MUNICIPAL BONDS SHOW SURPRISING RESILIENCE DURING PANDEMIC

By George Stericker

Few financial sectors are immune to the effects of the coronavirus pandemic, and municipal bonds have experienced their own unique brand of stress over the second quarter. A municipal bond, commonly known as a "muni," is simply a bond issued by a local government or one of its agencies to finance public projects, such as roads, bridges, schools, airports, and other public works. The incremental revenue streams that pay off debt incurred by these projects may have been altered by the recent shutdown of the economy, making bondholders wary about the riskiness of these obligations. Commerce Trust Company Municipal Bond Credit Analyst George Stericker has spent much of his career assessing the viability and credit strength of a variety of municipal bond issuers. In this commentary, George shares his insights on how the coronavirus impact may play out in the muni bond sector.

WE ARE HEARING A LOT ABOUT THE FINANCIAL STRESS THAT STATE AND LOCAL GOVERNMENTS ARE UNDER DUE TO THE PANDEMIC. HOW DO MUNICIPAL BOND ANALYSTS SEE THE IMPACT OF THE PANDEMIC ON THE MUNICIPAL BOND MARKET?

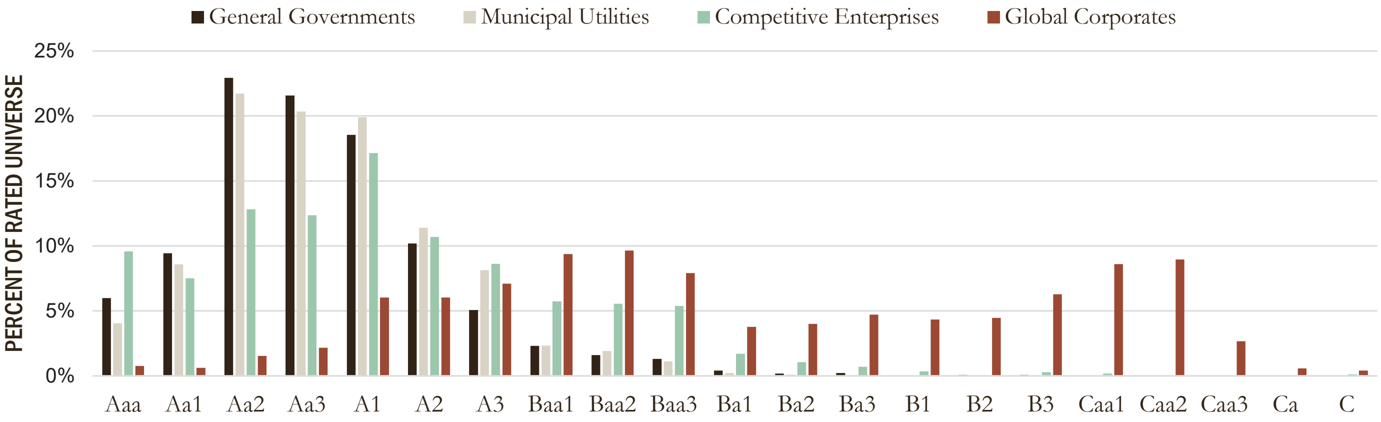
Overall, municipal credit trends follow the economy's lead, but with a significant lag, sometimes as long as a year or more. Municipal analysts incorporate broader economic conditions into their credit assessments, taking into consideration how different muni sectors and credits performed under previous economic cycles. Each downturn is different in character and causation, and each has left us with its own legacies. The United States currently finds itself in a unique situation due to the sharpness and suddenness of the shutdown of economic activity and the corresponding unemployment spike. While the speed and severity of the downturn has been unprecedented, so has been the response of the Federal Reserve and the federal government. The trillions of dollars of support for individuals, businesses, and the capital markets have gone a long way to fill the chasm left in the pandemic's wake as states now begin to reopen. With or without a vaccine, we will certainly be left with lingering effects from the pandemic, especially on the leisure and hospitality industries that were most directly impacted. While certain entities with the most concentrated exposure to those sectors will face significant pressure, we expect that most municipal bond issues will display the resilience shown in previous cycles and avoid meaningful distress or actual defaults.

HOW HAVE MUNICIPAL CREDIT RATINGS HELD UP SO FAR?

Since entering this unprecedented economic and healthcare crisis, the number of negative rating actions (e.g., rating downgrades or outlook changes to negative) taken by rating agencies such as Moody's or Standard & Poor's (S&P) has been relatively few. For example, for the months of March and April 2020, Moody's reported negative rating actions of about 1% for all its rated obligors. The main reason for this is that the rating agencies see State and Local Governments, and most of the municipal obligors that they rate, as being resilient to economic shock.

A key reason for this can be seen on the left-hand side of Moody's Rating Distributions chart (below), which displays the distribution of the Moody's-rated set of municipal obligors – General Governments, Municipal Utilities, and Competitive Enterprises – headed into this crisis. As the chart shows, most are fundamentally strong issuers, with ratings in the 'Aa' range.

MOODY'S RATING DISTRIBUTIONS BY SECTOR: MUNICIPALS BY SECTOR VS. CORPORATES, YEAR END 2019



Source: Moody's

WHY ARE MUNICIPAL CREDITS SO MUCH MORE RESILIENT THAN CORPORATE CREDITS?

Another feature of Moody's Rating Distribution chart (above) is that it compares the rating distribution for municipals with that of global corporate credits. What stands out is that the global corporates occupy much of the right-hand side of the chart, which is also the lower-rated (higher credit risk) portion of the scale. Interestingly, while nearly 50% of global corporate credit ratings are 'Ba1' or lower (i.e., below investment grade), only 1½% of municipal ratings fall in this range. Furthermore, over 90% of muni issuers' ratings are 'A3' or higher, and about 60% are 'Aa3' or higher.

The munis in the chart have been grouped by Moody's into three sectors: General Governments, Municipal Utilities, and Competitive Enterprises. Each sector has its own strengths and differences which warrant a few words. First, General Governments, including State and Local Governments such as Cities, Counties, and School Districts, have the unique ability to separate their revenues from the provision of any one service. That is, they can reduce short-term spending, by deferring spending on capital projects or cutting operational expenditures, while they continue collecting tax revenues. States, in particular, have very broad abilities to increase taxes, draw on "rainy day" funds, and cut spending in response to downturns. And Local Governments generally have very stable property tax-based revenue structures.

The next sector referenced is Municipal Utilities, which are often directly linked to Local Governments. These are essential service providers (such as water or sewer utilities), usually monopolistic, with strong liquidity, low leverage, and are often very efficient.

The final sector, Competitive Enterprises, encompasses the Healthcare, Higher Education, and Housing sub-sectors. Relative to Governments, issuers in this grouping generally have more business-like risk. Therefore, while the group's rating distribution is heavily concentrated on the left-hand, higher-rated side of the chart, it is also wider relative to the General Government and Municipal Utility distributions. Among the Competitive Enterprises included on the left-hand side are strong State Housing Finance Agencies with large, stable mortgage pools, as well as Public and Private Universities with significant endowment assets. As the rating distribution widens, many Healthcare providers, whose ratings tend to exhibit more volatility, as well as some ratings for smaller colleges and stand-alone housing projects, are represented. Overall, munis have earned their high ratings because of consistently lower default rates, as shown in the second chart, comparing municipal and corporate default rates over a period of nearly fifty years.

WHICH MUNICIPAL SECTORS ARE MOST AT RISK?

While the rating agencies largely see most rated municipal obligors as being resilient to economic shock, COVID-19 and the resulting economic slowdown will nevertheless impact the different municipal sectors to various degrees. The last chart reflects this continuum of risk. The most immediate negative impact will be on the

MUNICIPAL DEFAULT RATES LOWER THAN GLOBAL CORPORATES

Average Cumulative Default Rates, 1970-2018

Municipals	Moody's	S&P	Fitch	Average
AAA	0.0%	0.0%	0.0%	0.0%
AA	0.0%	0.0%	0.0%	0.0%
A	0.1%	0.1%	0.1%	0.1%
BBB	1.1%	0.8%	0.8%	0.9%
BB	3.7%	4.7%	5.6%	4.7%
B	17.9%	10.9%	1.9%	10.2%
CCC-C	25.8%	40.5%	15.4%	27.2%
Investment Grade	0.1%	0.2%	0.1%	0.1%
Speculative Grade	7.5%	9.0%	5.9%	7.5%
All Rated	0.2%	0.3%	0.2%	0.2%

Corporates	Moody's	S&P	Fitch	Average
AAA	0.4%	0.8%	1.5%	0.9%
AA	0.8%	1.0%	0.1%	0.6%
A	2.1%	1.8%	1.5%	1.8%
BBB	3.7%	4.3%	3.2%	3.7%
BB	15.5%	14.4%	9.1%	13.0%
B	34.3%	26.4%	13.1%	24.6%
CCC-C	48.2%	56.6%	41.5%	48.8%
Investment Grade	2.3%	2.5%	1.9%	2.2%
Speculative Grade	28.8%	23.5%	13.0%	21.8%
All Rated	10.1%	11.0%	4.1%	8.4%

Source: JP Morgan

Healthcare, Higher Education and Airport sectors, along with revenue-backed Mass Transit, and Special Tax-backed debt with very narrow revenue pledges. While there are various "Special Taxes" with which Governments may secure these bonds, it is the hospitality, leisure, tourist, parking fee, and gambling tax revenue that analysts see as most vulnerable during the slowdown. How quickly these tax revenues recover will depend on states easing restrictions, consumer perceptions of safety both home and away, and the rate at which employment returns to pre-pandemic levels. Similarly, financial recovery for the Healthcare sector will depend on the restart of nonemergency and elective healthcare and medical services and federal aid. It's important to note however that while the credit conditions in these particular sectors may be experiencing extreme pressure, the rating agencies' decision to take a negative rating action for a specific issuer also takes into consideration the credit strengths and weaknesses an individual issuer or obligor may have.

Source: Moody's

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