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Capital Formation | John Franklin

ONE YEAR LATER – AN EARLY 2021 MARKET UPDATE 2.21.21

Introduction

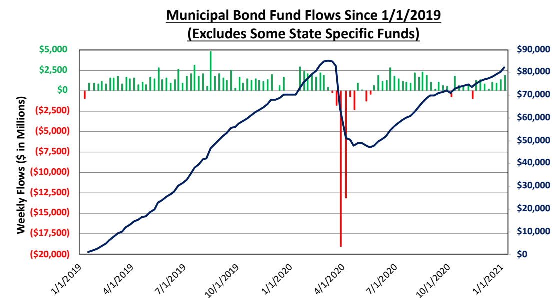
One year ago, the virus known as COVID-19 shut down the tax-exempt bond market. However, the bond market collapse was short-lived as the market bounced back quickly. And as the year continued, the tax-exempt 10-year MMD (AAA index) fell to its lowest level in 70 years. However, not all tax-exempt borrowers benefited equally. For strong investment grade credits, the bond market was back to pre-pandemic borrowing levels; however, for non-rated and weaker credits, not so much. We described this summer market phenomenon as a "Bifurcated Market." That Bifurcated Market has now evaporated with interest rates back to pre-pandemic borrowing levels for lower-rated and non-rated credits. How did we get there?

The Last Six Months

Although the tax-exempt AAA index was at all-time lows in August, investors were still wary of buying non-rated senior living deals due to the uncertainty of COVID-19's impact on the industry. And although tax-exempt bond funds were experiencing healthy cash in-flows, providing cash to invest in new deals, high yield mutual funds were still gun-shy due to the historical outflow that had occurred in March.

As a result, investors were willing to pay a higher premium for investment grade and higher rated credits, resulting in relatively wide credit spreads between rating categories. In August and September, 30-year maturities on tax-exempt BBB-rated senior living deals were getting sold in the 3.90% to 4.20% range, approximately 220 to 250 basis points over the MMD index, which was approximately 1.70% at the time. Alternatively, tax-exempt non-rated senior living deals were getting priced approximately 330 to 380 basis points over the 30-year MMD index, resulting in interest rates ranging from 5.00% to 5.50%, creating credit spreads of 110 to 130 basis points between BBB and non-rated credits.

As the end of 2020 approached, bond funds became more aggressive buyers of senior living bonds as it became evident that many senior living communities were weathering the pandemic. In addition, as the graphic shows, bond funds continued to enjoy robust cash inflows, creating more cash to invest.



However, offsetting this influx of cash to invest was a rush of deals that entered the market before the end of the year. In mid-October, the weekly supply of tax-exempt deals entering the market was $16 billion, twice the weekly average of $8 billion in 2019, keeping credit spreads from narrowing even further.

And although the $3 Billion of senior living deals that came to market in 2020 was well below the previous 4-year average of $5 Billion, most of that supply came to market at the end of 2020. And that supply has slowed to a trickle. Yet, the bond funds continue to enjoy robust cash inflows, providing more cash that has to be invested. As a result, the MMD index fell to 1.40% at the end of the year and has hovered between 1.40% and 1.50% since then.

This lack of supply, combined with continued cash inflows to mutual funds has created narrowing credit spreads with the expected spread on BBB rated deals now approaching 200 basis points, which is 20 to 40 basis points below late summer levels. And credit spreads for non-rated deals are approaching 300 basis points, 30 to 80 basis points below late summer levels. As a result, the 30-year tax-exempt bond rate for BBB rated senior living deals is approaching 3.50% and the 30-year interest rate for non-rated deals is approaching 4.50%, close to pre-pandemic levels. Consequently, if you chose not to complete a financing in 2020 and chose to wait until 2021, you may be rewarded.

The Bank Market

Banks have been slower to rush back to lending to the senior living market. Although banks began to loan again to the sector in the summer of 2020 - mostly to existing clients - they did so at wider credit spreads, stricter financial covenants, 1-Month LIBOR floors, and shorter commitment lengths.

However, that is changing. With bond rates so attractive, many senior living providers are choosing to convert bank debt to bond debt, or are choosing to finance projects with bond debt instead of bank debt. As a result, the banks are seeing fewer loan opportunities. And as the impact of COVID-19 becomes more certain, banks are seeking loans again, causing credit spreads on bank loans to fall, although not at pre-pandemic levels. Credit spreads for tax-exempt loans tied to LIBOR are approaching 100 basis points for BBB rated credits and 175 basis points for non-rated credits. Again, these are not at pre-pandemic levels, but they are nonetheless attractive.

Opportunities to Refinance?

Many of the bond deals that were completed in 2012 and 2013 were sold at interest rates higher than current rates. However, because the optional call date on those deals are months, if not years away, and tax-exempt advance refundings are no longer an option, many clients are exploring ways to refinance those deals and take advantage of current low rates.

Options include Cinderella Bonds, which Pearl Creek Advisors describes in a separate white paper, taxable advance refundings, “Forward Delivery Bonds”, or a “Swaption.” All of these are viable options and come with various advantages and risks. Because of the negative arbitrage or premium built into these options, another alternative is to wait until the call date to refinance. And if borrowers had a crystal ball and knew interest rates were not going to increase, they would wait. So, one question is “What is going to happen with tax-exempt interest rates?”

What Does the Future Hold?

With inflation so low for so long, most economists believe the Fed can hold interest rates low for the forseable future to help boost the economy as it recovers from the effects of the pandemic.

The Fed defines its inflation target in terms of consumer prices, such as those we pay for cars, toilet paper and beer, as 2%. And since 2012, this measure has averaged 1.3%—well below the Fed’s goal. And because critics who warned that the Fed’s easy money policies of the 2010s would lead to an inflation surge and an asset bubble were wrong, the Fed sees no reason to raise rates in the short run.

Yet, easy monetary policy in the past has led to asset price bubbles—a tech stock boom in the 1990s and a housing price boom in the 2000s—that caused economic hardship even though inflation remained low.

We can find reasons to believe we may be headed to another asset price bubble. Copper prices are up 56%. Soybeans are up 54%, and lumber, 117%. And with Covid-19 decimating the economy in major cities, rental housing costs in the past year rose just 2%, while home prices were up five times that rate.

Fed Chairman Mr. Powell was asked about this at a January press conference. He sees rising home prices as a temporary reaction to the Covid-19 crisis - people changing residences to adapt.

And with the yield on 10-year Treasury bonds rising to 1.37 percent, low by historical standards but well above its recent low of 0.51 percent in August and 0.92 percent at the end of December, those higher treasury rates should translate into higher private sector borrowing costs, taking the air out of bubbly housing and financial markets.

This does not neccesarily mean higher long-term tax-exempt bond rates in the near future. Back in August when the 10-year treasury was at 0.51% the 30-year tax-exempt MMD was at 1.70%. And while the 10-year treasury has risen to its current rate of 1.37%, the 30-year tax-exempt MMD index has fallen to 1.45%. Conversely, because rates on tax-exempt bank loans are tied directly to taxable rates, fixed rates on bank deals have increased substantially. In short, bond market supply and demand dynamics will probably impact long term tax-exempt bond rates in the short run more than concerns about inflation.

For now, the markets and the people monitoring them believe that interest rates will and should remain very low for the forseable future. And the swaps market, where companies hedge inflation and interest-rate risk, seems to agree. Firms are pricing inflation for the next several years at about 1% a year, well below the Fed’s target.

So, the market seems to be communicating that the risk of inflation is very low. So, based on the above, borrowers may want to consider waiting if it seems advantageous to do so. However, as the founder of a $1.5 billion investment fund recently said “Nobody knows what’s going to happen, especially the economists.”