Municipal Market Insight
Focus Article

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Portfolio Advisory Group – U.S. Fixed Income Strategies

What's inside

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Municipal resiliency

Municipal bond investors are understandably unsettled by news reports suggesting state and local governments' financial futures are dire because of the pandemic. However, while many governments will experience difficult times ahead, we believe some of the ruinous rhetoric by government officials is designed to maximize additional federal assistance from a divided federal government.

More importantly, we believe that investors should ignore the hyperbolic municipal forecasts, and instead focus on municipalities' inherent strengths that have resulted in exceptionally low default rates through numerous economic cycles over the past 50 years. We acknowledge this time is different because every market disturbance is unique. However, what is also unique compared to other asset classes are the tools and resources available to many municipalities to counter these distinct disruptions.

Many municipalities are likely going to face difficult financial challenges and imbalances that will result in amplified rating downgrades. Yet despite this forecast, we believe investors are better served focusing on—and continuing to invest in—the plethora of municipalities that will rebalance their fiscal operations as opposed to the relatively few high-profile, fiscally challenged municipalities that will dominate the airwaves. For every Puerto Rico, there are literally tens of thousands of municipalities that steadfastly honor their debt obligations, from Portland, Maine to Portland, Oregon, and from Franklin, Minnesota to Franklin, Louisiana.

Municipal attributes

Traditional municipalities are essential service monopolies that commonly have vast taxing power and the ability to reduce expenditures and services without immediately losing constituents. Layer in the widely perceived ability of municipalities to improve their operational efficiencies, and governments have three avenues—revenues, expenditures, and efficiencies—to restore fiscal balance.

Admittedly, increasing revenues is more difficult during an economic downturn, reducing services and staff is never popular, and maximizing operational efficiency may not be in a government's culture. But necessity is the mother of all invention. The fiscal fallout from this pandemic will force change—municipalities will increase taxes and cut spending and will be forced to find efficiencies, in our opinion. While the employment of these three solutions will vary greatly among municipalities, the collective effectiveness of these solutions to stabilize municipal finances seems clear from a historical standpoint.

Wealth Management

Investors should put any default in perspective and not project that widespread municipal defaults are therefore inevitable.

Structural protections

Many run-of-the-mill municipal bonds are backed by property taxes on a valuable asset (peoples' homes), which may be taken for non-payment. This legal structure strongly incentivizes residents to pay their property taxes, thereby better enabling municipalities to continue paying their debt service obligations even during economic downturns.

Also, many revenue bonds have excess debt service coverage ratios that provide a buffer against revenue declines that often occur during economic downturns. Moreover, revenue bonds often have debt service reserves that can be tapped if pledged revenues prove insufficient.

Parting thoughts

Naysayers seem to write off state and local governments during every economic downturn despite municipal bonds having an enviable repayment track record compared to almost all other asset classes.

Maybe municipal bonds have a tarnished image because they are perceived as being bureaucratic, sub-optimally run, and subject to the political winds. Yet despite these flaws, municipal default rates are orders of magnitude better than corporate bonds. According to a Moody's Investors Service default study, investment-grade municipal general obligation (GO) bonds defaulted less than 0.05% over 10-year rolling periods since 1970 compared to 2.25% for global investment-grade corporate bonds. Given the chronic malignment of municipal bonds, this comparison cannot be overstated to drive home the point that municipal bonds have been a much safer relative investment historically than corporate bonds, and—by extension—stock equity.

We acknowledge that some municipalities will fail their constituents and bondholders, but the failures will be rare, in our opinion, based on the reasons cited above. As such, investors should put any default in perspective and not project that widespread municipal defaults are therefore inevitable. Brooks Brothers, Virgin Atlantic, Gold's Gym, Cirque du Soleil, GNC, and Hertz—to name a few—have all declared bankruptcy this year, yet most investors are not indiscriminately maligning all corporate debt. We believe municipal debt should be afforded the same courtesy because every situation and solution is unique.

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