

U.S. Municipal Bond Market

Will War in Eastern Europe Lead to Cyber-Attacks on U.S. Public Finance & Infrastructure?

- A flight to quality occurred just after announcements were made about Russia's conventional attack on Ukraine. We are not convinced the flight to quality will continue and it is difficult to say how investor sentiment is likely to develop in coming days. Potential U.S. Fed policy shifts still weighs heavily on investors' outlook.
- We remain concerned about the potential for cyberattacks on U.S. public finance related targets such as utilities, infrastructure and state and local governments.
- Public finance entities who have prepared over a multi-year period for cyber intrusions and with healthy general fund balances will be best protected from cyberattacks. It is possible cyber insurance policies are only of limited value especially if there is an "Act of War" or similar clause that can be enacted by the policy provider.

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Russian Conventional Attack on Ukraine

Russian conventional military attacks have commenced on Ukraine and one report suggests that this aggression could allow Russian forces to enter and take the Ukrainian capital of Kyiv (Kiev) "within hours." U.S. President Joe Biden spoke at another press conference today and announced additional sanctions meant to deny access to capital and "impose severe cost on the Russian economy, both immediately and over time."

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Impact on Financial Markets, Municipal Bond Market

Investor sentiment is evolving and a flight to quality is occurring as some investors try to position themselves to account for this development. A key reservation is whether or not events in Eastern Europe should supersede market expectations about what is expected from the FOMC on March 16th and thereafter. Very soon after the Russian invasion announcement was made municipal yields fell, but not as steeply as Treasury yields in what is being described as a flight to safety, or flight to quality. We think municipals could be one of the asset classes investors continue to transition to as a result of geo-political pressure. Credit quality in U.S. public finance and especially state and local government credit is very high, mostly as a result of 2021 federal relief. We increased our credit sector outlooks on the U.S. state government, local government and school district sectors in the beginning of February to "Positive" from "Stable," and do not plan to revise these as a result of the recent conventional invasion. However, it is possible that this move to quality does not progress as quickly or even continue in days to come. Investors pulled \$1.3 billion from municipal funds last week and today Lipper announced another \$1.2 billion was withdrawn from municipal bond fund investments week-over-week. We do not have a clear sense of where investor sentiment will align in coming days to weeks despite what has recently transpired.

Cyber-Space Has Been Weaponized

Questions about Russia's near-term intentions in Ukraine are answered for now. It is important to realize that the conventional military attacks in Ukraine are not the only tactic being used. Cyber-Space has been weaponized and Russia is one of the few nation-states that engages in this strategy. Russian and Russian related entities have been striking Ukraine in recent months with higher levels of disruptive cyberattacks. Most recently Ukrainian computers have been hit with data wiping software.

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Warnings of Potential Cyber-Attacks on U.S. Targets

The United States could be directly impacted by the events in Ukraine in the form of higher energy and commodities prices. Another way the United States could be directly impacted by the events in Ukraine is through cyber-attacks by Russia or Russian sponsored entities. Russian President Vladimir Putin early this morning warned, "Whoever tries to hinder us, or threaten our country or our people, should know that Russia's response will be immediate and will lead you to consequences that you have never faced in your history." Some are interpreting this to include potential extreme military strategies, we think the warning could mean aggressive cyber-attacks could occur.

At the end of January 2022 a U.S. Department of Homeland Security memo circulated to U.S. entities such as infrastructure assets and state and local governments warned of potential cyber attacks. At the beginning of this week the FBI warned private business leaders and state and local government officials to be "mindful of the potential for ransomware attacks," also. A similar warning was delivered to U.S. banks.

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Where public finance entities are concerned we believe those who have prepared over a multi-year period for cyber intrusions will be best protected. We also think that those with stronger balance sheets and general fund reserves will be better able to more quickly absorb short-term costs associated with any type of cyberattack. Cyber-insurance could be of only limited value. The circumstances and the details of cyber insurance policies are important now. It is possible that entities that have cyber insurance may not be fully covered under the current circumstances if policies have an "Act of War" or similar clause. Again, the details of the policy and the type of attack will help determine the strength of the insurance.

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