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Congress Struggles With Covid Relief. How That Will Affect Some States and Their Muni Bonds.

Six states — New Jersey, New York, Illinois, Kansas, Oklahoma, and Louisiana — have a particularly pressing need for relief from the stimulus package currently being wrangled over by Senate Republicans and due to be released for negotiation and debate with Democrats next week.

The Republicans don't appear to want to provide new money to states, but do seem willing to give them more flexibility in how they spend the aid approved under the $2.2 trillion Cares Act, passed in March. Democratic leaders in the House, however, are pushing for more aid for state and local governments.

Failure to aid state and local governments may not hurt the municipal bonds of financially troubled states, but it may damage municipalities that depend on state aid, analysts say. At the same time, investors shouldn't fight the Federal Reserve, which has been supporting states by buying bonds.

As staggering unemployment and rising Covid-19 infections continue, state and local governments are in increasingly precarious positions. The demand for public services is as high as ever, while tax revenue is falling. Unlike the federal government, most states have balanced-budget requirements that mean declines in tax revenues, if not offset by increases in federal funding, must be met by spending cuts. While states aren't able to file for bankruptcy, municipalities can resolve problems with creditors via the bankruptcy route.

"Certainly compared to 2008, we went into this situation in a much stronger position across every municipal credit," says Cynthia Clemson, co-director of municipal investments at Eaton Vance Management. "But this was a very swift and violent downturn. We'll see budget gaps average 18% of state revenue. No question, there will be a continuing need for relief."

In a statement, Gov. Larry Hogan of Maryland and Gov. Andrew Cuomo of New York urged the Senate to include a $500 billion state stabilization fund in the Covid-19 relief package, noting that the states employ more than 20 million people and that governors have already cut budgets and reduced payrolls by 1.5 million.

The Cares Act provided $150 billion for states, but the money was restricted to Covid-19 uses. Most states didn't have much in Covid-related expenses, says Dan Clifton of consultancy Strategas, and even in states with large caseloads, governors said they wouldn't use all of the money. Clifton finds that given current tax-revenue forecasts, allowing states to apply Cares Act funding for any purpose and assuming they use their rainy-day funds, six states would still be in net deficit. All face different challenges: Louisiana and Oklahoma have been hit by the oil crisis. New Jersey, New York, Illinois, and Kansas have pension challenges, with underfunded plans facing the Covid-19 double-whammy of asset-price declines and falling interest rates exacerbating funding gaps.

Each state and related municipalities have thousands of obligations, and whether investors should stay away if additional aid doesn't materialize is a complicated question. "I could find literally hundreds of credits in each of these states that we would be comfortable buying," says Lyle Fitterer, co-manager of the $1.1 billion Baird Short-Term Municipal Bond fund (ticker: BTMSX).

For example, states may have local credits that can still generate positive margins, says Fitterer.

And much depends on whether a state has the flexibility to potentially increase taxes and cut expenses, as well as the long-term economic impact of the recent shutdown. For example, while New Jersey and Illinois both have large pension issues, Illinois' state income tax is much lower than New Jersey's. That may give Illinois a little more flexibility. Meanwhile, New York City has a large commercial real-estate tax base compared to Kansas. But will the values of those properties decline if more people work from home?

"You need to do your credit work on each one, look at valuations in the market, and determine if you are getting paid enough in additional yield to own these credits in your portfolio," Fitterer says.

Tom Kozlik, head of municipal strategy and credit at Hilltop Securities, says that any aid could also penalize states for having little in their rainy-day funds as a way "to get to a number that could potentially satisfy both sides." He expects to see $500 billion or so for state and local governments, and greater flexibility for states to use Cares Act money.

The hit for bondholders will come in the form of downgrades. Right now, all states are investment grade. Illinois has the lowest rating: Recently, Fitch downgraded it to BBB-, the lowest rating that is still considered investment grade. Thus, it has the widest yield spread, with its 10-year general obligation bond fetching 266 basis points above the benchmark Thomson Reuters Municipal Market Data (MMD) AAA index, up from 155 at the start of the year, but down from 425 in May when it began narrowing. The benchmark yield is 0.73%. That gives Illinois a yield of 3.4%, compared to 4.8% for high-yield corporate bonds.

The spread for a similar New Jersey issue is 86, up from 60 in May. For New York, it's 10 basis points, up from minus five in January. Louisiana is at 38, up from 28 in January. And Kansas has spent the year at 18, while Oklahoma started the year at 20 and is now at 19, according to Hilltop Securities.

These risk levels would have been high even before Covid-19, Kozlik says. Still, states have many levers to pull. For example, they can cut aid to municipalities, which can declare bankruptcy with a state's permission. In the past, observes Adam Stern of Breckinridge Capital Advisors, which specializes in fixed income, the governor of Illinois openly advocated for bankruptcy of Chicago public schools, and the governor of New Jersey threatened to put Atlantic City in Chapter 9 proceedings. Says Randall Gerardes, head of municipal strategy at Wells Fargo Securities: "States will take care of their house first, and are in a better position than local governments," at least from an investor point of view.

If you're worried about the outlook for bonds, don't forget that the Fed has provided support for the muni market. Illinois was able to issue short-term bonds directly to the Fed this year.

Even if more aid doesn't materialize, Clifton of Strategas tells investors to watch the election. "If the Democrats sweep, I'd expect there to be more aid."

Ultimately, much depends on the availability of a Covid vaccine: "If you get to 2022 with no vaccine, the willingness to keep the game going for a large number of issuers will start to deteriorate," says Stern of Breckinridge. Still, most people are expecting a vaccine next year. That should keep the markets liquid and reduce financial system risks, even if the economy does take a second dip.

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