Bond Case Briefs

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Municipal Bond Perspective: Where We Go From Here.

Summary

- Given the financial strength of the sector, we believe airports have the requisite resources to weather a decline in air travel over the next several months.
- If investment markets do not recover from recent declines before fiscal year-end (mostly June 30), schools will see significant investment losses in fiscal year 2020.
- We expect that sales taxes and income taxes will experience immediate shocks as a result of social distancing and demand-side pressures.

As the COVID-19 pandemic evolved during the first quarter, the municipal bond market experienced one of its most volatile periods in years. Here, the Franklin Municipal Bond Department shares how they plan to navigate the market, which they think is likely to show signs of distress and elevated volatility for some time.

Since the second week of March, when a broad financial market selloff due to the global COVID-19 outbreak extended into the municipal market, many investors have asked for our outlook on the health of the overall muni market, as well as specific sectors and states.

In our view, the indiscriminate nature of the recent municipal market selloff has certainly created more attractive opportunities than at the start of the year. We also view recent actions by the Federal Reserve and Congress as favorable for the market.1

However, we also believe that the municipal market is still likely to show signs of distress and elevated volatility for some time. In addition, the longer the coronavirus weighs on economic activity, the more credit and default risk will come into play, albeit to varying degrees across different sectors and states.

While we would reiterate the view that it is still too early to predict the full impact of the outbreak, it is abundantly clear to us that certain sectors and states are much more likely to be negatively impacted than others. Our research analysts have been intensely reviewing municipal-market sectors and subsectors based on assessments of impact and resiliency as it relates to the coronavirus, including hospital, transportation, education, and water and sewer. A summary of these views is outlined in the following sections.

Hospitals

Hospitals continue to be on the frontline of the COVID-19 pandemic. As expected, we continue to learn of significant impacts to revenue, liquidity and volume to hospitals across the nation.

Many hospitals have already secured and drawn on lines of credit to deal with short-term liquidity pressures. Over the next 9-12 months, we anticipate widespread technical defaults, with liquidity and debt service coverage issues beginning as early as this month. We also see more widespread violations picking up around the end of June, which will trigger ratings declines for many issuers in the sector.

While we recognize that the operating environment is more likely to get worse before it eventually gets better, we currently do not anticipate monetary payment defaults given significant federal, state and Federal Emergency Management Agency support and the return of high contribution margin elective and outpatient procedures once social distancing measures are relaxed.

Water & Sewer

Bonds in the water and sewer sector are tied to essential services and are traditionally viewed as more being more defensive compared to bonds in many other revenue sectors. According to our analysis, balance sheets are strong as utilities have deleveraged since the last recession and debt service coverage levels currently provide a nice margin of safety.

In addition, our research shows the sector benefits from favorable liquidity dynamics, which have also improved since the last recession. In our view, management teams are nimble and remain well-equipped to manage through economic volatility. For example, many utilities, especially large entities, have implemented rate stabilization funds and/or developed residential assistance programs over time to alleviate rate pressure to qualified, low-income customers which should provide short-term flexibility.

Although the sector clearly ranks favorably based on our assessments, it is not without risks and there are several factors we will be monitoring closely:

- In the short term, we expect to see impacts to top-line operating revenues as commercial and industrial revenue streams are stressed and we may witness a deviation from historically strong billing and collections across the residential customer base.
- Political pressure to limit or freeze rate increases or implement short-term collection relief could pose challenges, especially areas of the country particularly hard hit by the spread of coronavirus.
- Depending on the length and severity of the current crisis, longer-term risks could include a lasting reduction in commercial and industrial accounts/revenues.
- It’s possible that we could also see an increased rate of deferred capital projects, thereby exposing utilities to larger capital outlays later on in time as assets reach, and potentially extend further beyond, their useful life.**Transportation**Recent events have obviously weighed on the transportation sector more so than others. Here, we highlight key themes we are seeing in the airport and toll road subsectors.

Airports

- The coronavirus is obviously wreaking havoc on air traffic at present, with travel restrictions eliminating most international flights and social distancing as well as shelter in place orders greatly reducing demand domestically. While this will continue to cause downward financial pressure on the airports in the near term, we believe many are well -positioned to weather a temporary downturn in air travel. Air travel prior to the coronavirus was at all-time highs and to the point where many airports were operating at capacity.
- Robust traffic trends over the last several years have allowed airports to bolster liquidity. In addition to strong cash positions, most airports also have ample reserves to draw upon if needed.
- Many of the management teams are very experienced and have been through 9/11, SARS, airline bankruptcies and the financial crisis. We expect them to curtail capital projects and cut operating costs until traffic normalizes.

Our short-term outlook for the sector is negative as the current downturn in traffic will cause financial stress to airport balance sheets, which will require many to rely on their cash positions to offset revenue losses. However, given the financial strength of the sector, we believe airports have the requisite resources to weather a decline in air travel over the next several months.

While there may be some downgrades of the weaker airports operating in more limited economies such as those that are largely tourism-based, we do not anticipate many defaults in the near term, if any.

Toll Roads

The coronavirus has had, and will continue to have, a significant impact on vehicle traffic, with most non-essential businesses closing and employees working from home as much as possible. Again, this will certainly cause downward financial pressure on the toll roads themselves in the near term, but we believe they can withstand a temporary downturn in traffic. The following are key points to consider for the sector:

- The strong national economy and low unemployment of the last several years have led to record traffic levels for most toll roads.
- Positive traffic trends combined with rate increases have resulted in excess cash flow and robust liquidity.
- In addition to excellent liquidity, toll roads typically have reserves to draw upon if needed.
- The transition to electronic tolling systems has also cut expenses, while advance refundings in this low interest-rate environment have dramatically reduced debt service expense.

For roads that are still under construction or that have major expansion projects underway, they too are likely to be affected by labor and material shortages due to the coronavirus that could cause significant delays. We would expect managed lanes, smaller roads and those less seasoned to be impacted more than larger, well-integrated systems. Yet again, public-private partnership structures typically hold very little cash (excess cash flow goes to the parent companies), so those are more likely to encounter liquidity issues. Just to reiterate, if the situation is prolonged and results in an extended recessionary environment, senior and subordinate debt structures will be of great importance in the event of bankruptcy filings.

Our short-term outlook for the broader sector is negative, but, once again, given the financial strength of many issuers in the space, we believe toll roads have the resources to withstand declines in traffic over the next several months. While there may be some downgrades of the smaller systems in more limited economies, as well as those that are largely tourism-based, we do not anticipate many defaults in the near term.

Higher Education

Education revenue bonds are issued to finance the improvement of facilities at public and private colleges. As the coronavirus has spread across the United States, most universities were very quick to act by closing campuses and fully transitioning to online classes.

Fortunately, most schools already offer online courses, and so this delivery format is not foreign. While we recognize the potential for short-term challenges, we generally believe that faculty and students will be able to adapt. Beyond this transition, several key themes stand out as we assess the impact and resiliency of the sector:

- We do not expect any schools to offer tuition refunds, as they all intend to finish teaching all classes this semester.

- Most schools have asked students to move out of the housing facilities, if possible, and many are offering to pro-rate room and board fees. Although such policies will have a negative impact on revenues, the final net effect could be less impactful as schools cut costs on food, personnel, utility and maintenance expenses.
- If investment markets do not recover from recent declines before fiscal year-end (mostly June 30), schools will see significant investment losses in fiscal year 2020. Although this technically won't have a direct impact on fiscal year 2020 operating income, we do expect balance sheet resources will decline, which would negatively affect liquidity and leverage.
- Some schools are more exposed to these risks than others, and credit research will be required to differentiate.
- For public schools, we expect that state appropriations will be pressured as states grapple with the fiscal fallout from COVID-19. Schools with a higher reliance on state appropriations will face more negative pressure. However, many schools have lessened their dependency on state appropriations since the last recession.

Against this backdrop, our main concern for the sector is fall 2020 enrollment, especially since we are in the middle of what traditionally constitutes the peak recruiting period for the fall 2020 semester. On-campus tours and in-person meetings have switched to virtual tours and online meetings. How and to what extent the coronavirus will affect the decision-making process for these prospective students is unknown at this point and something we will be monitoring very closely.

Impacts at the State Level

As a general matter, we expect the broad economic shutdown, the unprecedented loss of jobs and delayed tax filing deadlines will cause state and local governments to receive less revenue. Among other things, financial performance will depend on the economic makeup and overreliance on sensitive revenue streams that fund state and local governments. State and local government revenues often come from a mix of sales taxes, income taxes and/or property taxes, which can vary based on the level of government.

We expect that sales taxes and income taxes will experience immediate shocks as a result of social distancing and demand-side pressures. In many cases, states have delayed filing deadlines for income and, in some cases, sales taxes, which could also create cash flow issues for some borrowers. However, the combination of federal support and access to the Fed's Municipal Liquidity Facility (MLF) should help states deal with potential cash flow issues from revenue delays and/or reductions over the near term. Timing is also an important factor in that not all revenue streams will be impacted during the same fiscal year, allowing governments an opportunity to adjust budgets lower.

We have developed two proprietary multi-factor models to evaluate each state's ability to confront a crisis and address various macroeconomic challenges, whether it's driven by COVID-19, oil-market volatility or some other major economic shock. These models help us evaluate the financial preparedness of every state and identify state or local governments whose economies depend heavily on at-risk sectors like tourism, oil and gas, transportation and retail. We expect the use of reserves to be a primary tool for states over the short term. The models help us to identify those that have more flexibility than others (i.e., which states are better prepared to confront economic and financial challenges, particularly in the short term).

We assess the resiliency of state and local governments credit-by-credit, but there are some general themes to note:

- First, we are coming off a 10-year economic recovery, which has allowed most governments to rebuild reserves used in the recession.

- Second, the US government is providing $150 billion of direct stimulus to state and local governments, which should help ease the fiscal burden from COVID-19-related costs. In addition, the MLF should help to mitigate cash flow issues.
- Third, while we know revenues will decline, most governments have multiple tools to manage a situation like this. Strong leadership will be key.
- And fourth, each credit is different and revenue and economic diversity along with strong bond security will protect many.

The situation is obviously very fluid and, while it is subject to continued changes and developments, we would outline the following bull, base and bear case scenarios:

- In the bull case, we expect that most state and local governments will be able to make debt service payments. Some of the weaker governments could see ratings declines and potentially higher borrowing costs. Some of the weakest governments could tip over the edge into default/bankruptcy or require restructuring.
- In the baseline case, we still expect most state and local governments to weather the storm without much more than ratings declines. But we do think we could see more bankruptcy, default and/or restructuring activity.
- In a bear case, we expect the gap between outperformers and underperformers to widen. We expect more widespread ratings declines and increased potential for default and/or bankruptcy. Here, the challenge for governments with high fixed costs will become even more elevated. We also think that a prolonged closure could structurally change the economy, which could have longer-term effects on revenues. As an example, a permanent shift from brick-and-mortar shopping to online could hurt retail centers, a slowdown in the housing market could decrease property values, or reductions in gas taxes could result from more companies keeping employees at home to reduce costs.

In our view, some pockets of the state and local government sector will still present attractive opportunities in the bear case scenario. For example, states with strong reserves and strong leadership are more likely to balance reserve usage and spending cuts, which also improves their ability to lend support at the local level, further contributing to the economy and ultimately state taxes.

Meanwhile, there will still be weak performers in our bull case scenario. For example, credits highly concentrated in the at-risk economic sectors of tourism, oil and gas, transportation and retail will face significant challenges in any case scenario. Governments with very high fixed costs (e.g., debt, pensions, retiree health care) will have much less flexibility to effectively cut costs to match revenue declines.

We believe credit research will be critical, and no matter what scenario unfolds, we will continue to leverage our traditional analysis, qualitative insights and revenue estimates, to best position our portfolios.

Conclusion

We believe levels of municipal market volatility are likely to remain elevated over the next few months, and potentially longer. However, our seasoned team of analysts and portfolio managers have experienced difficult market periods in the past, and we are using that collective knowledge to navigate through this panic as well.

Drawing on our dedicated research team, we remain focused on issuers that we believe possess the ability to withstand prolonged declines in economic activity. We will also seek to leverage the flexibility provided across all of our municipal strategies to capitalize on the potential opportunities that market selloffs – particularly indiscriminate ones – can create.

What Are the Risks?

All investments involve risks, including possible loss of principal. All investments involve risks, including possible loss of principal. Because municipal bonds are sensitive to interest-rate movements, a municipal bond portfolio's yield and value will fluctuate with market conditions. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in an investment portfolio adjust to a rise in interest rates, the portfolio's value may decline. Investments in lower-rated bonds include higher risk of default and loss of principal. Changes in the credit rating of a bond, or in the credit rating or financial strength of a bond's issuer, insurer or guarantor, may affect the bond's value.

1 On March 27, Congress passed the $2.2 trillion Coronavirus Aid, Relief, and Economic Security (CARES) Act. Thanks to the relief bill, the Fed now has the ability to purchase corporate and municipal bonds with maturities longer than six months in the amount of $454 billion, an amount which could increase over time.

Franklin Templeton Investments

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