Breckinridge CAPITAL ADVISORS

PERSPECTIVES

# AFFORDABLE HOUSING AIDED BY MUNI MARKET IN 2019

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Municipal bond market conditions during 2019 are boosting affordable housing efforts across America. A declining interest rate environment, a widening spread between taxable and tax-exempt bond yields, and muni market supply and demand technicals all combined to benefit providers of affordable housing financing and borrowers, as well as the investors who help keep the financing flowing.

As reported by *Bloomberg News* in July,[1] when heavy muni market fund inflows drove down yields, bond issuance accelerated at local and state housing finance agencies (HFAs). Improved long-term borrowing opportunities allowed the agencies to issue tax-exempt and taxable bonds to finance relatively attractive mortgages for qualifying single-family (SF) home buyers and multifamily (MF) housing developers, and to refinance bonds issued at higher rates in prior years.

## HELPING EXPAND THE SUPPLY OF AFFORDABLE HOUSING.

The changing circumstances in the housing sector emerged at just the right time. The real estate rebound over the past decade pushed housing prices out of reach for many first-time buyers and affordable housing developers. The HFAs issue municipal bonds and use the proceeds to finance more-affordable mortgages and construction loans by passing along lower interest rates to low- and middle-income buyers who are seeking mortgages or down payment assistance, or to developers seeking construction loans. In the last 50 years, HFAs have delivered more than $450 billion in financing to make possible the purchase, development and rehabilitation of more than 7 million affordable homes and rental apartments.[2]

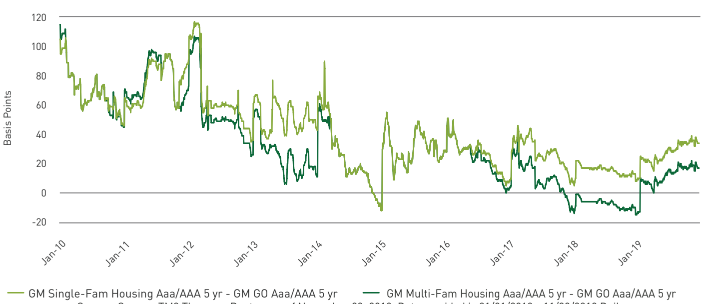
HFAs across the nation take a range of approaches to issuing bonds with individualized prepayment patterns, disclosures and redemption methods. SF and MF bonds can be issued in a number of ways: serial issues that are bullet bonds, whose entire principal value is paid all at once; longer final maturity term bonds that may have sinking funds that pay principal back in regular intervals; planned amortization class (PAC) bonds with certain payment protections and weighted average life assumptions built into them; or pass-through securities, which are bonds backed by a package of underlying mortgage loans. Many contain special redemption provisions that allow HFAs to call the bonds at par before the stated call and maturity date. As such, this warrants additional due diligence to calculate or model bond duration and expected yield or spread on the investment.

Payments of interest and principal on bonds issued by HFAs, which are generally considered special revenue bonds, are typically funded through the revenue from mortgage payments, accounts and reserves established under the issuer's indenture and investment income earned on balances of accounts and mortgage. An HFA has the choice of keeping the loan it originates on its balance sheet as a whole loan, which can be insured or uninsured, or wrapping it with a government-sponsored enterprise (GSE) to create mortgage-backed securities (MBS). Typically, HFA indentures that are composed primarily of MBS carry the highest credit-quality ratings due to their backing by a GSE.

## INVESTOR INTEREST IN HOUSING BONDS INCREASED IN 2019.

According to Bloomberg News, the improved borrowing environment for HFAs in 2019 gave bond investors a chance to improve relative performance. In a report headlined, "Sliver of the Muni Market Has AAA Bonds With Near-Junk Yields,"[3] Bloomberg observed, "Bond buyers who've been scouring the world in search of better yields seem to have missed a lucrative anomaly in a tiny corner of America's municipal-securities market: AAA-rated securities that pay out as much as those hovering a few steps above junk." At times during 2019, muni bond investors found that securities rated AAA boasted yields similar to bonds in lower-quality sectors, where higher risks demand higher yields in compensation. The higher credit rating is thanks to the presence of insurance for the muni housing bonds or their backing by GSE mortgage guarantors like the Government National Mortgage Association (Ginnie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae). Exhibit 1 shows the yield spreads between AA-rated single- and multifamily housing bonds relative to like-maturity AAA-rated general market municipal bonds from January of 2010 through November 29, 2019. While the spreads are higher than they were in 2015, they are still at low levels relative to prior periods.

FIGURE 1: YIELD SPREADS, WHILE OFF HISTORIC TIGHTS, ARE STILL AT LOW LEVELS

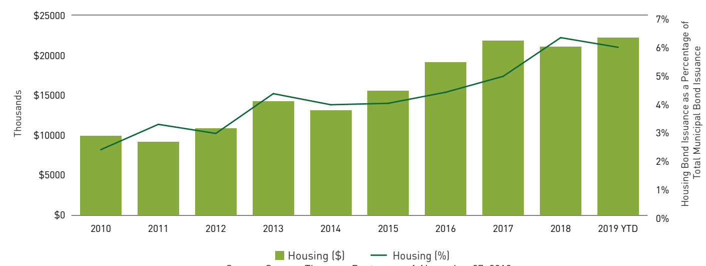



Source: Source: TM3 Thomson Reuters as of November 29, 2019. Data provided is 01/01/2010 - 11/29/2019 Daily.

Relative to the Bloomberg Barclays Municipal Bond Index's 7.21 percent year-to-date return, the housing sector of that index has returned 7.30 percent through November 30, 2019, at least in part due to the sector's longer duration. Historically, housing bonds have outperformed in rising rate environments, since the presence of early redemptions shortens the bonds exposure to rising interest rates. The additional spread on housing bonds compensates for potential early redemptions, a liquidity premium and sector-specific factors.

The market is on pace to make 2019 the busiest year for housing bond issuance since 2007, when the real estate mania made home prices unaffordable for many buyers around the U.S. Based on data collected from The Bond Buyer and as shown in Exhibit 2, from 2013 to 2018 muni housing bond issuance increased about 150 percent, from approximately $14 billion to $21 billion. Housing market bonds—about 4 percent of total issuance in 2013 to 2014—accounted for approximately 6.25 percent in 2018.[4] Driven in part by tight yield spreads between municipal bonds and Treasury yields (ratios), housing bond issuance as a percentage of total municipal market issuance is running at a 10-year high of 8 percent in 2019.[5] A reversal in this relationship could slow down issuance.

FIGURE 2: HOUSING BOND ISSUANCE IN THE AGGREGATE AND AS A PERCENTAGE OF MUNICIPAL BOND ISSUANCE HAS TRENDED HIGHER DURING THE PAST NINE YEARS TO 2019




Source: Source: Thomson Reuters as of November 27, 2019

According to *J.P. Morgan Municipal Markets Weekly*, the housing bond market is about 60 percent SF and 40 percent MF. SF bonds can further be broken down as: 50 percent as fixed-coupon and 10 percent floating/adjustable coupon bonds. Of the MF bonds outstanding, about 28 percent are fixed-coupon and 12 percent are floating/adjustable coupon bonds. Muni SF and MF serial bonds account for roughly 91 percent of outstanding housing bonds with coupon, call and tax features that are familiar to municipal investors. MBS pass-through bonds make up the remaining 9 percent.[6]

## BRECKINRIDGE TAKES A STRATEGIC APPROACH TO THE MUNI HOUSING SECTOR.

Breckinridge is participating in the housing sector opportunities based on a disciplined and strategic approach. Breckinridge focuses on the large-state HFAs that issue larger bonds collateralized by MBS with serial maturities. The approach allows our collaborative research, trading and portfolio management teams to model collateral for the bonds to deepen our understanding of risk/reward characteristics.

Breckinridge considers the municipal housing sector through an MBS lens that has been sharpened through our experience in our multi-sector trading activity. We believe this provides an additional advantage in the muni housing space. When considering structural issues, Breckinridge seeks deals that incorporate PACs as part of a series of bonds of an issuer. PACs are typically long-dated, premium dollar-price at issue, higher coupon bonds that may provide prepayment protection to the rest of the deal.

We are mindful of the risks specific to the housing sector, including potential changes that would affect GSEs. The Federal Housing Finance Agency is the conservator of Freddie Mac and Fannie Mae dating to the 2008-2009 financial crisis. An end of the conservatorship and potential privatization are key parts of the Treasury Department's housing finance reform plan. Investor perceptions of HFA credit strength and the bonds they issue could change as details about changes in the explicit or implied GSE guarantees emerge.

The muni housing market plays a key role in providing affordable housing for communities in need. In our opinion, a capable asset management team can capture value and impact for investors in the sector. At Breckinridge, our investment process seeks both value and impact for our clients. Our approach supports our up-in-quality bias during 2019, as well as our mandate to preserve capital and income in client portfolios. We believe the collaboration of our research, trading and portfolio management teams positions the firm well to participate in this sector of the muni market.

FOOTNOTES:

1. Danielle Moran, "Mortgage-Backed Munis Issued at Fastest Pace Since Housing Bust," Bloomberg News, July 1, 2019.
2. "State Housing Finance Agencies: At the Center of the Affordable Housing System," September 7, 2018. *https://www.ncsha.org/wp-content/uploads/2018/09/State-HFAs-at-the-Center-Current.pdf*.
3. Martin Z. Braun, "A Sliver of the Muni Market Has AAA Bonds With Near-Junk Yields," September 26, 2019.
4. The Bond Buyer, November 2019.
5. "TARGET: Record low 10yr A rated yields, Attractive 20yr4% A rated spreads, SF/MF/PAC housing bonds," J.P.Morgan Municipal Markets Weekly, August 2, 2019.
6. IBID.