Municipal defaults: Don't believe the hype

Wealth Management

Investors sometimes question the durability of state and local government finances despite municipal bonds having an enviable repayment record compared to almost all other asset classes. Maybe municipalities have a tarnished image because they are perceived as being bureaucratic, sub-optimally run, and subject to the political winds.

Despite these flaws, municipal bond default rates historically have been a magnitude better than corporate bonds Each day, tens of thousands of municipalities fulfill their duties, including paying their debt obligations. Municipal defaults make for good news fodder because they are such infrequent events.

Municipal attributes

State and local governments are essential service monopolies that commonly have vast taxing power and the ability to reduce services without the risk of losing taxpayers, at least in the intermediate term. Layer in municipalities' power to improve operational efficiencies and use their available reserves, and governments have four levers to restore fiscal balance: revenues, expenditures, efficiencies, and use of excess reserves.

Admittedly, increasing taxes and reducing services is never popular, maximizing operational efficiency may not be in a government's culture, and excess reserves are finite; however, necessity is the mother of invention. We believe that inevitable future challenges will force municipal governments to make necessary changes. While the solutions will vary greatly among municipalities, the collective effectiveness of these solutions in stabilizing municipal finances is well established from a historical standpoint.

Relative risk

All municipal bond defaults historically have been extremely rare, and general government bond defaults have been even more so. To emphasize this point, over rolling 10-year periods between 1970 and 2022, Moody's-rated general government issuers that were rated investment grade at the start of the 10-year period only defaulted 0.05% during the next 10 years. Otherwise stated, over 10-year periods, bonds initially rated investment grade paid their obligations 99.95% of the time. For a relative comparison, investment-grade corporate bonds defaulted 2.2% over the same time periods, which is orders of magnitude higher.

Another way to think about the relative risk is that as recently as 30 years ago, there were more than 60 AAA-rated publicly traded companies. However, as of this writing, there are only two. This statistic contrasts with states in the U.S., of which 16 are currently rated AAA, and all but two are rated in at least the AA category. Additionally, there is a plethora of local municipal borrowers that are rated AAA.

Municipal risk differs

Investors should appreciate municipal bonds are not homogenous, and that different security pledges have markedly different risk profiles. For example, charter schools and continuing care facilities (retirement communities) statistically default more than general government and essential utility issuers. Therefore, despite the relative dearth of municipal defaults in the aggregate, investors should be mindful of their risk tolerance and purchase municipal bonds accordingly.

Structural protections

Most conventional municipal bonds are backed by property taxes on their residents' most valuable asset (the home), an asset that may be taken for non-payment. This legal structure strongly incentivizes people to pay their property taxes, thereby allowing municipalities to honor their collective obligations even during economic downturns.

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Also, many revenue bonds have excess debt service coverage ratios that provide a buffer against revenue declines that frequently occur during severe economic downturns. Many revenue bonds also have a debt service reserve that can be tapped if revenues prove insufficient.

Pension challenges

Pension obligations are long-dated liabilities that do not fail simply because the value of the investment portfolio temporarily decreases. Pension-funded ratios (amount of assets compared to projected future payouts) fluctuate with economic cycles like any investment portfolio, so it is typically disingenuous to assess a pension's health at one point in time, especially during economic downturns.

Furthermore, municipalities can—and do—address their pension challenges through a combination of pension modifications, increased contributions, and service reductions. To be clear, we think long-term pension promises are a top issue for many municipalities, but these are well-known, well-telegraphed challenges, and have long lead times before they become critical. Importantly, as pension issues become more pronounced, we think politicians can use the mounting crisis to enact unpopular changes to improve the health of the pension system.

Status quo

We believe investors should ignore hyperbolic forecasts of municipal defaults arising from economic challenges or disruptive events. Instead, we believe investors should focus on state and local governments' inherent strengths, which have underpinned their exceptionally low default rates over the past 50 years through numerous economic cycles and despite many exogenous events. Any number of future market disruptions will force some municipal officials to make tough decisions, but they have many tools available to help them overcome their circumstances. We acknowledge that every market disturbance is unique, but the inherent strengths of state and local governments are constant.

Press coverage highlighting these positive attributes would be a snoozer. Insinuating that "this time is different" and that isolated municipal problems foretell a widespread municipal crisis elicits concern and gets people's attention—even if the statements aren't supported by the facts.

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