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Muni Bond Update: Credit Quality Still Looks Strong

While 2023 has started on shaky ground for the municipal bond market, there are reasons to be optimistic for more stability ahead, according to Jennifer Johnston, Franklin Templeton Fixed Income's Director of Municipal Bond Research. She explains why California's issues don't reflect all states, and offers reasons for optimism.

As we reflect on the disappointing performance of municipal bonds in 2022 and even so far in 2023, the fundamentals really have not been a driving force. In fact, in many cases we have actually seen a peak in terms of muni bond credit quality, and many municipalities are actually stronger today than they were prior to COVID-19. Hopefully, state and local governments have prepared themselves for the next rainy day.

Coming into 2023, municipal bond fundamentals were strong as most state and local issuers utilized COVID-19 relief funds to address pandemic costs and economic challenges so they shore up rainy day funds and position themselves for a potential economic slowdown. States in particular entered the year with very strong balance sheets that surpassed levels seen before the pandemic.

California an outlier, not an example
Following a huge surplus in the prior fiscal year, California now projects a large projected deficit in California for fiscal 2024. California's budget deficit has gotten a lot of media attention given the state's sheer size. But the deficit was not a surprise to us as we have been monitoring the state monthly and we think it's an outlier for a few reasons. However, we feel this volatility is not a trend we see nationwide. California is highly reliant on income taxes as a main revenue source. California's income tax structure is very progressive and as a result it has a high reliance on capital gains taxes, which were muted during last year's overall market downturn. We still feel California can utilize its reserve funds (which are the highest in its history) and other budget measures to preserve its fiscal strength over this coming year. We think California can weather this year's challenges.

In contrast, most other states are reporting higher-than-expected income and sales tax receipts. Illinois, for example, is a stronger credit than before the pandemic. The state is projecting an additional US$1.2 billion in revenue since the last projection in November. The state has utilized its surpluses smartly and has prepaid pension expenses and debt. It really has seen a turnaround.

The impact of inflation
Inflation not only hits consumers, it hits governments too. Wage inflation has created challenges, but it also increases income taxes, so that can actually have a positive impact for states. Sales taxes also increase as the price of goods increase, and we've seen good performance in sales taxes. To combat inflation, interest rates are rising, however, so the cost of borrowing for governments is going up.

The good news is that rainy day funds are near all-time highs as states used federal support funds to pay down debt and reduce expenses. So in sum, higher inflation, wage increases, and additional borrowing costs are having a negative impact on budgets, but these are being partially offset with higher tax revenue from additional economic activity.

by Jennifer Johnston of Franklin Templeton Investments, 3/8/23