilities provide to their residents. Meals, medicine, groceries and supplies are delivered to their doors. Residents receive frequent wellness checks and facilities are taking extraordinary care to protect residents and employees against the coronavirus. While these features increase costs, much of the CCRC sector is able to withstand these headwinds. We believe understanding the individual balance sheets and issues facing each issuer gives us a competitive edge when positioning our holdings for long-term success.

**US States**

States experienced significant revenue declines in April and May, and many will likely face difficult decisions in upcoming budget discussions. Income and sales taxes, two of the largest revenue streams, will likely be down, while increased expenditures to fight the coronavirus are also weighing on state budgets. Many of these difficulties should be ameliorated by federal government support. The CARES Act, for example, provides USD150 billion for state and local governments (Figure 2), the

establishment of a Disaster Relief Fund, and additional funding for state agencies and municipalities. While we expect to see further credit bifurcation, with the weak getting weaker and the potential for credit downgrades on the horizon, we do not believe we will see defaults. One of the essential tools states have to navigate the difficult fiscal times ahead is access to the municipal market. A default would likely destroy the very tool that they need now and potentially down the road.

[1] Source: CDC, https://www.cdc.gov/nchs/fastats/nursing-home-care.htm, March11, 2016.
[2] Source: AARP, https://www.aarp.org/caregiving/basics/info-2017/continuing-care-retirement-communities.html. Oct. 24, 2019.
[3] Source: US Census Bureau, https://www.census.gov/library/stories/2019/12/by-2030-all-baby-boomers-will-be-age-65-or-older.html, Dec. 10, 2019.

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All data as of May 29, 2020 unless otherwise stated. All data is USD, unless otherwise stated.

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