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Muni Bond Defaults Remain Rare.

In August, Moody's Investors Service released its annual municipal bond market snapshot, *US Municipal Bond Defaults and Recoveries, 1970-2018*, with updates through 2018. The report continues to affirm two hallmark benefits offered by muni bonds. First, municipal bankruptcies remain rare overall, even though they may have become more common over the last 10 years. (There were no rated municipal defaults in 2018.) Second, muni bonds continued to be highly rated in 2018, with more issuers upgraded than downgraded. (According to Moody's, though, on average, the size of the downgrades was larger than for the upgrades.)

Last year, we noted that the report featured a significant update to Moody's entire dataset extending back to 1970 and that the recalculation Moody's undertook had not only rendered key metrics more meaningful but also offered greater explanatory power. (This enabled more powerful inferences regarding long-term trends.) One important "observation" noted in this year's report was that, over the 48-year study period: "any one default may only reflect the idiosyncrasies of that individual credit, and not be representative of any general sector trend."

Muni Bond Defaults and Bankruptcies Remain Rare
The report noted, once again, the fundamental difference between municipal and corporate credits.

While the five-year all-rated cumulative default rate (CDR) of municipal bonds throughout the study period (1970-2018) might have increased a tiny bit to 0.10% (1970-2017: 0.09%) it still remains quite low. Likewise when compared to the five-year CDR of 6.6% for global corporates over the same time period. There were neither any rated municipal defaults in 2018, nor any new defaults in Puerto Rico (although many Commonwealth of Puerto Rico entities remained in default during the year). There was, however, one unrated default during the same period.

While there may have been a dearth of new rated defaults in 2018, Moody's did note that there had been "some notable developments concerning default, bankruptcy and recovery," not least in the context of the defaults in Puerto Rico. The rating agency went so far as to say: "One remarkable development in the past year is the number of court rulings that will have bearing on future municipal bankruptcies." It further noted that while pledge still matters, it might not shield against loss in either default or bankruptcy—especially when the payment of pensions is involved. (Muni investors will certainly have to bear this in mind going forward.)

Ongoing Stabilization in Muni Bonds
The report also notes, for the second year running, that nearly a decade after the Great Recession (2007-2009), the credit quality of the municipal bond sector is now stable. It has been aided in part by growth and economic recovery in many regions of the U.S. For the third year running, in 2018, muni bond rating upgrades outweighed downgrades (480 vs. 392), but there were fewer rating changes than in prior years.

In contrast with the trend of growing positive drift in 2017 (positive since late-2015), ratings drift,1 at 0.003% per credit, was nearly flat in 2018. The trend had been generally negative since mid-2008, and reached a low of -0.083 notches per credit in 2012. In addition, volatility, at 0.09 vs. 0.11

notches per credit in 2017, dropped 23% in 2018. The report added that the municipal sector overall is highly rated, with approximately 92% of all the municipal credits Moody's rates falling into the A category or higher as of the end of 2018. Further, at the end of 2018, the median rating for U.S. municipal credits was Aa3. This stood in stark contrast to the median rating for global corporates, which was Baa3.

Conclusion

As we concluded in our review last year, 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.

If one looks at defaults alone over the past 48 years, according to Moody's report, across all sectors there have been only 113 defaults in the total amount of a little over $72 billion. Of this figure, Jefferson County, Alabama and the city of Detroit, Michigan accounted for approximately $11 billion and Puerto Rico some $55.5 billion (combined $66.5 billion). There are more than 50,000 different state and local governments and other issuing authorities.

There are, however, as always, caveats. As Moody's states in the report's Introduction: "The once-comfortable aphorism that 'munis don't default' is no longer credible: rating volatility, rating transition rates and cumulative default rates (CDR) have all increased since 2009." The sector does face challenges. These include, among others, democratic shifts (populations both aging and relocating—affecting tax receipts), "substantial increases in pension and retirement health care leverage" and "the associated but new exposure to equity markets."

Moody's goes on to describe the sector's exposure to the equity markets as "unprecedented" and requiring attention. For state and local governments, this exposure has been gained through their pension fund trusts. The concern for Moody's is not only their resulting exposure to "financial market volatility in general," but also the size of this exposure, which is both significant and "a feature never before seen in the U.S. public sector."

Despite this, we still believe that municipal bonds remain important to the core strategy of constructing an individual portfolio.

by VAN ECK GLOBAL on DECEMBER 21, 2019

By Michael Cohick, Senior ETF Product Manager for VanEck Global

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