
Municipal Bonds Aren't Out of Peril.

The initial Covid-19 shock has faded, but assuming that things are back to normal in the $4 trillion municipal bond market would be a mistake.

Investors in staid municipal bonds got a shock when the U.S. went into lockdown in March: Yields on some of the highest-quality issues ballooned to more than three times that of Treasurys of similar maturity. They usually are somewhat lower than those of Treasurys due to their tax advantages.

The dislocation didn't last long, but assuming that things are back to normal in the $4 trillion market would be a mistake. There were two reasons for the big divergence: Investors rushed to own Uncle Sam's liabilities—the safest, most-liquid securities in the world—to the exclusion of nearly everything else. But they also fretted that the collapse in commerce, travel and employment would crush state and local revenue.

"We have no money," said New York Governor Andrew Cuomo in a March radio interview at the height of this spring's emergency.

New York's situation now looks less dire, but the damage to it and other issuers is substantial. State tax collections nationwide were 6.4% lower between March and August against expected growth of 2% to 3%, according to the Center on Budget and Policy Priorities. Cities were even worse off with an average 21% revenue drop since the pandemic began, according to a survey released this month by the National League of Cities. Meanwhile, the pandemic brought unexpected expenses.

The degree to which state and local coffers were hurt depended largely on how they raise money. Jurisdictions that rely largely on income taxes took a hit and those relying on tourist spending did even worse. Cities that fund themselves mostly on property taxes could be in fairly good shape as long as they aren't dependent on struggling malls and office buildings.

Yet most municipal bonds don't rely directly upon the general taxing authority of state or local governments. About two thirds are revenue bonds backed by some other stream of income. Investors should take little solace in the fact that downgrades have been muted so far. They also didn't spike during the global financial crisis, instead peaking in 2012.

This recession is different, hitting certain parts of the economy hard. Municipal bonds backed by airports, hospitals, toll roads, universities, nursing homes or stadiums could be in particular trouble. Normally these are desirable issuers because they are paid with the asset's revenue or from special taxes. Even a city or state's bankruptcy might not affect them.

Some bonds in this category were surprise winners. For example, those backed by payments from tobacco sales have had a great year, outperforming even Treasurys, as people smoked more than expected. An index of tobacco-backed bonds maintained by S&P Dow Jones Indices had risen by 15.3% over the past year through Dec. 18 while two backed by higher education and transportation both were up by just 4.7%.

Investors need to look past the ledgers of individual issuers and ask what the broader impact of financial strain might be. For example, New York's Metropolitan Transportation Authority, America's largest public transit system, can't legally declare bankruptcy, but it faces daunting shortfalls. Half of its revenue in 2019 came from fares and tolls, which could take years to recover. If train and subway service have to be cut back, as threatened, that would harm New York's attractiveness to commuters and tourists, with all the tax revenue they bring. Although the MTA does stand to receive some stimulus aid to delay service cuts, the city and state, along with the MTA, have been downgraded recently.

New York City is still far from its predicament in 1975 when it was hours away from defaulting after a failed appeal to Washington that sparked the famous headline "Ford to City: Drop Dead." The Federal Reserve has helped push bond yields, most munis included, to near record-lows, and has bought bonds outright through the Municipal Lending Facility. Even so, a lack of direct federal assistance to struggling cities and states in the latest stimulus package, as well as a pandemic and remote-work fueled exodus to suburbs and low-tax states, could lead to service cuts and fiscal strains for already shaky borrowers in a vicious cycle.

One saving grace has been the boom in stock prices since March. That, along with low bond yields, helps to buoy the value of trillions of dollars in public pension funds and to fuel individual capital gains taxes. But even a continuing bull market won't be enough to bail out the most at-risk retirement systems. Those in Illinois, Kentucky, Connecticut and New Jersey are less than half funded according to the Pew Charitable Trusts.

The pandemic's initial effect on the muni market might be scattered defaults in categories obviously strained by its initial effect such as hospitals, but states' cash flow problems today could hasten the market's real doomsday scenario—a state being forced to choose between shortchanging bondholders or retirees.

Much like its human pathology, Covid-19's symptoms faded quickly for most in the muni market but could continue to haunt those with weakened systems.

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