Bond Case Briefs

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Municipal Bonds Face New Challenges from Iran War, FEMA Changes.

Municipal credit quality continues to be resilient. S&P reports that upgrades exceeded downgrades in most sectors in 2025, elevating average municipal ratings. Smith's Research, which combines three rating agency actions, shows similar positive-weighted activity. However, the first quarter of 2026 saw a reversal, with downgrades exceeding upgrades by S&P. It makes sense that the ratio of upgrades to downgrades is narrowing or reversing after several years, with positive ratings actions exceeding negative actions. We have wondered for years when the credit outlook might change, since it has been strong for so long, even with challenges.

Munis have an average rating of AA, reflecting strong economies, improved budgeting tools, and financial cushions to help manage challenges that may lie ahead. Challenges include the ending of pandemic stimulus (some aid still flowed in 2026) that helped many municipalities over the hump of Covid-19 restrictions, changes to federal funding such as FEMA and Medicaid that need to be managed, as well as effects of the Iran war such as increasing oil prices and inflation and cyber risks.

Munis should prevail and usually do. The default rate is practically nonexistent for safe-sector, highly rated bonds. The default rate is extremely low and concentrated on non-rated or lower-rated bonds. The average five-year cumulative default rate from 2015 through 2024 for investment-grade munis was a very low 0.04%, according to Moody's, which is multiples lower than the 0.85% for investment-grade corporates. States have oversight and monitor local governments, which can act as an early-warning system to identify problems and trigger actions to provide aid in management or finances. Fortunately, states have many revenue sources, the ability to adjust expenses and revenue, and healthy reserve positions.

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