

Modern Muni Management: COVID, Infrastructure, and Beyond

Featuring:

Hamed Faquiryan, Vice President, Fixed Income and Multi-Asset Class Research, MSCI

Jenna Dagenhart

I'm here today to discuss the recent history of the muni markets and what investors can expect from this growing asset class in the future. We have Hamed Faquiryan, Vice President, Fixed Income and Multi-Asset Class Research at MSCI. Hamed, let's start with some muni fundamentals. What are muni bonds, and what's their function within the broader fixed income markets?

Hamed Faquiryan

Sure. Thank you, Jenna. So muni bonds in general, are sort of the way that states, municipalities and nonprofits across the US sort of fund various activities, as well as just sort of kind of smooth out tax receipts. And they're sort of very similar to other parts of the fixed income landscape except for a few crucial distinctions. First, off the yields on these things, so like the income you get from holding a muni bond is tax free, which is very different from sort of the rest of the fixed income landscape.

And then secondly, there's, to give you an example, there are \$12 trillion worth of corporate bonds out there, and there's about 20,000, individual bonds. In muni land, it's about 4 trillion, but there's about a million outstanding securities. So, there are a lot of new needs. And this presents sort of all sorts of different problems with liquidity, as well as complicated structures, and sort of, the fact that they don't trade very often and not having sort of the consistent supply and demand dynamics that we see in other markets, sort of make them special along with their sort of taxable preference that they have embedded in them.

Jenna Dagenhart

You mentioned that munis are a growing asset class. What's underlying that growth in the market?

Hamed Faquiryan

Well, there's several logs, many trends that sort of are undergirding the growth in the muni market. One is just sort of, as more Americans find themselves in higher tax brackets, the sort of demand for a tax-free income starts to increase as well. And we sort of see this effect in a number of different sort of fiscal avenues. But one thing you can see sort of climbing together is the growth of munis as an asset class and sort of the growth of wealth management as a sort of component of financial services. And sort of secondly, I think, basically, the structure of issuance often responds to new legislation.

And so, if the new infrastructure laws sort of become laws, then we can sort of expect a sudden burst of issuance to come out of the muni market to sort of respond to that demand shock. And then lastly, as we were sort of talking about before, there's sort of a merciless march of technology that sort of undergirding muni growth because of the sort of increasing ease of transacting in the market, as I was saying this sort of lots of illiquidity within the market. And so, as the market modernizes, and it is sort of like the last frontier to really sort of modernize and electrify in terms of all the trading, we'll just sort of see more activity within the market itself.

Jenna Dagenhart

Let's take a step back now and discuss the historical sentiment around munis. What we learned in previous years and how is future research and development changing in this space?

Hamed Faquiryan

An excellent question. I think my personal opinion, is that munis as an asset class have sort of been given short shrift by quants like myself for a long time. And what I mean by that is that oftentimes analytics or sort of modeling techniques are really sort of focused on the sovereign bond market or the corporate bond market and then are sort of like haphazardly or after the fact applied to the muni market, without a whole lot of thoughtful considerations about whether or not it's an appropriate approximation, basically. So, this sort of proclamation and shortcutting is most of the time, it's sort of no big deal, because we use an extremely safe asset class, in terms of defaults. And so, getting things wrong here and there might not be super important.

But I can tell you that, in the midst of March 2020, and sort of the pandemic writ at large, whether the investor is holding a transportation bond issued by the MTA or long-term care facilities or just run of the mill general obligation bonds, that distinction becomes extremely important during these enormous shocks. And I think the future of research is to really sort of capture all these different arcane details within the muni market. Whether to use swaption volatility to price, a callable bond or cook up something specific communities, these things can seem sort of arcane and second order. But, in the midst of crises, these distinctions sort of, they determine a lot in terms of the path and well-being of a portfolio

Jenna Dagenhart

You mentioned previously that munis had been affected by tax policy changes. What are some of the recent policy changes, tax or otherwise, that have had important consequences for munis, and what can investors expect going forward?

Hamed Faquiryan

Yeah, so I think this is sort of the name of the game, in terms of how current muni investors are thinking about sort of short run dynamics in the market. So most recently, what has been extremely influential in the market is the 2018 Tax Reform; The Tax Cuts and Jobs Act. There, we had sort of an

entire elimination of a class of muni bonds that so called pre-refunded bonds. And moreover, we also had sort of a change in tax structure that affected high tax jurisdictions, whereby you can no longer deduct from income tax that for your federal income taxes, any income taxes you pay for states or municipalities. And so that, again, was sort of a demand shock for muni bonds. Secondly, I think the Federal Reserve's interventions during the sort of height of the nadir, depending on what you want to say, of the COVID crisis were really extraordinary for the muni market. And that there was sort of direct backstopping by the Central Bank of sort of liquidity provision.

So, there is a buyer of last resort for muni bonds as well. And we've never seen the Fed take that sort of action. And I think investors will sort of probably keep that in mind going forward, if there's sort of a liquidity crunch in munis or one that at least affects the market writ large, will the Central Bank step in? And then sort of looking even more forward, was there sort of two extremely large pieces of legislation, as we said here in November of 2021, that could sort of add a lot of fuel to the muni fire. So, the infrastructure package, the BIF, and sort of the larger reconciliation bill, Build Back Better Act, plan, they could sort of lead to an enormous amount of muni issuance, depending on the structure and nature of them. We've sort of don't have a clear handle on how that'll turn out. But I think it's definitely top of mind.

Jenna Dagenhart

Lastly, Hamed, climate risk seems to be top of mind within financial markets, how can muni investors adapt to and navigate risks from climate change?

Hamed Faquiryan

So this is something that we're currently sort of thinking very deeply about. And I think the muni investors should be sort of more concerned about climate as a risk factor than I think a lot of other investors. You know, there are special cases, but you know, if you think about a corporate bond, the cash flows that are sort of generated to pay back investors that hold that bond, there might be a headquarters for that corporate issuer somewhere. But, the cash flows come from all sorts of different places.

Think about, all the different people that pay Microsoft for their product. Whereas in for a municipality, or a municipal issuer, they often have a very explicit sort of anchoring to a geography. And if that geography is going to be sort of exposed to sea level rises or any other impacts from climate change, then those cash flows are going to be hit in a much more direct manner. And so muni investors sort of need to understand how this will play out for their portfolios. A school district in Miami, might have sort of very different dynamics than the school district in Nebraska. And sort of keeping these sort of geographic, climate change exposures in mind, I think is going to be sort of more and more important as we deal with the ramifications of climate change.

Jenna Dagenhart

Well, Hamed, great to get your thoughts and insights into the muni market. Thanks so much for joining us.

Hamed Faquiryan

Thanks, Jenna.

Jenna Dagenhart

And thank you for watching. Once again, I was joined by Hamed Faquiryan, Vice President, Fixed Income and Multi-Asset Class Research at MSCI. I'm Jenna Dagenhart, with asset TV.

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