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Muni Bonds Report Reinforces Stability.

Moody's Investors Service's recently released annual municipal bond market snapshot, *US Municipal Bond Defaults and Recoveries, 1970-2017*, with updates through 2017, reaffirms two hallmark benefits that muni bonds continue to offer. First, muni bonds continued to be highly rated in 2017, with upgrades narrowly outpacing downgrades for a second year running. Second, municipal bankruptcies and defaults remain extremely rare, even amidst headline-grabbing defaults by Puerto Rican entities.

The latest report also featured a significant update to Moody's entire dataset extending back to 1970. Using an algorithm, the authors were able to bring the historical credit ratings in line with Moody's 2010 Global Scale Recalibration, which affected most of the main default and performance metrics. According to Moody's, this recalculation has rendered key metrics more meaningful and offered greater explanatory power, enabling more powerful inferences regarding long-term trends.

To save you the hassle of poring through a 100-page document, we highlight three takeaways from this year's report.

Ongoing Stabilization in Muni Bonds

Nearly a decade after the Great Recession (2007-2009), the municipal bond sector is now stable and recovering, aided in part by growth and economic recovery in many regions of the U.S. For the second year running, muni bond rating upgrades have outweighed downgrades, resulting in a positive rating drift1 overall of 0.017 notches per credit by the end of 2017. "In fact," the authors observe, "rating drift has been mildly positive since late-2015." The trend had been generally negative since mid-2008, since reaching a low of -0.082 notches per credit in 2012. The report also found that greater stability was demonstrated by A-and-above rated munis when compared to like-rated global corporates.

Muni Bond Defaults and Bankruptcies Remain Rare

The five-year all-rated cumulative default rate (CDR) on municipal bonds throughout the study period (1970-2017) remained quite low, at just 0.09%, especially when compared to the 6.7% CDR of global corporates over the same time period. In this context, it is perhaps unsurprising that even in a year with a relatively elevated number of defaults, there were only ten in all of 2017 out of many thousands of issues.

The report observes that municipal defaults have been notably rare throughout the study period, even in times of financial stress, thanks to a defining feature of state and local governments: delinked revenues and expenditures. This enables municipalities to "kick the can down the road" and delay a crisis, even taking on more debt where corporate issuers might be unable to do so. Still, default volumes have grown, with 55 of the 113 defaults since 1970 occurring after 2007.

Muni Defaults Concentrated in Puerto Rico in 2017

Of the 10 defaults that occurred in 2017, entities associated with the Commonwealth of Puerto Rico accounted for seven. Due in large part to Puerto Rico's ongoing financial woes, 2017 set a U.S. dollar record for defaults: $31.15 billion, a 15% increase from 2016. The lion's share was concentrated in Puerto Rico, while the three non-Puerto Rico defaults accounted for a relatively tiny $85 million.

As the authors of the study observed, municipal credits can be strongly correlated with one another. Although a range of different entities in Puerto Rico defaulted in 2017, they were "tied together by overlapping debt burdens and shared economies and tax bases," which exacerbated the competition among the entities for revenues.

Moody's expects defaults in 2018 to be fewer in number and substantially smaller in amount, consisting of a few remaining speculative-rated Puerto Rico issuers with roughly $4.7 billion in debt outstanding.

Conclusion

Although it is still a struggle to obtain the same amount of timely disclosure from issuers of municipal bonds as one sees in other asset classes, the pure empirical evidence suggests that muni bonds continue to offer a fiscally sound vehicle for deriving an income stream free from federal and, in some cases, state taxes.

A total contrarian might say that this cannot, or will not, hold true for the long haul. But as best one can tell from Moody's study, there are no red flags flying over the industry. True, not all public sector projects succeed, but more conservative fiscal management coming out of the deep recession of 10 years ago seems to be the backstory. Ride the wave!

1 Rating drift measures the net average number of notches a credit will change over the study period. It is defined as the average upgraded notches per issuer minus the average downgraded notches per issuer.

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