MUNICIPAL BONDS:
CREDIT UPDATE
IN VOLATILITY

MARCH 23, 2020

We expect a challenging year for municipal bonds. However, we think issuers that entered into the crisis in sound financial health will emerge with little or no long-term damage. At the same time, issuers previously under stress will be under even more pressure, in particular if they had underfunded retirement liabilities made worse by losses in the equity market.

We see the 2020 outlook as negative, but we expect long-term stability. In our research, we aim to understand how economic cycles and event risk may impact investments. As part of our credit process, we don’t only look at how an issuer performs when the economy is strong. We also gauge how well an issuer can manage through downturns and stress.

When situations such as the coronavirus pandemic arise, we aim to maintain a level of confidence in how our investments will respond. We are constantly following the evolving situation and assessing our borrower’s ability to manage through.

2020 OUTLOOK BREAKDOWN

In the near-term, we think there will be deep cuts in tax revenues. We expect a number of rating-agency downgrades, but we do not anticipate a large uptick in defaults by investment-grade issuers. In fact, we see an encouraging number of issues well prepared for a downturn with cash reserves. The U.S. government also is likely to step in with support, though the scale and speed is unknown.

Here’s how we break down the outlook by issuer type:

- States will experience declines in most revenue sources, including sales tax, personal income tax, corporate tax, and energy-based revenues for some. That said, states have a tremendous ability to adjust spending, borrow internally, and spend down reserves that were built up for exactly this reason. State reserves were reported at the highest level in 20 years prior to the outbreak. Those states that enter a downturn with material credit stress (the states we have already been cautious of) will see that stress heightened as we emerge from downturn (i.e. pensions).

We think that investors can rely on the long-term fundamental strength of the municipal market to remain intact.

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Local municipalities largely rely on property tax revenue, sales tax revenue, and city fees and services. The latter two sources will weaken in the coming months. However, property taxes are likely to act as a stabilizer for 30% to 60% of revenue for most municipalities. Much like the states, municipalities maintain strength in cash reserves which they can draw on to ease stress. Debt service for general obligation bonds is often paid directly from a property tax levy, which is unlikely to see material disruption.

Dedicated tax bonds (bonds backed by sales, gas or other taxes) will experience deep cuts in revenues as purchases shift to essential household goods, which is most often not taxed or taxed at a much lower rate. Dedicated tax bonds are vetted on their ability to handle declines in revenue. Given the current base case scenario, we anticipate sufficient coverage of debt service payments with a rapid rebound in the late summer and fall months. Hospitality tax bonds, those backed specifically by hotel taxes, likely will see more severe stress as occupancy has been reported as low as 10%.

Essential service providers (power, water, sewer) should experience modest impact. Most entities employ both a fixed and variable rate structure to maintain stability during variability in usage. Many also maintain adequate liquidity to handle temporary disruptions.

Higher education will experience temporary disruption, most notably in endowment losses, lower housing revenues and on-campus spending, and potential for lost international enrollment in the fall semesters. The rapid utilization of on-line learning, even for those schools that largely employ an in-person model, will allow for rapid adjustment as the situation evolves.

Hospitals will experience significant cost increases along with a deferral of profitable elective procedures such as non-urgent surgery. However, funding from the U.S. government should help mitigate higher costs related to the pandemic. The majority of hospitals maintain improved liquidity compared to pre-recession.

Transportation is generally well positioned to withstand this short-term stress, with strong coverage and cash reserves. U.S. government support for airlines should support flow of dollars to airports. Direct federal support is also possible for ports and airports. Toll roads will likely draw down on cash reserves to support operations.

CONCLUSION: REMAINING INTACT

Volatility will likely dominate in the coming weeks as the pandemic is addressed. We expect state and local preparedness as well as federal action will offer support in the medium term. We think that investors can rely on the long-term fundamental strength of the municipal market to remain intact.