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UBS Sees Muni-Bond Market Facing Biggest Storm in Modern History.

- **States still seen as a haven, despite vast budget gaps**
- **But once-booming high-yield niche may see 'surge of defaults'**

To the analysts at UBS Global Wealth Management, the $3.9 trillion municipal-bond market is heading into the biggest financial storm anyone has ever seen.

The nation's swift economic collapse is hitting virtually every corner of the market, which extends far beyond states and cities with the power to raise taxes.

Nursing homes that have sold tax-exempt debt are being ravaged by the outbreak. College dormitory operators are facing vacancies, while small private schools that were already competing for students face uncertain prospects. Airlines whose lease payments back some bonds are seeing losses pile up. Stadiums and museums are empty.

Worries about the impact of the pandemic triggered a record-setting sell-off in March, and investors have continued to pull cash out of mutual funds. UBS strategists led by Thomas McLoughlin said in a report released Thursday that the firm has gotten an "unprecedented" amount of inquiries about credit conditions in recent weeks.

"COVID-19 now poses the most severe challenge to municipal credit in living memory," according to the report by strategists led by McLoughlin.

The state and local debt market, which is used by over 50,000 issuers, has a well-deserved reputation as one of the world's safest havens. Bankruptcies by local governments remained extremely rare even after the last downturn and no state has defaulted since Arkansas did after the Great Depression.

The UBS analysts said that states will remain safe bets even as they contend with massive budget shortfalls.

But the municipal junk-bond market had boomed in recent years as rock-bottom interest rates led investors to plow money into the riskiest securities to capture bigger returns.

That sector has since been roiled by the pandemic. High-yield state and local debt has dropped about 9% this year, on track for their worst yearly loss since 2008, according to Bloomberg Barclays indexes.

High-yield munis have yet to rebound as much as safer assets
UBS had warned clients about the risks of investing in high-yield before the sell-off began in March and said that such debt issued for student housing projects, shopping malls and recycling factories may not recover anytime soon.

“The unprecedented monetary and fiscal support for the economy will allow most municipal bond issuers to recover, but the high yield sector is particularly exposed,” UBS said in the report.

UBS said higher education and health-care bonds pose particularly high risks. For private colleges, the economic crisis may exacerbate long-standing concerns around enrollment declines and affordability, causing default risk to rise “appreciably,” the firm said.

“We expect the severity of the current recession to result in a surge of defaults among high-yield bonds,” they wrote. “There are simply too many bonds secured by nursing homes, continuing care retirement communities, and economic development projects to reach a more benign conclusion.”

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By Amanda Albright and Danielle Moran

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— With assistance by Martin Z Braun