Breckinridge
CAPITAL ADVISORS

NOVEMBER 10, 2020

Round Table: Breckinridge Assesses the 2020 Election

Breckinridge Capital Advisors investment team members got together after Joseph Biden was declared to have accumulated sufficient Electoral College votes to secure victory. They discussed the implications of the outcome in the months ahead. Participants were Matt Buscone and Jeff Glenn, co-heads of Portfolio management; Nick Elfner and Adam Stern, co-heads of Research; and Laura Lake, chief investment officer.

Their comments as of November 10 follow.

Authors

LAURA LAKE
CHIEF INVESTMENT OFFICER

ADAM STERN
CO-HEAD OF RESEARCH

JEFF GLENN
CO-HEAD OF PORTFOLIO MANAGEMENT

MATT BUSCONE
CO-HEAD OF PORTFOLIO MANAGEMENT

NICK ELFNER
CO-HEAD OF RESEARCH

Adam: Well, the election results are in but, a period of legal challenges is in the offing. The results of those challenges at this time are uncertain and could be consequential.

Laura: Yes, and the lack of the much discussed "Blue Wave" has implications for governance going forward as well as the corporate, municipal and securitized bond markets.

Nick: We have been talking every day for the last couple of months about potential outcomes, reviewing the near- and long-term implications of each. So, notwithstanding the high level of uncertainty at this time related to the transition of government and the volatility that would cause, the outcome of the election is important for corporate bonds, because policies could change under any outcome.

Matt: Adam wrote about the election's implications (*Update: Muni Credit and the November 2020 Elections)*, which is on our website, and each of us has reviewed key issues with clients in meetings.

Jeff: And, that is in addition to interviews that Nick, Adam and Laura did with media in the days leading up to and following the election (See: *Media Coverage*).

I am happy to get our conversation going. I think that, like many, we saw the most potential benefit in a so-called Blue Wave, at least as far as the prospects for substantial and quick stimulus for local municipal bond issuers. It has not occurred, so we are left with the likelihood of a slow walk to the new year as far as stimulus goes.

Adam: I think that is fair, Jeff. A Blue Wave—the Democrats taking the White House and the Senate and retaining the House majority—would probably have meant a more expedited path to a larger stimulus bill and the likelihood of higher levels of direct aid to states and cities, which would have benefited the economy in general and municipal bonds, specifically.

Laura: I think an immediate focus on stimulus is appropriate. While the election is important and the legal challenges will be interesting, for the markets, the path of the pandemic—and, certainly the latest results of the Pfizer vaccine trials are encouraging—and the size and shape of economic stimulus and fiscal policy will have more immediate and substantial effect for investors.

Matt: Agree. I would offer as an overarching point of view for investors, say, in the next three to six months as everything shakes out—regardless of the side of the political spectrum you stand on—don't overact to headlines. At Breckinridge, as investors, we remain focused on the long-term and avoid shifting portfolio strategies in response to the daily news.

Laura: Right. There likely will be near-term volatility and, often, volatility brings opportunity. That said, we are long-term investors and I think it is fair to say that for us it is prudent during periods like this to keep our eyes on the long term.

But, Adam, what are the prospects for stimulus and municipal bonds?

Adam: Now that we're through the election, it's looking very likely that any stimulus will include less state and local aid than the more than $900 billion in the HEROES Act. On balance, that's a negative for muni credit.

Just to unpack that a bit: We've got a few things happening right now that weren't really happening even just a week ago. So, as an initial matter, we've got Senate majority leader McConnell suggesting stimulus in a lame-duck session. We've also got Pfizer's vaccine announcement. Both of these things make it more likely that a deal is done sooner and for a smaller amount than what was expected. It's possible that millions of doses of vaccine will be disseminated in late January when Biden becomes president. So, there may be less support for a big bill after inauguration. House majority leader Pelosi and Biden may prefer an earlier lame-duck deal to having a big fight over a bill in January or February.

Of course, the Georgia senate runoff races now scheduled for January and the President's willingness to sign a bill could easily complicate matters.

Laura: As we have discussed in our strategy meetings, Breckinridge remains comfortable with our credit exposure given our high-grade bias and longstanding bottom-up approach to credit. So, while we expect challenges during the next several months, we continue to consider them to be manageable.

Matt: Yes. I would add that the Federal Reserve's current Municipal Liquidity Facility (MLF) offers lower-quality municipal bond issuers an alternative source of funding to the market. That program is scheduled to close on December 31. We will be listening for any discussion of an extension.

I will also note that with the election outcome, efforts to reinstitute a program like Build America Bonds or change the tax treatment of municipal bonds—events that could have affect supply—are less likely to occur. That could provide a technical tailwind for municipal bonds in the months ahead due to lower levels of tax-exempt supply. In addition, the likelihood of higher taxes at the federal or state and local level remains, as the government addresses growing deficits. That also augers well for the role of tax-exempt bonds in portfolios.

Laura: How about in the corporate market, Nick. What are you and Jeff thinking about?

Nick: On the subject of not overreacting, consider the behavior of corporate spreads after Presidential elections. If you look at the past five elections since 2000, investment grade (IG) spreads widened after three of those and tightened after two. On average, about a month and a half after the elections, spreads returned to pre-election levels. So, volatility was an aberration and potentially a buying opportunity for long-term investors.

Of course, past experience is not a guarantee of future performance, but markets can be agile in their ability to process news—even unexpected news—and find equilibrium.

Laura: That is interesting. The Fed continues to play a significant role in backstopping the corporate bond market—buying corporate bonds and exchange-traded funds; tactics it had not employed prior to the economic damage the pandemic caused, as well as keeping interest rates at the zero lower bound.

Like Matt and Adam with regard to the MLF, Jeff and Nick, I know that you will be alert to any changes in the Primary and Secondary Market Corporate Credit Facilities that the Fed instituted early in the pandemic. Both are scheduled to expire at the end of this year.

What are you thinking about relative to the political situation in addition to those stimulus measures?

Nick: What really matters for IG companies, in our view, is a COVID-19 vaccine, the trajectory of U.S. and global economic growth, the direct flow through to cash flows and impact on credit fundamentals. Under a Biden administration, a Democratic House, and a majority Republican Senate, which is up in the air until January, we expect to see the following impacts on the corporate market and a few key sectors:

For multi-nationals and most corporate sectors, tax policy is key, and changes seem unlikely unless the Senate goes Blue and the tax rate moves higher. In that case, estimated 2021 earnings would likely decline. Energy, Real Estate, and Technology could be hardest hit. Materials, Financials, and Consumer discretionary would see lesser impacts. Again, base case taxes will not change but, if the Senate goes Blue, then it is on the table.

Also, once through the pandemic and in light of Biden's goal to raise the minimum wage, we could see upward trajectory on wages put pressure on labor-intensive Retailers and Restaurants, among others, with a credit-negative effect on EBITDA margins.

We could see some positives for large banks as further regulatory changes would seem less likely under a split result. We do not see a major credit impact on the Technology sector. For Manufacturing and Industrials, trade policies and tariffs will be a focus. As it pertains to Energy, Biden has a climate agenda. His potential clampdown on emissions would reverse the Trump administration's relaxation of environmental regulations, potentially raising costs for the oil and gas industry. Biden will likely look to bolster the Affordable Care Act and expand health insurance coverage with subsidies to help people afford it. He is likely to double-down in COVID testing and investing in new equipment, which could buoy the med-tech industry.

Jeff: Picking up on the theme of not overreacting, we looked at securitized spreads following elections to see they performed in-line with Nick's comments on corporate spreads. After the disputed 2000 election, 30-year fixed-rate mortgage spreads were steady. The relative attractiveness of agency mortgages is primarily driven by the strength of the economy, and therefore the housing market. The absolute level of interest rates is another important driver as lower interest rates typically equate to higher prepayment speeds and increased supply. Taking a step back, the point, again is that it is prudent not to overreact and to keep a long-term focus.

Nick: Jeff, what about the Fed's role that Laura mentioned?

Jeff: Since March, the Fed's overwhelming presence has had more impact on the corporate and securitized markets than almost any other fundamental or technical factor. Investors are starved for yield. Performance of lower-rated credits over the last several months suggests that decisions may be colored by a belief that Fed will backstop the market more than on fundamentals or technicals.

We think that with the Fed's extensive participation in the mortgage market, spreads are likely to trade in a range.

I would not expect that the Fed will exercise tools at its disposal that it mentioned in the past such as yield curve control or negative interest rates.

Matt: There were some state ballot initiatives that were clarified on election night. I know you were tracking a few, Adam.

Adam: One of the most important ones was Illinois' progressive income tax amendment, which failed. Illinois residents voted against amending the state constitution to enact a graduated income tax. If approved, the amendment would have lessened Illinois' near-term cashflow issues. We anticipate with the initiative's failure could cause Illinois' credit rating could fall to below-investment-grade, a first for a U.S. State. Illinois' bonded debt load is eminently affordable, but its cashflow challenges will now be tougher to deal with. Clearly, voters have had enough with the last decade's fiscal erosion and shenanigans.

Most of the major credits in Illinois are now rated below IG, including Chicago and Chicago Public Schools. It is going to be a long road back.

Arizona's Proposition 208 to increase personal income taxes passed. The initiative proposes to enact an income tax surcharge of 3.5% for single filers making more than $250,000 and joint filers making more than $500,000. In effect, the measure would create a fifth tax bracket in the state for filers earning over $250,000 or $500,000 of income, depending on filing status. The surcharge, combined with the current top tax bracket rate of 4.5 percent, would push the income tax to 8 percent for earners in the new top bracket. The additional funds raised through the 3.5% surcharge would target public education, including compensation increases for teachers and support staff, and other grants. A change would make Arizona more of a specialty state, one where tax-exempt income is highly valued. We would expect increased demand for Arizona municipal bonds from clients in the state. We also likely would increase the in-state bias in Arizona-oriented accounts.

In California, passage of Proposition 15, a potential credit positive for many local general obligation bond issuers, failed. The initiative would have mandated reassessment of high-end commercial properties more frequently and increased tax revenue.

Puerto Rico's ballot initiative to seek statehood passed. It is unclear how the statehood initiative will intersect with The Puerto Rico Oversight, Management, and Economic Stability Act, a 2016 federal law related to debt restructuring. Past Puerto Rico statehood initiatives have descended into on-island partisan disputes. We will watch this latest referendum.

Laura: Well, plenty to think about and factor into our decision making. Thanks for the discussion.

#238279 (rev. 11/10/2020)