

The downside of low rates and Fed easing



Payson F. Swaffield, CFA
Chief Income Investment Officer
Eaton Vance Management

- As the Fed contemplates cutting rates, money has poured into municipal bond funds at a record pace in 2019, including high-yield muni funds.
- The stretch for yield by investors is attracting marginal issuers to the municipal bond market – in some cases, companies that couldn't get funding in other capital markets.
- Though overall credit quality in the sector remains strong, there are notable outlier issuers that offer enticing yields (and risk).
- In today's environment, we believe the warning flag is out for the highest-yielding muni strategies. Now, it is especially important to know what you own and understand the risk you are taking in your muni portfolios.



As market expectations, politics and slowing global growth pressure the U.S. Federal Reserve (Fed) to consider cutting rates, it's an opportune time to step back and consider the potential downside of lower rates. As James Grant has pointed out, one danger is the misallocation of resources: "People who find that money costs nothing to borrow do silly things with it."

We have seen similar concerns expressed over the past couple of years by regulators and commenters in the press. They focused principally on the large net flows into floating-rate loans, along with anecdotes of "frothiness" and deteriorating credit quality in the sector.

The emergence of marginal borrowers

As the perception of rising rates drove investors to floating-rate assets with the highest yield, marginal corporate borrowers with weak credit structures did emerge. Despite this, I argued last quarter that contrary to popular perception, the overall fundamental credit strength of floating-rate loans (and high-yield bonds as well) has been improving, supported by ongoing economic growth, reasonable leverage and historically high interest coverage – a metric that is certainly aided by low interest rates.

More recently, evidence of slowing global economies and uncertainty over international trade has led markets to expect monetary easing in the form of rate cuts by the Fed and European Central Bank (ECB). Fed funds futures currently indicate that the market is anticipating three 25

basis point rate cuts by the Fed by January 2020. This thinking has led to record net inflows into longer-duration, relatively high credit quality (vs. corporate bonds) U.S. municipal bonds.

Greater investor demand combined with tepid new-issue supply has caused yields in the sector to drop significantly. Similar to the floating-rate loan story of a couple years ago, now muni investors searching for the highest yields are bringing some marginal municipal issuers out of the woodwork. But unlike floating-rate loans, the story of froth at the edges of the municipal bond market has largely not been told.

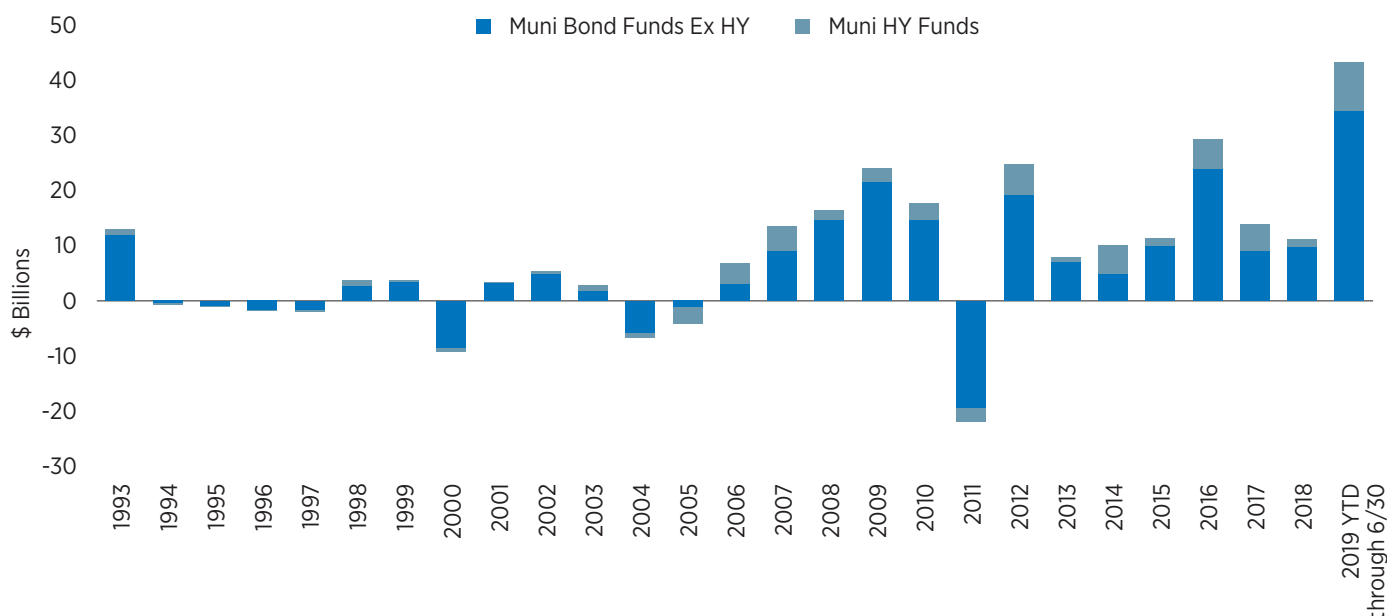
The case of Virgin Trains USA

Virgin Trains USA is a private company that runs a high-speed passenger rail line in Florida between Miami and West Palm Beach and has plans to expand service to Orlando, as well as an additional route to connect Las Vegas with Southern California. Virgin is backed by Fortress Investment Group LLC, the private equity firm, and changed its name from Brightline last November when it partnered with the Virgin Group (Richard Branson's company).

Virgin tried tapping the loan market in 2011, when it was known as the Florida East Coast Railway, but was rebuffed out of concerns about cash flow and leverage. Last November, Virgin filed a prospectus for an equity IPO, but the deal never saw the light of day. Virgin then turned to the recently hot high-yield muni market and received a much warmer reception.

Exhibit A

Strong demand has pushed muni fund net inflows to a record level.





A welcoming high-yield muni market

In April, Virgin raised \$1.75 billion in the high-yield muni market – demand was so overwhelming that the deal size was increased from its original \$1.5 billion, and the bonds subsequently traded in the secondary market up a half point.

Virgin is not alone in attracting capital from the muni market. With talk of rate cuts in the air, and the relative scarcity on other tax-advantaged options in the wake of the new limit on state tax deductions, the fixed-rate muni sector has been on pace to greatly exceed any year on record. Just through May 31, muni bond funds have attracted a net \$43 billion – already surpassing the \$29 billion in all of 2016, according to Simfund (Exhibit A).

High-yield muni funds have taken in a net \$8 billion. That is by far the largest yearly net inflow for the high-yield segment – 59% more than in 2012. The strong demand for muni debt has pushed down the yield on the Bloomberg Barclays Municipal Bond High Yield Index¹ to around 4.5% at the end of June, near a 16-year low.

Steel rail blues

Virgin's story is an impressive one. Its existing rail line is an irreplaceable asset; it is the first new major private passenger intercity railroad in more than a century, with access to three different ports. Its affiliations with Fortress and Virgin Group lend credibility, and the Virgin Group's extensive presence in the travel and hospitality businesses offers numerous cross-selling opportunities.

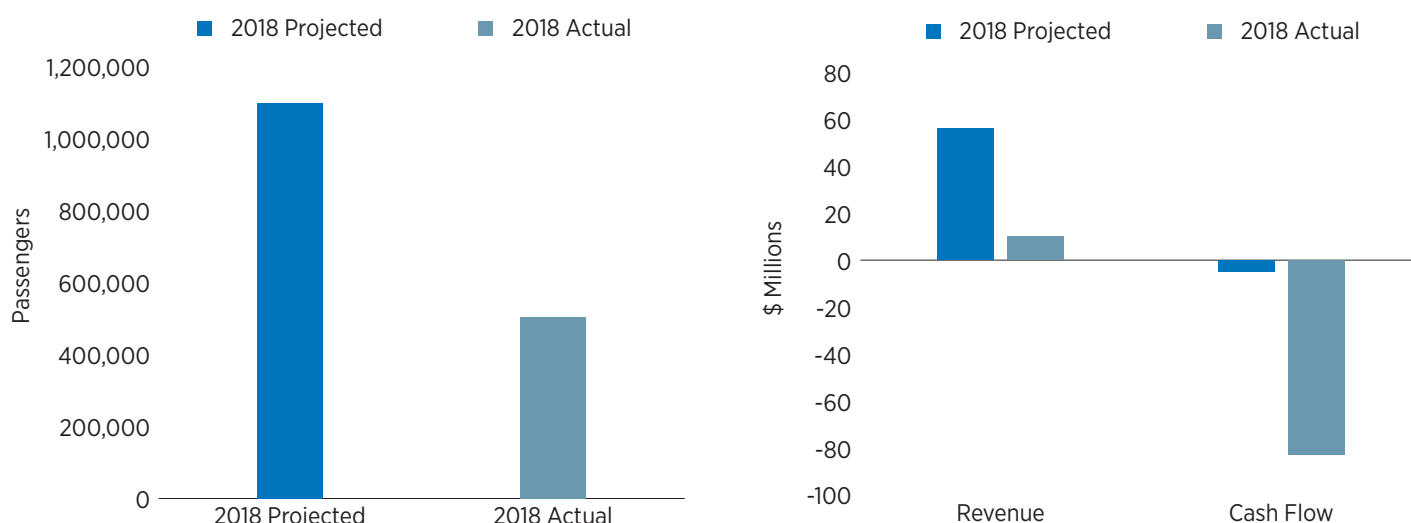
However, Virgin has been struggling to attract ridership, with a little over 570,000 passengers last year, 49% below what was projected in 2017, and annualizing ridership through May 2019, ridership is just 54% of what was projected for the full year 2019 (Exhibit B). Revenues in 2018 were projected at more than \$56 million, but in fact were only \$10 million. Projections from 2017 showed that free cash flow in 2018 would be negative \$5 million, but it was severely below projections at negative \$83 million, and annualizing operations through the first quarter of 2019, free cash flow for the year would be negative \$71 million.

Of greatest concern for bondholders, Virgin currently has only \$19 million in liquidity, a residue of the April bond offering. However, as part of the 2019 bond deal, interest will be paid for through 2022 with \$287 million in capitalized interest. Additional liquidity could come from Fortress or Virgin, but they are under no obligation to provide it.

Virgin came to market with a tax-exempt yield of 6.5%, and in mid-June had been bid up to yield about 6%, or a little over 10% on a taxable-equivalent basis. Bonds have recently traded below par, but we don't believe that is a sufficient discount for the level of risk we see in the issue.

Exhibit B

Virgin's ridership and revenues are way below projections.



Source: Virgin Trains USA as of November 30, 2018.

¹Bloomberg Barclays Municipal Bond High-Yield Index is an unmanaged index of municipal high-yield bonds traded in the U.S.



A fundamentally sound muni market

While it's important to understand the risks in high-yield muni issues such as Virgin, it's just as important to recognize that the deal is not representative of the muni market overall. From a fundamental perspective, the market is in solid shape. For example, Moody's upgrades have surpassed downgrades every year since 2015. The same is true for S&P ratings going back to 2008 (with the exception of 2010, when the upgrade/downgrade levels were equivalent). Unique muni defaults have declined every year since 2010 – from 140 in 2010 to 39 last year (Exhibit C).

There is a parallel here with my discussion of the leveraged credit sector, in that there is a broad base of sound issuers, along with outliers where the credit risk escalates, sometimes significantly. This is not to say that deals like Virgin shouldn't be considered, but they should be carefully evaluated: Is there enough potential return for the risk assumed? Muni funds have recently attracted

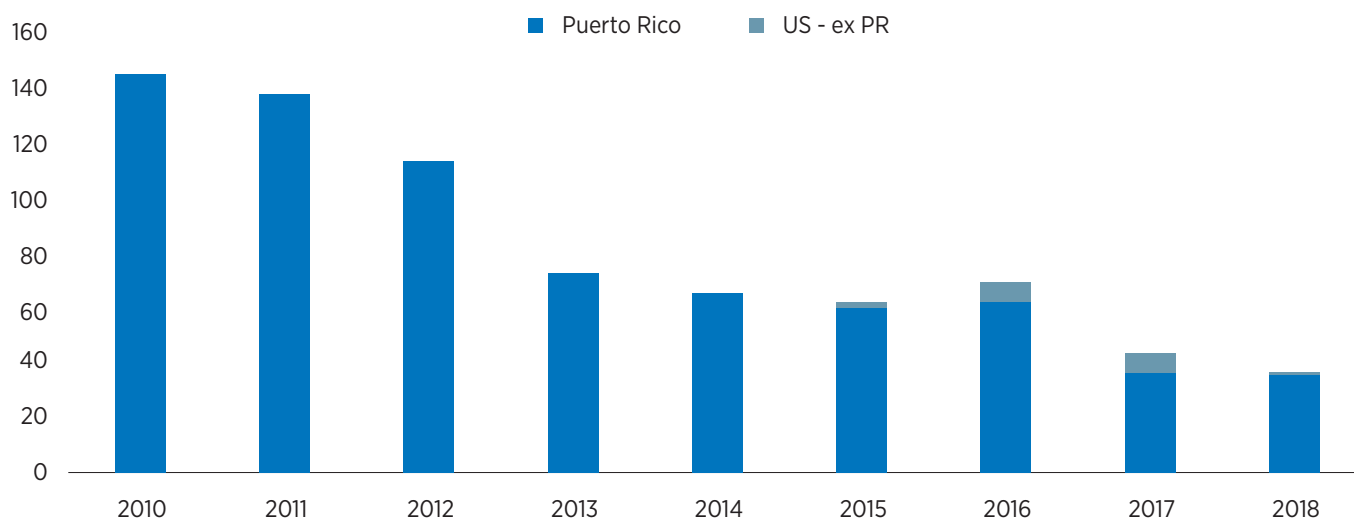
significant net inflows due to a market perception that the Fed needs to lower rates to prolong economic growth. In this environment, investors should be particularly wary of eye-popping yields offered by certain municipal bond strategies – ones that are dancing at the fringes of credit risk in the muni bond market.

Missing out on the misallocation

Ultimately, the downside of low and even lower rates is a misallocation of capital. The warning flag is out in the highest-yielding portions of the U.S. muni bond market. The good news is that there are plenty of sound opportunities in the market for which forward-thinking investors can take advantage and capture what the sector has to offer – attractive tax-advantaged income with downside protection.

Exhibit C

Muni defaults are at historically low levels.



Source: Municipal Market Analytics. Default data as of December 31, 2018.



About Risk

An imbalance in supply and demand in the municipal market may result in valuation uncertainties and greater volatility, less liquidity, widening credit spreads and a lack of price transparency in the market. There generally is limited public information about municipal issuers. Investments in income securities may be affected by changes in the creditworthiness of the issuer and are subject to the risk of nonpayment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. As interest rates rise, the value of certain income investments is likely to decline. Investments involving higher risk do not necessarily mean higher return potential. Diversification cannot ensure a profit or eliminate the risk of loss. Debt securities are subject to risks that the issuer will not meet its payment obligations. Low-rated or equivalent unrated debt securities of the type in which a strategy will invest generally offer a higher return than higher-rated debt securities, but also are subject to greater risks that the issuer will default. Unrated bonds are generally regarded as being speculative.

Credit ratings measure the quality of a bond based on the issuer's creditworthiness, with ratings ranging from AAA, being the highest, to D, being the lowest, based on S&P's measures. Ratings of BBB- or higher by Standard and Poor's or Fitch (Baa3 or higher by Moody's) are considered to be investment-grade quality. Credit ratings are based largely on the rating agency's analysis at the time of rating. The rating assigned to any particular security is not necessarily a reflection of the issuer's current financial condition and does not necessarily reflect its assessment of the volatility of a security's market value or of the liquidity of an investment in the security. If securities are rated differently by the rating agencies, the lower rating is applied. Holdings designated as "Not Rated" are not rated by the national rating agencies stated above. Ratings are based on Moody's, S&P or Fitch, as applicable. Ratings, which are subject to change, apply to the creditworthiness of the issuers of the underlying securities and not to the strategy or composite.

Important Additional Information and Disclosures

Source of all data: Eaton Vance as at June 30, 2019, unless otherwise specified.

This material is presented for informational and illustrative purposes only. This material should not be construed as investment advice, a recommendation to purchase or sell specific securities, or to adopt any particular investment strategy; it has been prepared on the basis of publicly available information, internally developed data and other third-party sources believed to be reliable. However, no assurances are provided regarding the reliability of such information and Eaton Vance has not sought to independently verify information taken from public and third-party sources. Investment views, opinions, and/or analysis expressed constitute judgments as of the date of this material and are subject to change at any time without notice. Different views may be expressed based on different investment styles, objectives, opinions or philosophies. This material may contain statements that are not historical facts, referred to as forward-looking statements. Future results may differ significantly from those stated in forward-looking statements, depending on factors such as changes in securities or financial markets or general economic conditions.

This material is for the benefit of persons whom Eaton Vance reasonably believes it is permitted to communicate to and should not be forwarded to any other person without the consent of Eaton Vance. It is not addressed to any other person and may not be used by them for any purpose whatsoever. It expresses no views as to the suitability of the investments described herein to the individual circumstances of any recipient or otherwise. It is the responsibility of every person reading this document to satisfy himself as to the full observance of the laws of any relevant country, including obtaining any governmental or other consent which may be required or observing any other formality which needs to be observed in that country. Unless otherwise stated, returns and market values contained herein are presented in US Dollars.

In the United Kingdom, this material is issued by Eaton Vance Management (International) Limited ("EVMI"), 125 Old Broad Street, London, EC2N 1AR, UK, and is authorised and regulated by the Financial Conduct Authority. EVMI markets the services of the following strategic affiliates: Parametric Portfolio Associates® LLC ("PPA"), an investment advisor registered with the SEC. Hexavest Inc. ("Hexavest") is an investment advisor based in Montreal, Canada and registered with the SEC in the United States, and has a strategic partnership with Eaton Vance, and Calvert Research and Management ("CRM") is an investment advisor registered with the SEC. This material is issued by EVMI and is for Professional Clients/Accredited Investors only.

This material does not constitute an offer to sell or the solicitation of an offer to buy any services referred to expressly or impliedly in the material in the People's Republic of China (excluding Hong Kong, Macau and Taiwan, the "PRC") to any person to whom it is unlawful to make the offer or solicitation in the PRC.

The material may not be provided, sold, distributed or delivered, or provided or sold or distributed or delivered to any person for forwarding or resale or redelivery, in any such case directly or indirectly, in the People's Republic of China (the PRC, excluding Hong Kong, Macau and Taiwan) in contravention of any applicable laws.

Eaton Vance Asia Pacific Ltd. is a company incorporated in the Cayman Islands with its Japan branch registered as a financial instruments business operator in Japan (Registration Number: Director General of the Kanto Local Finance Bureau (Kinsho) No. 3068) and conducting the Investment Advisory and Agency Business as defined in Article 28(3) of the Financial Instruments and Exchange Act (as amended) ("FIEA"). Eaton Vance Asia Pacific Ltd. is acting as an intermediary to promote asset management capabilities of Eaton Vance Management (International) Limited and other Eaton Vance group affiliates to registered financial instruments business operators conducting the Investment Management Business, as defined in the FIEA. Eaton Vance Asia Pacific Ltd. is a member of JIAA Japan with registration number 01202838.

In Singapore, Eaton Vance Management International (Asia) Pte. Ltd. ("EVMI") holds a Capital Markets Licence under the Securities and Futures Act of Singapore ("SFA") to conduct, among others, fund management, is an exempt Financial Adviser pursuant to the Financial Adviser Act Section 23(1)(d) and is regulated by the Monetary Authority of Singapore ("MAS"). Eaton Vance Management, Eaton Vance Management (International) Limited and Parametric Portfolio Associates® LLC holds an exemption under Paragraph 9, 3rd Schedule to the SFA in Singapore to conduct fund management activities under an arrangement with EVMI and subject to certain conditions. None of the other Eaton Vance group entities or affiliates holds any licences, approvals or authorisations in Singapore to conduct any regulated or licensable activities and nothing in this material shall constitute or be construed as these entities or affiliates holding themselves out to be licensed, approved, authorised or regulated in Singapore, or offering or marketing their services or products.

In Australia, EVMI is exempt from the requirement to hold an Australian financial services license under the Corporations Act in respect of the provision of financial services to wholesale clients as defined in the Corporations Act 2001 (Cth) and as per the ASIC Corporations (Repeal and Transitional) Instrument 2016/396.



EVMI is registered as a Discretionary Investment Manager in South Korea pursuant to Article 18 of Financial Investment Services and Capital Markets Act of South Korea.

EVMI utilises a third-party organisation in the Middle East, Wise Capital (Middle East) Limited (“Wise Capital”), to promote the investment capabilities of Eaton Vance to institutional investors. For these services, Wise Capital is paid a fee based upon the assets that Eaton Vance provides investment advice to following these introductions.

In Germany, Eaton Vance Management (International) Limited, Deutschland (“EVMID”) is a branch office of EVMI. EVMID has been approved as a branch of EVMI by BaFin.

Mutual Funds are distributed by Eaton Vance Distributors, Inc. (“EVD”). Two International Place, Boston, MA 02110, (800) 225-6265. Member FINRA/ SIPC.

Eaton Vance Investment Counsel. Two International Place, Boston, MA 02110. Eaton Vance Investment Counsel is a wholly-owned subsidiary of EVC and is registered with the SEC as an investment adviser under the Advisers Act.

Investing entails risks and there can be no assurance that Eaton Vance, or its affiliates, will achieve profits or avoid incurring losses. It is not possible to invest directly in an index. Past performance is not a reliable indicator of future results.

About Eaton Vance

Eaton Vance provides advanced investment strategies and wealth management solutions to forward-thinking investors around the world. Through principal investment affiliates Eaton Vance Management, Parametric, Atlanta Capital, Hexavest and Calvert, the Company offers a diversity of investment approaches, encompassing bottom-up and top-down fundamental active management, responsible investing, systematic investing and customized implementation of client-specified portfolio exposures. Exemplary service, timely innovation and attractive returns across market cycles have been hallmarks of Eaton Vance since 1924.

For further information, please contact:

Eaton Vance Management
Two International Place, Boston, MA 02110
800.836.2414 or 617.482.8260 | eatonvance.com

Eaton Vance Management (International) Limited
125 Old Broad Street, London, EC2N 1AR, United Kingdom
+44 (0)203.207.1900 | global.eatonvance.com

