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Trouble Ahead for the Municipal Bond Market in a COVID-19 Pandemic Recession?

Most investors think of bonds as safer and less volatile than stocks. That may be true for Treasury securities, but going down the line of mortgage-backed securities, corporate bonds and even municipal bonds, they can be a very different story. It turns out that municipal bonds have a lot of exposure to a bad economy.

Fitch Ratings has warned that local governments in the United States may struggle to maintain historically sound liquidity levels and that the pressure is likely to come from multiple sources. The report is not full of downgrades in the municipal bond sector, but it sure sounds like a wave of credit ratings reviews is on the way. Fitch now considers liquidity to be the most significant near-term risk for the credit quality of local governments. Most local governments are expected to maintain sufficient liquidity that would offset "significant near-term revenue declines," but some are expected to see enough strain that will trigger credit rating downgrades.

Fitch does believe that even the financially stressed issuers will do whatever they have to do to keep making full and timely debt service payments. Those efforts could include deficit financing, cash flow conservation and other measures. The report said:

> Failure to create adequate liquidity and financial buffers that protect debt repayment capacity even during a potentially protracted crisis would be inconsistent with an investment-grade rating. A missed debt service payment, even if on a temporary basis, would be treated by Fitch as a default.

While liquidity is said to be sufficient for normal operations through cyclical downturns, the uncertainty from the coronavirus pandemic, as well as the depth and duration of the total economic impact, is likely to push many local governments to look for new ways to support cash flows. Those efforts could include financial market and operational solutions: tapping credit lines, issuing tax or revenue anticipation notes, layoffs and furloughs, service reductions, delaying vendor payments, cutting equipment purchases, postponing capital spending or even payroll deferrals.

Fitch further outlined more specifics about where the weakness would be seen:

> Liquidity strains are more likely for local governments that exhibited negative financial trends prior to the outbreak, or those with lower IDRs and financial resilience assessments, reflecting more limited flexibility to address the emerging economic and revenue challenges. Local governments with a disproportionately large exposure to economically-sensitive revenues such as sales and income taxes, or economies with significant tourism and retail sector dependence, are also considered more vulnerable.

Perhaps the most stable historic item that contributes to local governments is property taxes, but these may now face uncertainty as the property markets enter disarray. Fitch warned that the coronavirus pandemic could negatively affect home prices in a way that could erode tax base values and could hamper total property taxes ahead if the fallout remains in place. Fitch indicated that local governments have not proposed delaying property tax due dates. While escrowed property tax payments inside a mortgage have helped high property tax collections, the recent and coming mortgage payment relaxations could push out property tax collections.

Fitch counted 38 of the 44 states that have personal income taxes have extended their filing or payment, out to as late as July 15, to be in line with the recent federal tax filing delay.

Another source of risk coming to the local markets is from the state aid that school districts and counties typically rely heavily. Those are at a higher risk of being cut back in fiscal year 2021. Fitch further said:

> The ability to reduce or delay local government transfers is an important financial tool for states. Fitch believes this flexibility is likely to be invoked given states' near-term revenue and liquidity stress. While the Coronavirus Aid, Relief and Economic Security (CARES) Act will distribute $150 billion in aid to state and local governments in the near term, it provides expense reimbursement rather than a pure cash flow infusion. The high IDRs in the local government sector indicates most will be able to withstand even this period of unprecedented stress; Fitch is reviewing the adequacy of each issuer's available tools as well as management's willingness to utilize them.

Investors often look for safe havens in times of turmoil. The lesson here is that not all bonds are created equal, and the risks often become much more clear in times of market turmoil and economic pain.

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