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Muni Defaults: Just One in 2022

Resilient and liquid: Moody's annual report offers an overall picture of strength and stability for munis. We explore the key findings.

Toward the end of July, Moody's Investors Service released its annual municipal bond market snapshot, US municipal bond defaults and recoveries, 1970-2022, with updates through 2022. In addition to noting that the muni sector remained resilient and strongly liquid in 2022, the report continued to affirm two hallmark benefits muni bonds offer. First, defaults and bankruptcies remain rare overall: just one in 2022. Second, municipal credits continue to be highly rated compared to corporates, and, indeed, in 2022, in general, the sector saw ratings continue to "drift up," and global corporates' ratings drift down. And according to Moody's: "The five-year average defaulter position was 97% for municipals and 84% for global corporates."

An important observation, noted, once again, in this year's report, was that over the 53-year study period: "Any one default may only reflect the idiosyncrasies of that individual credit, and may not represent a general sector trend."

Continuing a theme noted in the previous year's report, in relation to the effects of the pandemic, Moody's observed that, in addition to "lingering effects with downstream credit consequences including escalating inflation" and the acceleration of remote learning and work, there are not only "potential longer-term effects for K-12, higher education and the mass transit sector…", but also changes "in municipal revenue structures from shifts in commercial real estate or other consumer preferences." An eye should be kept on all of these in the context of the municipal bond market.

Muni Bond Defaults Remain Rare

The report illustrated the fundamental difference between municipal and corporate credits and drew attention to the sector's "infrequent rated defaults" and its "extraordinary stability."

While the average five-year municipal default rate since 2013 has been 0.08%, this figure also matches that for the entire 53-year study period from 1970 to 2022. In contrast, the comparable figures for global corporates were 7.8% since 2013 and 6.9% since 1970, respectively.

Puerto Rico remains " … a reminder of the power of credit fundamentals, such as leverage, operational balance, and economic capacity, over ostensible security features written on paper. While legal security will influence recovery, credit fundamentals drive defaults."

This year's report once again notes that " … we have yet to see a rated default due to natural disasters." And that, although the small town of Paradise in California was nearly destroyed, it has continued to make its bond payments.

Continuing Stability for Muni Bonds

In 2022, in addition to rating upgrades outnumbering rating downgrades, there was less rating volatility and were fewer rating changes than in prior years. And, when compared to that of global corporate bonds, rating volatility has been “significantly lower.” (The stability and strength of the municipal sector’s credit quality in the last 10 years has benefited from “ … accelerated economic recovery and growth across many parts of the US over the two years leading into 2020” and after that from a combination of federal stimulus support and an influx of liquidity.)

According to the report, municipal credits remain, typically, very strong, and “their rating distribution is substantially skewed toward the investment-grade, where ratings tend to be more stable.”

The report added that the municipal sector overall remained highly rated, with approximately 91% of all Moody’s-rated municipal credits falling into the A category or higher as of the end of 2022, the same as in both 2020 and 2021. Further, at the end of 2022 (as in 2021 and 2020), the median rating for U.S. municipal credits remained at Aa3. This continued to stand in stark contrast to the median rating for global corporates, which was, once again, at Baa3 (2021: Baa3).

Muni Bond Market Exhibits Soundness and Resilience

As we mentioned last year, while we continue to argue that municipal bonds still offer a fiscally sound vehicle for generating an income stream free from federal and some state taxes, it remains challenging to obtain the same level of timely disclosure from issuers as one sees in other asset classes. Despite this, the muni market’s behavior not only during the COVID crisis in 2020 and 2021 but also after that is prima facie evidence of both its (and muni bonds’) solidity and resilience.

According to Moody’s report, there were only 115 distinct Moody’s-rated defaults, representing a little over $72 billion, across the whole universe of more than 50,000 different state, local, and other issuing authorities between 1970 and 2022.

As Moody’s states, while the U.S. public finance sector remains remarkably stable and experiences infrequent rated defaults, there remain caveats, especially as a result of how it has evolved. In the first instance: “There is a growing evidence that legal security, while important in recovery, is a weak shield against default when credit fundamentals are poor.”

In the second, as noted last year, the challenges associated with demographic shifts (aging and relocating populations—affecting tax receipts), substantial increases in pension and retirement healthcare leverage, and “the associated heightened exposures to equity markets.”

Finally, it is important to note that, with reference to both this study and Moody’s ratings in general, its rated universe is, actually, exceeded by that of the U.S. municipal debt market: the company estimates it covers around a third of municipal bond issuers, “but a substantially larger proportion of outstanding debt.”

Looking at the rated and unrated market together, Moody’s noted that: “Disclosures reveal that much of the risk in the US municipal debt market after Puerto Rico’s defaults lurks in two sectors: senior living and local government special districts. These two sectors represented nearly 60% of the 191 missed payments we observed in 2022, with Puerto Rico representing much of the remainder.” Going forward, therefore, it will be interesting to monitor both these sectors.

Despite this, we still believe that municipal bonds remain important to the core strategy of constructing an individual portfolio.

VANECK

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