Municipal Bonds

Weather Report

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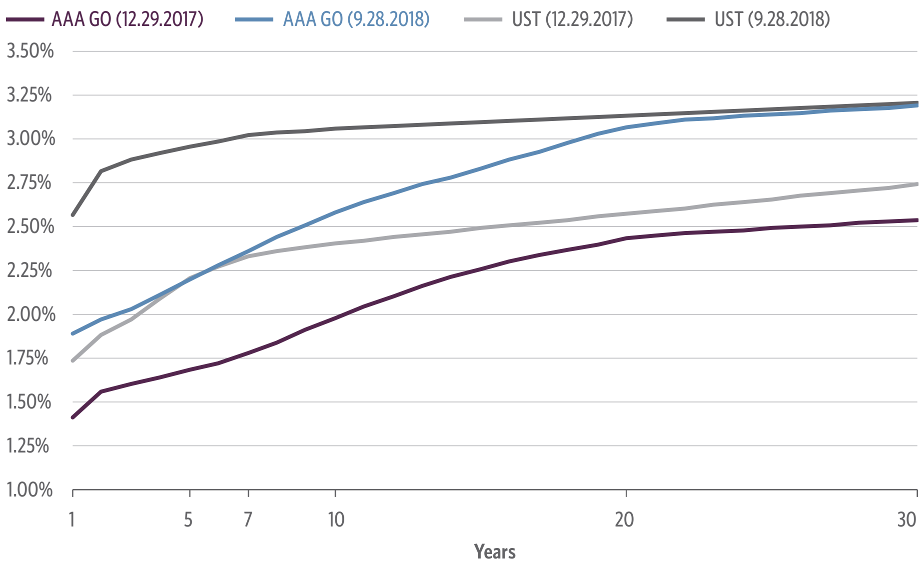
Technicals support short-term performance, but many municipalities are ill-prepared for an economic downturn.

Favorable technical dynamics and positive headlines buoyed municipal bond performance in 2018. While total issuance declined by 20 percent year over year, new money supply increased by 22 percent over the same period and has been consistently met with excess demand. Meanwhile, the AAA-rated tax-exempt municipal yield curve experienced a more parallel shift higher versus the bear flattener seen in Treasurys, providing greater relative compensation for assuming duration risk (see chart, top right).

Since 2017, historically tight spreads have reflected improving credit developments, highlighted by timely state budgets, Supreme Court decisions with favorable fiscal implications (e.g., *South Dakota v. Wayfair*, *Janus v. AFSCME*), and Puerto Rico's consensual restructuring negotiations. However, we believe these favorable factors are more than offset by states' mounting fiscal challenges ahead of the next recession, which we believe will begin in the first half of 2020. We expect municipalities to be less prepared to weather the next economic downturn given the smaller relative size of their reserves compared to past cycles (see chart, bottom right), and rigid budgets hampered by growing healthcare and pension costs. Structural pension issues will only compound in the economic downturn as pension assets are directly vulnerable to equity market performance. Our Macroeconomic and Investment Research Group's work indicates that U.S. stocks could see peak-to-trough declines of more than 40 percent in the next bear market, which would further undermine municipal issuers' credit quality by expanding pension funding gaps—or in other words leverage.

Over the past year, the municipal market has been amenable to issuers' undesirable late-cycle behavior such as replacing bond documents with weaker provisions, employing aggressive financing strategies (e.g., use of pension obligation bonds), and issuing tax securitizations with zero-sum implications for general obligation bondholders. As we continue to observe diminished market liquidity, we remain focused on the need for credit discipline and defensive positioning.

AAA Tax-Exempt Munis Offered Better Risk Compensation than Treasurys

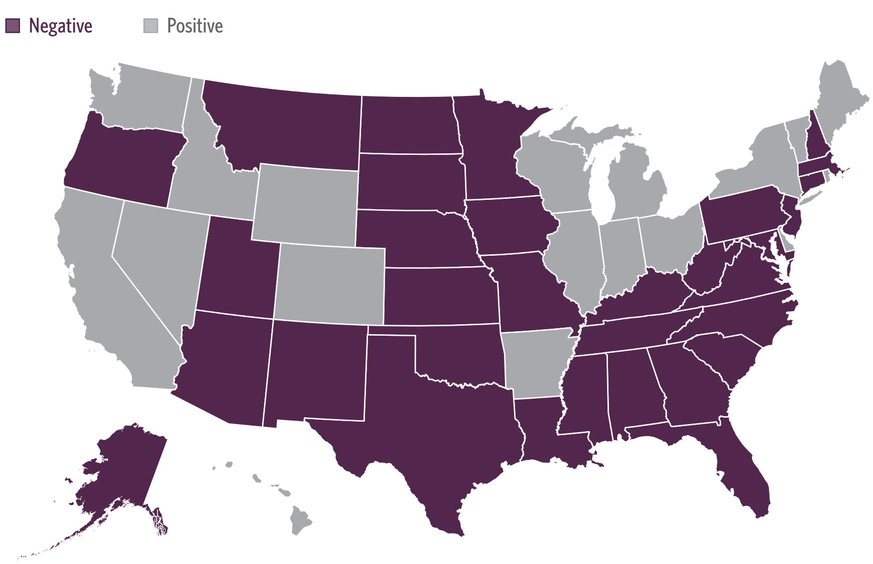


Source: Bloomberg, Guggenheim Investments. Data as of 9.28.2018.

The AAA-rated tax-exempt municipal yield curve experienced a more parallel shift higher versus the bear flattener seen in Treasurys, providing greater relative compensation for assuming duration.

Most States' Reserves Have Declined Since the Last Downturn

Change in State Fund Balances as % of Expenditures Since 2007



Source: Pew Trusts, Guggenheim Investments. Data as of 8.29.2018.

Favorable factors are more than offset by many state issuers' mounting fiscal challenges as we approach recession in the first half of 2020. We expect municipalities to be less prepared to weather the next economic downturn given the smaller relative size of their reserves compared to past cycles.