BERNARDISECURITIES INC.

MUNICIPAL BOND SPECIALISTS

Thomas P. Bernardi, CFA—Director of Portfolio Management July 2020
Brian Shea—Director of Municipal Credit

Summary:

- The 5-10 year range of the municipal curve offers the most value as yield steepness is 0.47%.
- Municipals vis-à-vis Treasuries remain very attractive. Muni/Treasury ratios are well above 100%.
- Credit downgrades may broadly follow in two waves.
- Reg BI brings much needed transparency to the market.

Municipal Market Spotlight – Uncertainty Remains

The 10-year treasury yield hit an all-time low on March 8th, touching 0.32% during the overnight session. Currently the 10-year trades at 0.65% and moved to as high as 0.90% in early June. Since the onset of the coronavirus pandemic, the Fed Reserve's balance sheet has grown by $3 trillion to just under $7 trillion in a matter of three months. In fact, the balance sheet did surpass the $7 trillion mark but has since fallen as it has seen a decrease in its liquidity swap lines with other global central banks. It took six years for the Fed to build its balance sheet by the same amount during the Great Financial Crisis. This demonstrates the swift action on the part of the Fed in helping to stem financial market and economic fallout.

Municipal yields were volatile in mid-to-late March, as mutual funds sold en masse when forced out of positions by fund investor redemptions. Leverage (at both the fund level, and oftentimes investor level) exacerbated trading dynamics. This led to mutual fund and ETF net asset values (NAV's) plummeting. Our portfolio management team was a net buyer during this period due to the attractively high yield levels available as a result of the sell off prompted by the pandemic. This dynamic was temporary, however, and primarily – if not entirely - liquidity induced. Municipal bond prices rallied upwards almost as quickly as they sold off. That said, the more economically sensitive sectors and issuers who entered the crisis on weak financial footing continue to trade at relatively elevated yields due to ongoing uncertainty of credit risk. Largely speaking, municipal portfolio allocations played their part and dampened volatility experienced in client equity/mutual fund/ETF portfolios during market volatility in March.

New issue municipal yields remain low on an historical basis. We continue to be patient investing in this environment and remain steadfast in our approach of focusing on sound credit quality issues. We are seeing the most value in the 5-10-year range of the municipal yield curve where yield steepness is 0.43%. This compares to a 0.16% difference in the 1-5 year range and 0.32% in the 10-15 year range.

Municipal Credit Commentary – In the Eye of the Hurricane

State and local governments are in the "eye of the COVID-19 hurricane". The initial wave of uncertainty has passed but the ultimate economic fallout is still unknown as a new pandemic wave is emerging in particular regions. Additionally, recent protests in many cities will likely increase public safety costs. It remains to be seen what the longer-term economic effects on communities and their various revenue sources will be as a result of all of this.

To provide some perspective on the effects of the coronavirus pandemic, we examined the charts below taken from the Municipal Securities Rulemaking Board's (MSRB) EMMA website[1]. Chart 1 shows the number of rating changes occurring in 2020 as disclosed to the MSRB. Following nationwide lockdowns, we saw rating changes rise sharply during March and April. Many issuers also experienced outlook or CreditWatch/Review changes. **These actions are not reflected in either chart.** The numbers remain elevated on a rolling basis, but the downtrend was clear in May and June – the "eye of the hurricane" so to speak.

Municipal Credit Commentary – In the Eye of the Hurricane cont.

It is important to note, Chart 1 is a short 'snapshot in time.' If we compare these figures over the past three years (Chart 2), you will see both 2018 and 2019 were similar to this years number of rating changes during the same period. According to Moody's from March 1st to April 15th period, "We placed ratings of 17 issuers on review (mainly for downgrade) and changed ratings for 75 issuers including 40 downgrades of one notch."[2]

Chart 1 - Rating Changes in 2020

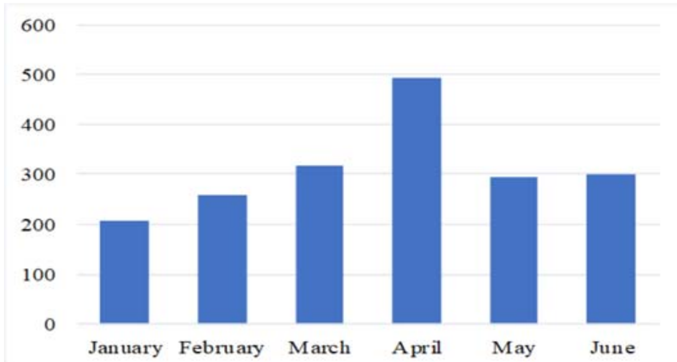
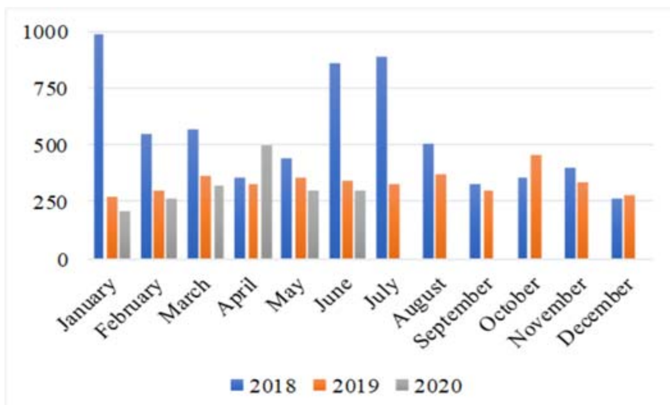


Chart 2 - Rating Changes in 2018 to 2020



At this stage, the pullback in negative rating actions may be only temporary. As has been reported in recent weeks, certain states are recording a significant increase in COVID cases and hospitalizations. We expect many of those negative outlook or CreditWatch actions to result in additional downgrades as the pandemic elongates.

It appears that downgrades may broadly follow in two waves:

1. The initial wave may be driven by liquidity pressures, that is insufficient cash flow to maintain current expenditures including debt service. This has already been seen in certain sectors, such as public transportation and long-term care/retirement home. Local governments will likely be affected starting in late summer and early fall as the full impact of reduced local tax and state sources of revenue weigh on cash flow. If the pandemic brings a fall/winter peak in the manner of prior flu pandemics, the initial liquidity wave would likely be repeated. The severity of the liquidity freeze may be greater, but Fed and Treasury involvement likely would dampen this dynamic.

2. The second wave would be more drawn out and would greatly affect issuers that were stressed from long-term economic deterioration or high fixed cost pressures prior to the outbreak. For these issuers, the economic recession/depression caused by the pandemic may foreclose options to manage fixed costs or economic decline outside of drastic measures. Examples from the 2008-2009 recession include Central Falls, RI, Detroit, MI, and Puerto Rico.

Since the pullback in negative rating actions exhibited in the graphs above is matched by a firming in market prices, now is the time to de-risk out of weaker names in your portfolio. If you would like to discuss further, please call us.

Municipal Credit Commentary – In the Eye of the Hurricane cont.

Credit analysis is essential now more than ever. Our process remains fluid and dynamic to respond to the ongoing crisis as updated information and financials become available. In general, however, most municipalities entered the current pandemic with strong fiscal dynamics. Municipalities nationwide have spent much of the last 11 years shoring up their balance sheets, paying down or refinancing debt, and cutting excess from their budgets. Additional 'clean up' will be necessary given the widespread impact of the current crisis, but overall municipal issuers will be able to prevail due to the positive strides they have made over the past decade. Additionally, the market is pricing in a high likelihood of another federal stimulus package which will be largely allocated to states, cities, and other municipal authorities. We believe such a package will ultimately be approved, though we wouldn't rule out a delay. We are long-term investors and looking forward to 2021 and 2022, we continue to target high grade essential purpose and revenue issues and shy away from mid-to-low grade, non-essential sectors.

Sources:
[1] https://emma.msrb.org/Home/Index
[2] Moody's Report, "Coronavirus effects: Credit drivers and rating consequences." May 1, 2020.

Portfolio Management Commentary – Relative Value

During the March muni sell-off, buying opportunities were plentiful. Since then tax-free municipals have witnessed a historical rally. Although yields are low on an absolute basis, tax-free yields remain attractive on a relative basis compared to other high-quality taxable counterparts.

The most recent Muni/Treasury ratios below are well above 100%. Historically, this ratio tends to be in the 70 - 90% range.

Curve	Live Tsy	MMD	MMD/Tsy
2YR	0.156	0.24	**153.88%**
5YR	0.289	0.38	**131.53%**
7YR	0.474	0.60	**126.66%**
10YR	0.627	0.81	**129.09%**
15YR	0.795	1.13	**142.17%**
30YR	1.319	1.53	**116.03%**

Unlike in mid-March, currently we are more patient in our investment opportunities. The current market provides an attractive platform to reduce exposure to 'weaker' credits, improving overall portfolio credit quality. Additionally, the Bank Qualified (BQ) space offers investors seeking liquidity tremendous value.

BQ bonds are a class of municipal bonds that enjoy a tax-advantage when purchased by commercial banks. Banks can deduct 80% of the interest expense associated with funds invested in BQ securities. With economic uncertainty elevated, loan demand is muted. As a result, banks are flush with cash and looking to invest in BQ issues. This dynamic leads to premium prices for BQ paper, making them attractive sell candidates for our clients' portfolios.

Given the high demand for BQ bonds, we are capturing attractive sale yields, while reinvesting the proceeds into higher yields comparable to sell levels. This strategy has helped our clients realize premium prices on their current BQ holdings and reinvest into high-quality bonds.

We do not anticipate muni market dynamics to change materially in the coming months. If the Fed 'put' remains in the market, rates should remain stable. We expect volatility in the equity market to remain for some time. As the COVID-19 pandemic is elongated, we expect credit concerns to increase which may lead to spread widening. However, this will be issuer specific and high-quality names should continue to trade well. This dynamic should present opportunities, as long as proper credit analysis is done. Muni's continue to provide tremendous relative value. Strategies such as selling BQ issues at premium prices will continue to benefit our clients' portfolios until the current pandemic is behind us and some of the fear in the market is reduced.

Regulation News – It'll Cost You More Than $1/bond… It Always Has

Over the past several years on numerous occasions prospective clients have told us, "I can buy bonds for $1/bond on my discount brokers platform." For years this is how many discount brokers advertised, confusing many investors. **There was always more to the rest of the story** – oftentimes, buried deep in the disclosures there was language detailing spread charged when bonds were bought and sold by the firm's brokerage desk. The "$1/bond" only represented the ticket cost of that trade, not the entire cost paid by the investor. Luckily, this will soon change to the benefit of retail customers.

On June 5, 2019 the U.S. Securities and Exchange Commission ("SEC") adopted Regulation Best Interest (Reg BI) under the Securities Exchange Act of 1934. Per Reg BI rule requirements, registered investment advisers and registered broker-dealers are required to provide a relationship summary, Form CRS, to retail investors. The Form CRS details Firm Information, Investment Options, Relationship Minimums, and types of fees. Here is a link to our Form CRS.

We encourage all clients and prospects to read through their providers CRS in detail. You will find the type of fees charged and specific to discount brokers, you will find language regarding their $1/bond trades also include a "spread" or "mark-up". If anyone tries to sell you $1/bond trades, we encourage you to ask questions and read the fine print.

BERNARDI ASSET MANAGEMENT LLC

Bernardi Asset Management ("BAM")

Fee-only, SEC registered, investment advisory arm of Bernardi Securities, Inc. ("BSI"). It is a wholly-owned subsidiary of BSI. BAM management is conducted on a separate account basis, with BAM serving as an investment advisor with a fiduciary duty. Client payments are based upon percentage of value of assets under management. BAM does not receive any direct or indirect fees from vendors. Please request a copy of BAM's Form ADV Part 2A for more information.

BAM Strategies

Strategy Spotlight - *High-Income Municipal*

The **High Income** strategy offers the ability to capture higher yields without sacrificing credit quality. We think insulating portfolios from economically sensitive issuers and low priority revenue streams is vital in today's economic climate. Therefore, the way to increase portfolio income should be primarily duration extension. The **High Income** strategy offers this and can be paired with existing client SMA portfolios as a "sleeve" strategy.

Total Return Portfolios
BAM Strategies: Short-Term Municipal, Tactical Ladder Municipal, Short Taxable, & Intermediate Taxable

Our Total Return strategies performed well in the first half of 2020. The mid-March sell off proved the value of the separately managed account (SMA) structure, as mutual fund and ETF NAV's plummeted while client SMA values held up well. This framework allowed us to capture higher yields during this sell-off period, as we were buyers while the rest of the market was selling. The portfolio values have benefited from the recent bond rally and we continue to look for value within the market.

For more information on our strategies please ask your Investment Specialist or Portfolio Manager. Strategy Fact Sheets available upon request.