Bond Case Briefs

Municipal Finance Law Since 1971

Coronavirus Chaos Torpedoes Municipal Bond Market.

After initially staying strong as markets declined, munis tumble 11% in 11 days.

The COVID-19 pandemic has shown no mercy for the municipal bond market, which has plummeted in the past two weeks despite being considered a relatively safe investment when the markets are down. And this could be particularly damaging to institutional investors, who own the majority of outstanding municipal bonds.

According to Bernardi Securities, a broker/dealer specializing exclusively in municipal bonds, 40% of outstanding municipal bonds are owned by institutional investors. Pension funds, insurance firms, community banks, and trust departments own approximately 35% of outstanding municipal bonds, while 25% of them are owned by hedge funds, bond funds, arbitrage firms, and other general institutional investors.

Municipal bonds initially responded well when the markets began to fall in February. As the Dow 30 and the S&P 500 tumbled 18.6% and 17.5% respectively between Feb 5 a.nd March 9, the Bloomberg Barclays Municipal Bond Index, which tracks the US dollar-denominated long-term tax exempt bond market, rose over 2%. But during the next 11 days the index fell nearly 11% to its lowest point since the end of November 2018, and it was down 7.5% year to date as of March 20.

A sharp drop of this degree is "extremely rare" said Cooper Howard, director, fixed income and income planning at Charles Schwab.

"Munis are feeling the impact of COVID-19 on two fronts," Howard wrote in a recent market commentary. "First, this is a unique trading environment in which liquidity is strained. Second, there are longer-term concerns about the impact that a sudden and severe slowdown in economic activity could have on municipalities' finances."

Howard said that contributing to the limited liquidity was the fact that municipal mutual funds experienced their first week of fund outflows after more than 50 consecutive weeks of inflows. In some cases, this means that fund managers may have to sell them to meet clients' redemption requests, driving down prices. Additionally, he said long-term concerns about how the coronavirus will affect interest rates have led to a limited number of buy offers or have resulted in bids that are much further away from the market than expected.

"While we don't expect widespread municipal bond issuer defaults due to COVID-19, we do expect the decline in consumer activity to have an impact on some municipalities' finances," Howard said. "This impact will be felt especially hard by issuers in certain sectors with already lower liquidity."

In particular, the sectors of the municipal bond market most affected include state and local governments, hospitals, airports, and universities.

Goldman Sachs has revised its unemployment forecast sharply higher due to the impact of COVID-19 and estimates a 5.5 percentage point increase in the unemployment rate to a 9% peak in impending quarters. This translates to lower personal income tax revenue for states, which is among their biggest sources of revenue. And as non-essential businesses are being shut down in many states, local sales taxes will also take a big hit.

Howard says these factors will pose a risk for states with already lower liquidity levels, and local governments that are reliant on sales taxes will suffer more the longer it takes for the crisis to subside.

“Depending on how the equity markets perform for the rest of the year, some local governments may be faced with higher pension costs,” Howard said. “This too could pressure their finances.”

Meanwhile, increased hospitalizations and the strain the virus is having on hospital resources could pressure high-occupancy hospitals and potentially crowd out other services. And drug and medical device supply chains could also be negatively affected, Howard said. “The health care sector already tends to be lower-rated, on average, compared with the rest of the muni market,” he said, “so we would suggest further caution here.”

And because COVID-19 has devastated the air travel industry, airlines have been forced to significantly reduce capacity, which has led Moody’s to recently downgrade its outlook on the sector to “stable” from “positive.”

“However, most US airports tend to benefit from fixed revenues, and should be able to manage through declines in demand,” said Howard, noting that other outbreaks, such as the SARS coronavirus outbreak in 2002, haven’t resulted in ratings downgrades. But, he added, “if concerns about the coronavirus linger and severely curb travel demand, this could result in downgrades.”

As for colleges and universities, they are likely to be less affected by the virus as many of them have already moved to an online format for the remainder of the 2019-2020 school year.

“This is unlikely to affect near-term revenues, but enrollment could be hurt if concerns about the virus linger,” Howard said. “Schools that are reliant on foreign students will be affected to a greater degree than those with a more diverse student mix.”

Chief Investment Officer

March 23, 2020