

# **Bond Case Briefs**

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## **UBS: Muni Credit Quality is Resilient Amid Uncertainty**

**Municipal bonds have had a rough start to the year in the wake of rising inflation and geopolitical tensions. While market returns have been unfavorable year to date, the fundamental credit quality of key sectors such as states, local governments, transportation agencies and utilities remains robust and overall credit downgrade and default risks remain low.**

If history is any guide, investors should note that the high inflation periods of the late 70s and early 80s saw very few defaults even as the value of municipal bonds declined significantly during that period.

Municipal credit quality has improved from the pandemic-induced disruption in 2020. Rating upgrades outpaced downgrades in 2021 in the wake of federal financial assistance, which stabilized the balance sheets of many municipal obligors.

Although, rating changes are usually a lagging indicator, we expect overall credit quality to remain stable in 2022 despite market headwinds and a tapering off of federal fiscal support. Municipal finances are generally better insulated from global events than other asset classes and most municipal issuers entered this period of high volatility with substantial financial strength. Moreover, the US economy's oil intensity is much lower than it used to be in the 70s and 80s. State and local tax revenues remain robust coming out of the pandemic.

Stellar investment returns in 2021 bolstered underfunded state and local pension plans, although some of that benefit has been clawed back by recent market declines. High essentiality sectors with rate autonomy, such as water sewer and electric utilities, have strong pricing power to combat inflationary pressures. Toll roads have historically demonstrated strong ability and willingness to adjust toll rates in line with inflation. However, some sectors such as not-for-profit hospitals and private colleges will continue to experience margin pressures in 2022, especially smaller issuers with low pricing power. However, there may be some buying opportunities in high quality healthcare issuers.

While high inflation in the near term will have limited credit impact, prolonged and unrestrained inflation over the longer term (which we don't expect), would indeed pressure municipal credit quality. In our view, strong credit fundamentals support good entry points for long-term buy and hold investors currently, as outlined in our blog [Municipal market performance update](#).

**by UBS Editorial Team**

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