PEARL CREEK
ADVISORS, LLC
Capital Formation | John Franklin

AN EARLY 2022 MARKET UPDATE - WHAT'S IN STORE FOR '22?

Introduction

Two years ago, the virus known as COVID-19 shut down the tax-exempt bond market. However, the market rebounded quickly. And as we got deeper into the year, tax-exempt interest rates fell to record lows in August of 2020 as evidenced by the MMD index falling to its lowest level in 70 years. And interest rates remained low for all of 2021 with little volatility. However, the "Historic Low-Interest Rate Era" may be over.

Early 2021 Events

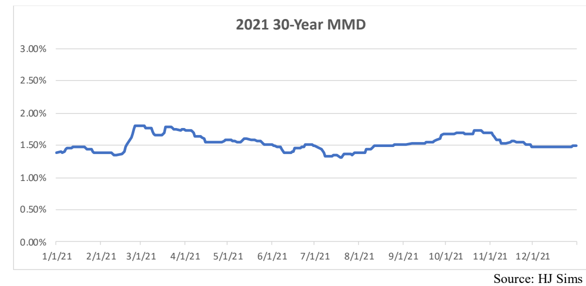
Last February, based on warnings from some economists, Pearl Creek Advisors reported in its Market Update that the Fed's continued easy monetary policy could cause higher inflation and another asset bubble. In addition, 10-year treasury rates had risen significantly at the end of 2020 and early into 2021. When Fed Chairman Mr. Powell was asked about this and escalating home prices at a January 2021 press conference, he replied that rising home prices was a temporary reaction to the Covid-19 crisis - people changing residences to adapt. So, the Fed messaged to the market that the Fed was committed to keeping interest rates low for the foresable future.

As a result, the markets and the people monitoring them believed that interest rates would remain low well into 2021. And the swaps market, where companies hedge inflation and interest-rate risk, seemed to agree, pricing inflation for the next several years at about 1% a year, well below the Fed's target of 2%.

So, based on the above, back in February of 2021 Pearl Creek Advisors suggested that non-profit senior living borrowers would enjoy low tax-exempt borrowing rates well into 2021. So, what happened the past year?

The Past Year Summarized

With the Fed committed to not letting COVID slow down the economy, the 10-year treasury traded in a narrow range between 1.20% and 1.65% for most of the year. The 30-year tax-exempt MMD Index followed suit, averaging 1.54% for the year with a low of 1.32% during the summer and highs near 1.80% during March and again in October, before falling below 1.50% at the end of 2021. ***So, yes, tax-exempt borrowers were able to enjoy historically low long-term tax-exempt borrowing rates for all of 2021.***



Source: HJ Sims

In fact, as rates continued to stay low during 2021, credit spreads became more compressed and continued to narrow relative to the 30-year MMD Index, allowing BBB rated deals to get done at credit spreads of 180 to 190 basis points over MMD, well below 2020 credit spreads of 200 to 220 basis points.

Part of the reason for narrowing credit spreads during 2021 was the amount of cash that continued to flow into tax-exempt mutual funds - the major buyers of tax-exempt bonds. Bond funds enjoyed net cash inflows for all but one week during 2021. With not enough deals to absorb all of that cash, buyers were forced to compete for fewer deals, allowing senior living borrowers to negotiate lower rates.

Notable deals included LifeSpire and LifeSpace, two BBB rated deals that came to market in August with 30-year yield-to-maturities of 3.31% and 3.40% respectively. And credit spreads narrowed even further towards the end of the year, with the $50 million UMRH transaction getting done in November at a 30-year rate of 3.45%, only 180 points above MMD.

Buyers were so starved for tax-exempt paper that the premium they charged for forward delivery transactions fell to 4 basis points per month. In addition, investors were also willing to buy forward delivery transactions with longer and longer delivery dates with some transactions getting done with forward delivery dates well beyond one year.

But Here Comes Inflation

Back in February of 2021, PCA also reported that the Fed, the market, and most economists believed that inflation would remain well below the Fed's target of 2% for the next several years. That did not happen. In November, consumer prices rose 5.7% from a year earlier, rose to 7% in December and accelerated to a 7.5% annual rate in January, the highest level in four decades. And it does not look like it is slowing down.

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Although interest rates remained low for 2021, two factors, neither of which were taken into account by the Fed, spurred higher demand for goods and services. To understand the current dynamics, it is important to understand that high inflation is driven by ***supply*** of goods and services not keeping up with higher ***demand***. Some economists and the Fed believe that the situation is being caused by a *supply side issue* - that supply chain disruptions due to COVID have disrupted the ability of goods and services to reach the consumer, creating a shortage, thereby causing price increases and higher inflation.

Other economists believe that it is a *consumer demand issue*. And they believe that two factors in particular, both of which the Fed underestimated, have spurred higher consumer demand. First, economies tend to bounce back faster after a natural disaster than a financial crisis because consumers tend to see natural disasters as a short-term versus long term-problem. And because the Fed treated the current situation more like a financial crisis than a natural disaster, it underestimated how quickly demand for goods and services would bounce back.

Second, the Fed missed the impact that stimulus money had on the economy. Between March of 2020 and March of 2021, over $5 Trillion was pumped into the economy by the Federal Government, with almost $2 Trillion approved and spent in 2021. This had the effect of insulating people from the economic impact of COVID. As a result, consumer demand remained high.

Source: USA Today

The truth is probably somewhere between the two theories with the current high inflation rate of 7.5% being caused by both stronger consumer demand and pandemic-related supply constraints.

Early 2022 - What's Happening Now?

With very few tax-exempt bond deals coming to market early in the year, the tax-exempt bond market remained calm for the first few weeks of 2022 as demonstrated by the interest rates obtained on the $52 million BBB+ rated Westminster-Canterbury of the Blue Ridge transaction, which Ziegler brought to market on January 20th and on which PCA acted as municipal advisor. On that transaction the 27-year bond got priced at a yield-to-maturity of 3.33%, an attractive interest rate that was only 164 basis points over the MMD index, which would indicate strong demand. However, most buyers refused to buy the deal because investor sentiment was shifting to a view that higher inflation would impact the market and cause interest rates to go up. And that sentiment has played out over the past few weeks, causing a very volatile tax-exempt bond market. The week after the WCBR transaction came to market, the 30-year MMD index rose 25 basis points.

As a point of reference, the 10-year MMD at the end of 2021 sat at 1.03% and is now at 1.48%. And the 30-year MMD at the end of 2021 sat at 1.49% and is now at 1.91%. To put this in persective, the 27-year bond for WCBR that was sold several weeks ago at a 3.33% yield-to-maturity would be sold today at an interest rate of 3.55% - and that assumes the same credit spread over MMD. And we all know that in a rising interest rate environment, credit spreads widen. So, the interest rate in today's market would probably be closer to 3.65% to 3.70%. So, here is the question. Is this recent volatility in the market just a hick-up, or will tax-exempt bond rates continue to go up in 2022?

The Rest of 2022

The Fed has indicated that it will raise the Fed Funds Rate at its meeting in March. Before recently adjusted higher employment gains and higher inflation than expected, the financial markets were anticipating a 25 basis point rate hike. Fed officials have indicated that rate increases will be guided by the data. Based on recent data, some market participants anticipate a rate hike of 50 basis points instead of 25. However, most participants believe the rate hike in March will be 25 basis points with 2 or 3 more rate hikes later in the year.

The Fed has indicated that it will continue to increase interest rates well into 2022 and at a faster pace because labor demand is strong and inflation is well above its target of 2%. Unlike the beginning of 2021, where the Fed indicated that it would keep rates low for several years - maybe not as low as the current 0.25% - but well below 1.0%, the Fed is now signaling that it wants to return interest rates closer to a neutral setting, estimated between 2% and 3%, designed to neither spur nor slow down the economy.

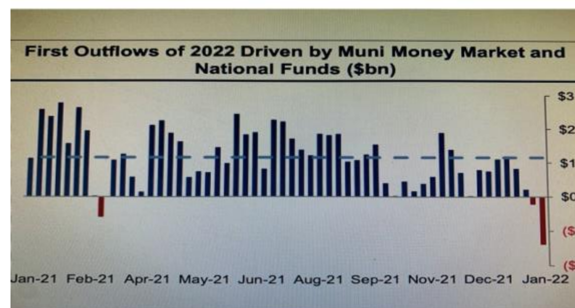
So, economists are estimating that the Fed Funds Rate will be between 1.00% and 1.50% at the beginning of 2023. And assuming inflation gets down to 3% to 4% by the end of the year, we could see more rate increases into 2023 to get inflation back down to the Fed's target of 2%.

Impact On the Tax-Exempt Market in 2022

Two factors will impact interest rates for tax-exempt borrowers choosing to enter the bond market in 2022. The first will be long term treasury rates. And long term treasury rates will be dictated by the financial markets' expectation of long term inflation. The current swap market is very flat with only a 5 to 8 basis point difference between a 5-year LIBOR swap and a 30-Year LIBOR swap. A 10-Year 67% of LIBOR Swap is currently priced at 1.40% and a 30-Year 67% of LIBOR Swap is currently priced at a 1.41%. So, the Swap markets are communicating a belief that the current high inflation situation is temporary and/or that the Fed will aggressively act to bring down inflation. This would mean that the yield curve will flatten with short term rates increasing and long term rates increasing very little. This would be good news for long-term tax-exempt borrowers.

However another dynamic will also impact long-term tax-exempt bond rates. And that dynamic is tax-exempt bond fund in-flows and out-flows. And this goes back to demand-supply theory. When tax-exempt mutual funds have a lot of cash to invest and few deals to buy, this excess demand pushes rates down relative to treasuries. And just the opposite when they have little cash and lots of deals to buy. During the past 10 years the relationship between the 30-year tax-exempt MMD Index and 30-Year Treasuries has been 99%. In other words, an investor in a AAA tax-exempt security was getting the same return as an investor in a taxable treasury. However, due to record cash inflows to mutual funds in the second half of 2020 and robust cash inflows continuing during all but one week of 2021, that relationship changed. During 2021, the 30-year MMD averaged 75% of 30-year treasuries due to all of that cash flowing into tax-exempt bond funds.

> Long-term interest rates for tax-exempt borrowers are not only dictated by inflation and the outlook for inflation, but also by the amount of cash tax-exempt mutual funds have to spend on the deals that do come to market.



Source: Goldman Sachs

However, after 45 straight weeks of municipal bond fund inflows, bond funds recently experienced enormous cash outflows, with outflows totalling over $1.6 billion, causing the ratio to increase from 75% of treasuries to 85% of treasuries. So, long-term interest rates for tax-exempt borrowers are not only dictated by inflation and the outlook for inflation, but also by the amount of cash mutual funds have to spend on the deals that come to market. A recent Goldman Sachs market update states, "MMD may continue to underperform Treasuries until ratios reach a level which brings relative value buyers back into the market."

Over the past year, 30-year treasury rates have averaged 1.57%, well below the 10-year average of 2.69%. In addition, the 30-Year MMD to Treasury Ratio averaged 75% the past year, well below the 10-year average of 99%. So, assuming that the Fed continues to raise rates and cash inflows to bond funds normalize, we should see an increase in long-term tax-exempt bond rates, despite what the swap markets are indicating. We may also see more volatility in the tax-exempt bond market in 2022 than in 2021. However, even with more volatility and higher interest rates, PCA believes the increase in rates will be moderate with rates remaining attractive relative to historical averages. As one of my industry colleages stated, "The macroeconomic factors that have kept inflation in check for the past 30 years haven't changed."