PEARL CREEK
ADVISORS, LLC

WHERE IS 2021 HEADED? – PCA MARKET UPDATE 3.31.21

Introduction

It was just six weeks ago when Pearl Creek Advisors ended its last Market Update with the following:

"For now, the markets and the people monitoring them believe that interest rates will and should remain very low for the forseable future…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…However, as the founder of a $1.5 billion investment fund recently said 'Nobody knows what's going to happen, especially the economists.'" Never have more truer words been spoken.

With another massive stimulus bill in the works and the possibility of bringing back Advance Refundings, there is a great deal of uncertainty. When our last market update was released, the 10-year Treasury was at 1.37%. Since then, the 10-year Treasury yield has continued its climb, reaching 1.77% earlier this week, a level not seen since January of 2020.

What does this mean for tax-exempt borrowers for the rest of 2021, especially non-profit hospital and senior living providers?

Inflation and the Treasury Market

First, let's discuss inflation. Long Term Treasuries – maturities between 10 and 30 years – are most impacted by the financial market's perception of future inflation. If the market perceives low inflation, long term interest rates remain low. If the market perceives high future inflation, long term rates will increase.

Less than a month after passage of a $1.9 trillion stimulus bill, Biden announced plans for an additional government spending package that could total between $2 trillion and $4 trillion. Market participants now believe that these massive fiscal stimulus packages will overheat the economy and cause higher inflation. As a result, treasury yields continue to climb with many economists predicting a 10-year Treasury yield of between 2.0% and 2.25% by the end of the year, 25 to 50 basis points higher than where it is today.

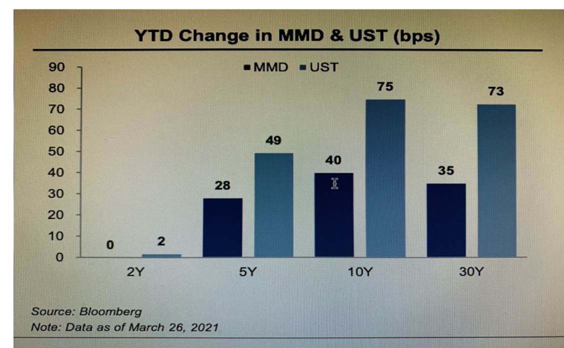
So, with the Biden administration accelerating the vaccine campaign and borrowing heavily to rebuild U.S. infrastructure, investors now seem to be betting on a realtively quick U.S. economic recovery. As one London-based fund manager declared, "If you want to see how quickly an economy can rebound, and surprise experts, just look at Australia. That same narrative could play out in the U.S." Another international fund manager who manages about 4.5 billion euros ($5.3 billion) predicts that 10-year Treasury yields will push to 2% as early as May of this year.

Understanding the M/T Ratio

So, to understand how the Treasury market could impact the tax-exempt bond market, it is important to understand the Municipal/Treasury ("M/T') Ratio. The M/T ratio is calculated by comparing the yield on the tax-exempt AAA/MMD municipal index vs. the yield on the equivalent Treasury Bond. For example, if the 10-Year MMD index was yielding 0.8% and 10-Year Treasuries were yielding 1.0%, then the M/T ratio would be 80% (0.80%/1.00%= 0.80), ***which has been the historical average for the past 30 years.***

The rationale is that municipal bonds are tax-free while treasuries are taxable. So, as the example above shows, a municipal bond usually has a lower yield than a Treasury Bond because it is a more attractive investment for high net-worth investors who have higher tax rate considerations.

At the end of December the 10-Year M/T Ratio and 30-Year M/T Ratios were 76% and 84% respectively, fairly close to the historical average. However, since the beginning of the year - as the graph below shows (courtesy of Goldman Sachs) - Treasury yields have risen much more quickly than MMD, creating 10-Year and 30-Year M/T Ratios of 63% and 72% respectively, near all time lows.



This is creating upward pressure on tax-exempt yields. This means that if Treasury yields continue to increase later in 2021 due to inflation concerns, the Tax-Exempt MMD index will have to follow, increasing the borrowing costs of non-profits later in the year.

Other Factors

From 1990 to 2006, during the early part of my investment banker career, the M/T ratio averaged 81% and exceeded 95% for only 44 weeks, never topping 100% during that 17 year period. However, the U.S. Treasury market does operate independently from the municipal bond market, and due to market disruptions, tax-code changes, and supply and demand dynamics in both markets, the M/T ratio has not been as stable in recent years.

For example, the financial crisis of 2008 caused the ratio to skyrocket, and it continued well into the next decade. From 2009 to 2013, the ratio was over 100%, even hitting 200% at one point due to increasing muni yields, raising the numerator of the equation. Additionally, during this period Treasuries were being artificially depressed by the Fed's quantitative easing program, making the denominator decrease; a double-edged sword that drove the ratio upward to record highs. This happened again during 2020 when the Pandemic caused a major disruption in the municipal bond market, resulting in higher tax-exempt bond rates, again, causing the ratio to skyrocket.

So, other factors that could impact the M/T Ratio and long term tax-exempt rates for 2021 and beyond include liquidity and future tax rates.

Liquidy – Supply and Demand

Municipal bonds are far less liquid than Treasuries, which affects their pricing in relation to the M/T ratio. We saw this play out in March of last year when there was very little liquidity in the municipal bond market, which caused tax-exempt bond rates to increase sharply relative to treasuries. And again during the first quarter of this year when massive cash inflows to tax-exempt bond funds created a lot of liquidy, fueling demand for muni bonds, which caused tax-exempt rates to fall relative to treasuries, resulting in the current M/T Ratios that are near all time lows.

Bringing Back Advance Refundings

Last week, a bipartisan group in congress consisting of 16 Democrats and 5 Republicans co-sponsored legislation that would bring back Advance Refundings for municipalities and 501©3s. The legislation, known as the "Investing in Our Communities Act" allows tax-exmpt borrowers to reduce their borrowing costs by refinancing current bond transactions before the stated "call date." The legislation reverses changes made under the tax reform law of 2017, restoring the tax-exemption for advance refunding bonds. What does this mean?

First of all, any hospital or senior living community *contemplating a Cinderella Refinancing using Bank Debt, a taxable transaction, or a Forward Delivery Bond should reconsider*. And if this legislation passes, there will be more supply of tax-exempt bonds, which will absorb some of the extra cash in mutual funds, which would in turn lowers liquidity and demand for bonds, thus possibly increasing interest rates for tax-exempt borrowers. And based on the press release that came out of Washington D.C., it seems likely the legislation will pass.

Future Tax Rates

Lastly, the M/T ratio also reacts to expectations for tax rates, and not necessarily what the rates are right now. This is the wildcard. Because the Democrats control both Houses of Congress and the White House, it is possible that Congress would consider increasing the tax-rate on corporations and the marginal income tax rate for individuals. This would increase the value of tax-exempt bonds, thus reducing the M/T Ratio, driving down yields on tax-exempt bonds, thus lowering the cost to tax-exempt borrowers.

We saw a similar dynamic play out when corporate tax rates were cut in 2017. Overnight the tax-exempt rates that borrowers paid banks went from 67% of LIBOR to 78% of LIBOR. The reverse could happen if corporate tax rates increase.

In Summary

PCA recently spoke to underwriters at three separate firms and asked the following question, "What do you think will happen to long-term borrowing rates for non-profit senior living communities during the remainder of the year?" The consensus seemed to be that there would be a fair amount of market volatility with rates remaining in a 40 basis range through the summer. After that, all bets are off.

So, inflation fears and additional supply due to a possible reinstatement of Advance Refundings will put upward pressure on tax-exempt rates. The wildcard is higher corporate and higher income tax rates, which would help lower rates. But nobody really knows what will happen, especially the economists.