Fiscal fallout
State and local bond issuers are grappling with financial uncertainty.

This has been a year without precedent in a number of societal and entertainment respects. Virtual schools, cancelled sporting events (even full seasons!), closures of restaurants and theaters, and stay-at-home and wear-that-mask orders—just to name just a few.

Interestingly, while there have been some dubious milestones on the economic front, there also appear to be some incongruities. We know about the rapid escalation of unemployed workers and the 30%+ decline in GDP in the second quarter. How does that square with stock market indices setting records (at quite frothy price/earnings ratios, I might add)? And more relevant for community bankers, what is causing portfolio managers to wade into the municipal bond market with abandon, even as we hear warning after warning of looming financial peril for state and local governments? Let’s take a look under the hood of the muni machinery to see if it’s time for some scheduled service.

Ebb and flow
First off, the muni market ride this year has been more thrilling than any other segment of the bond market. This is residue of the investor base for that market, namely retail customers. About two-thirds of the entire $3.9 trillion muni
market is owned by individuals, either through purchases of individual bonds or through mutual funds. In early March, when news of the pandemic spread as rapidly as COVID-19 itself, retail investors began dumping their bonds, causing all prices to plummet and yields to spike. Bloomberg estimates that in the month of March, spreads on 10-year investment grade taxable munis ballooned by almost 100 basis points (1%).

The market quickly recovered, and bond fund inflows resumed. By the middle of April, year-to-date invested dollars were on the plus side and have continued to grow since. What caused this immediate—and apparently sustained—change of heart? For one thing, the Fed announced a lending facility aimed at supporting state and local governments. The Municipal Liquidity Facility (MLF) has had more of a psychological impact on investors than anything, since as of this writing exactly one entity—the state of Illinois—has borrowed under that program.

Port in a storm?
For another, the credit quality for the currently outstanding issues is quite good. Moody's Investors Services currently has both the State Government and Local Government Sectors on Outlook Negative, although local governments (i.e., counties, cities, school districts, utility districts and the like) in particular entered this crisis in healthy financial condition. Around 75% of the general obligation (GO) issues to which Moody's assigns a rating are currently “A3” or better. Downgrades at the local level have thus far in 2020 been almost nonexistent, but that can be expected to change.

Going further into the why's of investor demand, it can be said that banks are scrambling to maintain some modicum of interest rate margin. Durations have shrunk below many managers' targets, and muni bonds are among the few longer maturity options for depositories. And for GO issues, which are backed by property taxes, investors are assuming for the moment that most obligors will be able to stay current.

Regardless of metrics, investors understand two more fundamentals about municipal finance in 2020. One is that most issuers have the legal authority to raise revenues, even though it may be a tough sell politically, as well as the ability to reduce expenses when possible during the fiscal year to assist in balancing operations. The other is that there are a number of federal government assistance programs, such as the MLF, that can help backstop the muni bond market.

Easy does it
Another variable that's boosted municipal bond prices is the supply. So far the amount of municipal bonds out there hasn't improved, although it is possible that at some point local governments may have to borrow to plug some revenue leaks. That prospect hasn't yet factored into valuations, but would actually be welcomed by many investors who are trying, unsuccessfully, to buy local munis.

Common sense and sound practices are the advice here. Most banks have a strong preference for GOs or essential service revenue bonds. This year may not be a good one to invest in a bond that's backed by transit or greens fees. Community banks can also avail themselves of alert systems that can notify them whenever there's a public notice regarding one of their holdings. Brokers and consultants can also provide access to demographic data for buyers to review before and after purchases are made, to identify potential soft spots.

The muni market has seen and weathered storms before. Moody's reports that there has been a total of 113 defaults of rated issues in the past 50 years, from a population of more than 100,000. Community banks should exercise all due caution but will continue to participate in the municipal bond market.

Chances of fiscal fallout from the pandemic? Likely. Is this an opportunity for community banks to remain invested in high-quality municipals? Also likely.