Coronavirus Fiscal Fallout on U.S. Muni Issuers Worries Investors.

CHICAGO, April 3 (Reuters) – Investors in the U.S. municipal bond market are growing increasingly worried over the ability of states, cities and other debt issuers to weather the financial fallout of the COVID-19 pandemic caused by the novel coronavirus.

Those concerns are creeping in to the $3.8 trillion market, where bond yields have whipsawed in recent weeks.

“Most of the activity is still being driven by liquidity factors, but credit quality will rise in importance the longer the social distancing policies remain in place,” said Tom Kozlik, head of municipal strategy and credit at Hilltop Securities Inc.

Large parts of the nation have shut down in an effort to stop the virus’ spread, with some states extending stay-at-home orders until the end of April. Sales, income and other taxes are expected to drop as unemployment skyrockets and consumer spending falls.

BofA said in a Friday research report it was turning “more cautious” on muni credits in the intermediate term due to growing financial pressures on issuers.

S&P Global Ratings’ outlooks on credit trends for 2020, which started out as stable for most public finance sectors, underwent a wholesale change to negative this week.

In New York, the nation’s epicenter for the virus, credit ratings for the city and state were given negative outlooks by Moody’s Investors Service, which cited expected severe revenue declines. Governor Andrew Cuomo on Thursday pegged revenue losses due to the health crisis at $10 billion in fiscal 2021, which began on April 1.

Some other states have also reduced their revenue projections for the current and next fiscal years. Michigan is eyeing a loss of $1 billion to $3 billion for fiscal 2020, which ends on Sept. 30, and $1 billion to $4 billion for fiscal 2021, according to the state treasurer’s office.

Total state taxes grew by 7.6% in February compared with the same month in 2019, according to Lucy Dadayan, senior research associate at the Urban Institute, based on reporting from 45 states. March tax collections from a handful of early reporting states show no major revenue drop so far, indicating April revenue reports may provide a fuller picture of the hit to state budgets.

Richard Ciccarone, president of Merritt Research Services, which provides data on muni credits, said investors will undertake a “sorting-out process” to gauge which issuers and areas of the country are financially at risk.

“Today’s regions that are not hurt may be tomorrow’s worst case,” he cautioned.

He added that so-called credit spreads for some issuers will widen significantly.

Spreads for bonds issued by Illinois, the lowest-rated state at a notch or two above junk due to its chronic structural budget deficit and huge unfunded pension liability, have done just that. After starting March at just 82 basis points over Municipal Market Data's benchmark triple-A yield scale, the spread for the state's 10-year bonds ended Friday at 298 basis points.

Reserve funds, management, and potentially higher pension costs due to investment losses will help determine how well governments ride out the fiscal storm.

Federal support is also a factor. The $2.3 trillion stimulus bill enacted last week earmarks $150 billion for states and local governments but only to cover expenses incurred from fighting the virus and not to replace sinking revenue.

"There may have to be another wave (of federal assistance) to deal with the recovery aspects," said Howard Cure, managing director of municipal bond research at investment banking advisory firm Evercore.

(Reporting by Karen Pierog in Chicago Editing by Ira Iosebashvili and Matthew Lewis)