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From Oil Prices to Credit Pressure: The Slow-Build Risk for Municipals - Morgan Stanley

The conflict in Iran has introduced a familiar dynamic for municipal investors: Geopolitical uncertainty translating into higher energy prices, rising inflation expectations and increased rate volatility. To date, the muni market has remained relatively resilient, with yield movements largely tracking Treasuries rather than signaling broad credit stress. The more meaningful potential longer-term risk lies not in the immediate shock of elevated oil and gas prices, but in the duration of the oil shock gradually pressuring issuer fundamentals through higher operating, labor and capital costs paired with revenues that adjust more slowly. In this environment, credit outcomes will increasingly hinge on oil price trajectories and fiscal discipline, with issuers that maintain strong reserves and cost flexibility better positioned to navigate the cycle.

State and local governments generally enter this period from a position of strength, but higher energy costs can still act as a slow-moving headwind. Rising gasoline prices may dampen consumer spending, particularly on discretionary items that support sales tax revenues, while persistent inflation can force municipalities to absorb higher costs across capital goods, public safety, infrastructure and contracted services. However, the impacts aren't uniform. A subset of states, including Texas, New Mexico, North Dakota, Colorado and Alaska, stand to benefit from higher oil prices through increased severance tax revenues and energy-driven economic activity. Similarly, states with large defense footprints like Texas, Virginia and California may see incremental support from increased federal defense spending tied to geopolitical tensions. These revenue tailwinds can help offset rising costs and, in some cases, allow governments to reinvest in infrastructure, education and other public priorities.

The more pronounced credit pressures are likely to emerge in sectors directly exposed to energy costs and consumer behavior. Higher fuel prices can weaken travel demand, placing pressure on transportation-related credits such as airports, toll roads and ports. Airports with greater exposure to leisure travel or low-cost carriers may be particularly sensitive if elevated costs persist and discretionary travel declines. While toll roads may experience some reduction in traffic, many retain pricing power that can help mitigate revenue declines. Public power and utility issuers may also face higher input costs, though the extent of the impact depends on their ability to pass costs on to ratepayers. More broadly, inflationary pressures can strain capital-intensive projects, increasing construction costs and complicating long-term planning. Active credit analysis plays an essential role in selecting issuers with strong balance sheets and management teams that can weather significant uncertainty.

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