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Coronavirus Surge Strains Municipal Bond Market, but Investors Still Pile In.

Despite pressure on state and local governments from lost tax revenue, investors are drawn by yield and relative safety

The recent surge in Covid-19 cases has brought more bad news for a municipal bond market already reeling from the impact of coast-to-coast shutdowns and record unemployment.

On Wednesday, the U.S. Virgin Islands Water and Power Authority narrowly avoided default. The utility got a badly needed reprieve when Chicago-based Nuveen LLC agreed to accept a \$34 million payment due Wednesday on Aug. 31 instead.

Analysts question whether the territory has enough money on hand to make the payment.

The territory isn't alone in facing pressure. Ten municipal borrowers defaulted for the first time in May and another 10 in June, the highest for those months since 2012, when borrowers were still absorbing hits from the 2008 financial crisis, according to Municipal Market Analytics data.

Many municipal borrowers are being crushed by the massive falloff in the collection of sales, income and hotel taxes, airport fees and other revenues. Even some investment-grade issuers are showing signs of serious strain in their abilities to pay future debts.

Despite the pressure on issuers, some investors are seeing opportunity rather than a reason for panic.

Even with coronavirus losses weighing heavily on the roughly \$4 trillion municipal market, investors are piling back into municipal debt, hungry for yield and seeking more safety than the stock market can provide. Many fled munis in droves when the U.S. first shut down in March, but investors seem to have overcome their initial fears and have plowed about \$11 billion back into muni mutual funds since mid-May, more than one-third of the amount withdrawn in March and early April, according to Refinitiv.

Inflows have continued even as some government and nonprofit borrowers face financial struggles. Universities, convention centers, student housing, senior living facilities and some transportation projects are confronting significant revenue disruptions, and those already in trouble could tip into insolvency. The Archdiocese of New Orleans, already facing expensive payouts for sexual-abuse claims, filed for bankruptcy in May and said in a filing June 26 that it wouldn't make a debt payment due Wednesday.

Dan Genter, chief executive of Los Angeles-based RNC Genter, said many of his clients are shifting more of their portfolios into bonds to avoid the uncertainty and volatility of stocks. But the stakes of picking which muni bonds to invest in are particularly high, he said, and the risks include more than default. A bond that is downgraded to junk can lose 25% of its market value, a concern for any investor who wants to resell it rather than wait until maturity.

"The fire alarm has sounded, and people really need to go look at their bond portfolios," Mr. Genter said.

High-yield muni funds lost \$14 billion in investments during 11 weeks of almost ceaseless outflows from the beginning of March through mid-May, according to Refinitiv.

Those risky funds are now in their sixth straight week of inflows and have added back nearly \$2 billion. The buying has pushed up prices, and the S&P Municipal Bond High Yield Index has regained 68% of its March losses.

Some high-yield borrowers including the Virgin Islands face a deteriorating financial picture, however, as tourism revenue dries up. About \$345 million worth of debt issued by the junk-rated U.S. territory sits in Nuveen mutual funds, most of them high-yield. The debt, whose interest is exempt from all state taxes, also appears in state-specific funds not listed as high-yield for Arizona, Kansas, Louisiana, Maryland, New Mexico, Virginia and Wisconsin, according to records of holdings disclosed by the firm. In the Wisconsin fund, Virgin Islands debt makes up 4% of total holdings.

A Nuveen spokeswoman said most of the debt "is secured by dedicated tax revenues backed by strong security features." The Water and Power Authority debt on which Nuveen granted the two-month extension is held in four high-yield funds, she said.

Virgin Islands Gov. Albert Bryan Jr. said last month that the pandemic had caused significant shortfalls in revenue collections, but he still expected to be able "to find ways to streamline government operations while maintaining an acceptable level of service."

The many U.S. towns that thrive on local or regional tourism are in particular distress, and nearly 90% of cities are projecting budget shortfalls, according to April surveys by the National League of Cities and the U.S. Conference of Mayors. More than a third reported they were having to make cuts to capital improvements, infrastructure maintenance and other critical public works services.

New Jersey's governor and New York City's mayor said this week they would postpone the planned resumption of indoor restaurant dining as Covid-19 cases spiked across the country. Even before those announcements, New York City was expecting to lay off or furlough as many as 22,000 employees in the fall, and New Jersey was anticipating a \$10 billion budget shortfall over the next two years.

"The one certainty forecasters can agree on at this point is that uncertainty lies ahead," said New Jersey Treasurer Elizabeth Maher Muoio. "Unfortunately, this means we must brace ourselves for more painful decisions on the road ahead."

The delay in indoor dining meant casinos scheduled to reopen in Atlantic City this week will have to do so without food or alcohol, a serious blow to the economy of the city, which narrowly avoided default in 2016. The value of taxable property in Atlantic City has been falling since the recession, and the unemployment rate already topped 8% before the pandemic in February, according to a May report by Moody's Investors Service, which rates the city's debt as speculative, or junk, grade.

"It's not a popular decision due to the fact that a lot of casinos and a lot of restaurants were looking forward to doing indoor dining this weekend," Atlantic City Mayor Marty Small said of the delay announced by Gov. Phil Murphy days before the Fourth of July holiday.

Congress hasn't approved any aid to make up for lost revenue, and cities and states are suffering massive losses in sales and income tax collection as the pandemic has driven unemployment to record levels and eroded consumer spending.

Mikhail Foux, head of municipal strategy at Barclays, said the widening spread of the virus might inspire more stimulus measures in Congress, which would help the municipal market.

“The negative might actually become a positive,” he said.

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By Heather Gillers

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