Muni Risks Papered Over by Federal Aid Threaten to Reappear.

- **'Some of this sunshine is artificial,' investor Venditti says**
- **Money managers' dilemma is that cash keeps pouring in**

The influx of federal aid to U.S. municipal-bond issuers has papered over longstanding credit risks that threaten to come back to bite investors when the relief runs dry.

States, local governments and other borrowers are receiving $350 billion through the American Rescue Plan, a short-term infusion meant to cover revenue lost to the pandemic or offset its economic toll. The aid, combined with a rebound in tax revenue, has boosted confidence across the municipal market and helped some lower-rated credits reach lofty valuations.

Some investors say parts of the market — from states and cities with chronic fiscal strains to small private colleges grappling with affordability and demographic pressures — still face abundant challenges. The risk, the money managers say, is that fiscal headwinds such as underfunded pensions and budget deficits will resurface and weigh on portfolios after the aid is spent.

The federal funds "stabilized every balance sheet of every municipality everywhere, but eventually the money will bleed out," said Nicholos Venditti, a senior portfolio manager at Wells Fargo Asset Management Corp. "I'm largely bullish on munis, but I don't think investors should ignore that some of this sunshine is artificial."

Wall Street strategists are already talking about the rally in munis running out of gas. The bonds have offered an oasis in 2021, at a time when most parts of fixed income have delivered losses. The outperformance is due in part to a push by the Biden administration to hike taxes on the wealthy, bolstering demand for tax-exempt funds that have been luring heaps of cash.

The dilemma for asset managers is that they have to put the money to work in the face of ever-rising prices on even the riskiest debt. There's been a big reward to trading down in credit quality. Junk and non-rated munis have earned 7.1% this year, compared with 1.7% for the broad muni market, Bloomberg Barclays index data show. Treasuries have lost 2.3%.

'So Expensive'

Investors have to decide how much more spreads can narrow, Venditti said. When the aid runs out, bonds sold by the more challenged issuers will likely trade back to values more consistent with their underlying risk, producing losses, he said.

"You don't need a default to have a bad day as a muni investor," he said. "Just because they're going to survive doesn't mean you want to buy them today, because they're just so expensive."

Case in point: At one point this month, yields on 10-year Illinois general-obligation bonds were barely 50 basis points above those on top-rated debt, the lowest gap in Bloomberg data going back to 2013 and almost 400 basis points narrower than in May 2020.

The state, among those logging better-than-expected revenue collections, has been allocated $8.1 billion of aid from the federal rescue plan. It had its credit rating upgraded by Moody's Investors Service and S&P Global Ratings in recent weeks, bringing it back from the brink of junk. Yet it's still the lowest-rated state, its pensions are only roughly 40% funded and it's bleeding residents.

Not Buying

Eve Lando, a portfolio manager at Thornburg Investment Management, said she's not buying Illinois bonds at current levels.

"They have been helped definitely by the stimulus, but I feel like people overbuy there thinking that it can only go up," she said. "I don't think it reflects the correct state of affairs."

Lando said that when she and her team evaluate bonds, they "discount" the stimulus aid a borrower may have gotten, to make sure the credit can stand on its own.

Chicago is another issuer that has seen yields decline in the face of fiscal woes. Citigroup Inc. analysts say that while they've historically been bullish on the city, they've recently turned more hesitant because of its unfunded pension liability and a limited ability to raise revenue given its already-high combined state and local sales-tax rate.

"Now, we run the risk of becoming bearish on Chicago" despite the federal aid package, the group led by Vikram Rai wrote in a mid-year outlook report late last month. The junk-rated city received $1.9 billion in relief funds. "It is a legislative success story in the near-term, but structural issues are yet to be tackled."

'Priced to Perfection'

For Craig Brothers, a portfolio manager at Bel Air Investment Advisors, the relief funds afford a reprieve, but the structural challenges some governments face are evident. He said he's avoiding reaching down in credit quality, a view that Mellon Investments Corp. is taking as well.

"Everything is just really priced to perfection," Brothers said.

The stimulus has had a "tremendous" impact on the municipal market, said Susan Courtney, head of the municipal-bond team at PGIM Fixed Income. "But with certain credits that had specific challenges pre-pandemic, those still exist. They don't just go away."

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