Municipal Market:
Why a Quality Bias Still Makes Sense

Baird Funds

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In periods of economic distress, municipal bond investors are no different than other investors. They quickly become very risk adverse. As long-time investors, we realize that people invest in municipal bonds for safety, stability and tax-free income. The stability was rocked recently by the economic concerns from the COVID-19-induced shutdown, and the safety of municipal debt has come into question. The media has focused their attention on the potential increase in municipal defaults/bankruptcies. What is needed now is some balance and perspective.

Default Bells are Ringing

As is the case in all economic downturns, "bells" have started to ring warning investors that municipal bond defaults are going to increase. And we agree. A declining economy generally leads to lower revenues for municipalities, just as it does for many corporations as sales fall. Individual income levels also decline as the unemployment rate rises. However, higher-quality bonds – those rated AAA, AA, and A – tend to default less frequently than BBB rated bonds, which in turn default less frequently than bonds rated below investment grade (BB+ and lower as well as non-rated bonds), as the chart below illustrates.

Ten Year Cumulative Default Rate (%):

Municipals	Moody's	S&P	Fitch	Average
AAA	0.0%	0.0%	0.0%	**0.0%**
AA	0.0%	0.0%	0.0%	**0.0%**
A	0.1%	0.1%	0.1%	**0.1%**
BBB	1.1%	0.8%	0.8%	**0.9%**
BB	3.7%	4.7%	5.6%	**4.7%**
B	17.9%	10.9%	1.9%	**10.2%**
CCC-C	25.8%	40.5%	15.4%	**27.2%**
Investment Grade	0.1%	0.2%	0.1%	**0.1%**
Speculative Grade	7.5%	9.0%	5.9%	**7.5%**
All Rated	0.2%	0.3%	0.2%	**0.2%**

Source: Moody's, S&P, Fitch, JP Morgan. As of latest (2017) default study

Is this economic downturn different than a "typical" recession? Yes, but in five years we expect to be able to look back on this period and see that most of the bonds that did default were by lower-rated or non-rated issuers.

The most recent "bell" that sounded was due to the comment from Senate Majority Leader Mitch McConnell. Responding to a question in a radio interview, Senator McConnell said he would be in favor of allowing states to declare bankruptcy. In the following days, state governors and legislators as well as congressmen from around the country, both Republican and Democrat, spoke out against the idea. Our view is that his comment was political pushback to a State of Illinois' request for funds to shore up its poorly funded pension plan. McConnell wanted more time to analyze what assistance municipalities need versus simply acquiescing to other "kitchen sink" requests.

Federal Support Initiated – Much Already and More to Come

The Federal Government has provided several programs to support municipal issuers:

$2.2 Trillion CARES Act:

- $150 Billion to State and Local governments for COVID-19 costs
- $100 Billion to hospitals
- $30 Billion to primary and secondary education
- $25 Billion to mass-transit systems across the US
- $10 Billion to airports

Municipal Liquidity Facility: $500 Billion to provide market access

"Phase 3.5" Stimulus package of $484 Billion:

- Additional $75 Billion to hospitals

In addition, the stimulus packages will send money directly to individuals and provide loans/grants to businesses. As this money gets spent, it will gradually revive the economy and indirectly provide tax revenue to many municipalities.

We believe there will be continued pressure for the Federal Government to pass another stimulus bill that focuses directly on State and Local support. The National Governors Association has outlined the need for $500 Billion of additional and immediate fiscal assistance to States/Territories and a coalition of the National Association of Counties, National League of Cities and US Conference of Mayors have called for $250 Billion assistance package for Local governments. While it may take a few weeks for Congress to debate the details of such a package (and it will NOT include a bailout of state pension plans), ultimately we think the Federal government will provide further support to offset the large decline in state/local revenues associated with the COVID-19 forced shutdowns.

Starting from a Position of Strength

Coming into this economic shutdown, states had built up approximately $75 billion of rainy-day reserves, or about 7.7% of yearly spending, well above the 4.8% levels coming into the great recession. While this will help weather the downturn, there are many other aspects of the municipal bond market that contribute to its historic track record of incredibly low default rates. The average credit rating of the Bloomberg Barclays Municipal Bond Index is AA. In periods of distress, even if these credits are downgraded, they maintain investment-grade ratings which allows continued market access. State/local governments are required by law to pass a balanced budget and while some may use financial games to skirt the edges of this requirement (e.g. skipping pension fund payments), most abide by these rules. The debt they issue tends to require relatively level payments over the life of the bonds versus a typical balloon principal payment often seen in the corporate marketplace. This reduces refinancing risk for municipalities. For many lower-quality municipal issuers, a debt service reserve (DSR) fund sets aside enough money at the time of issuance to cover principal and interest payments for one year. This DSR can be drawn from during periods of economic distress to continue to make debt payments while allowing revenues to rebound as the economy recovers. Municipalities issue debt for essential services (water & sewer, education, healthcare, transportation, etc.) that tend to provide stable sources of revenue, even in an economic downturn. They are also required by bond covenants to charge users a fee which provides enough revenue to pay principal and interest as it comes due. Finally, a large source of revenue for many municipalities is property tax revenue, which tends to provide more stability throughout an economic cycle.

Newsflash – Riskier Bonds will have Higher Default Rates
Long-term default statistics show that certain riskier sectors within the municipal bond market tend to have higher expected default rates. For example, project finance (borrowing for a single-site project), land-development, senior care retirement facilities, and charter schools are just a few of those riskier sectors. Many of the bonds within these sectors are either rated below investment grade or non-rated and most are held by high yield municipal funds. A recent Barron's article (April 25/26), mentioned three municipal bonds that have defaulted in the last two weeks. All three were non-rated, one was a skilled-nursing facility, a second was for a tire-recycling plant and the third a single-site YMCA. The rating agencies have also recently downgraded or put on negative watch Illinois and New Jersey General Obligation bonds, both states with well-known and poorly funded pension issues. To quote Matt Fabian at MMA-research, "The more speculative areas of the municipal market, which have accounted for 94% of all payment defaults in the last decade, should see the large majority of permanent defaults over the next year."

Defensively Playing Offense
Now is not the time to get aggressive as it relates to municipal debt. Both the tenure of COVID-19 and the pace of economic recovery remain uncertain. Even strong municipal credits will be faced with tough budgeting choices over at least the next several months until the federally provided support is able to work through the funding channels. In the meantime, we expect municipal defaults in riskier sectors and lower-quality issues to rise. Yet, for every high yield municipal bond that defaults there will be thousands of higher-quality bonds that will continue to make timely principal and interest payments. We continue to believe that maintaining a high overall credit quality across our portfolios is the most prudent approach. Until the outlook is more certain or investors can get "paid" enough in additional yield to compensate for the higher levels of risk, it pays to stay up in quality. On a tax-adjusted basis, valuations for many higher-quality municipal bonds have seldomly looked more attractive.

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The quality breakdown (market value basis) for the Bloomberg Barclays Municipal Bond Index is as follows: Aaa: 15.6%; Aa: 51.9%; A: 24.1; Baa: 8.4; Below Baa: 0.0%.

Fixed income is generally considered to be a more conservative investment than stocks, but bonds and other fixed income investments still carry a variety of risk such as interest rate risk, regulatory risk, reinvestment risk, credit risk, inflation risk, call risk, default risk, political risk, tax policy risk and liquidity risk. In a rising interest rate environment, the value of fixed-income securities generally decline and conversely, in a falling interest rate environment, the value of fixed income securities generally increase. Municipal securities investments are not appropriate for all investors, especially those taxed at lower rates.
Ratings are measured on a scale that ranges from AAA or Aaa (highest) to D or C (lowest). Investment grade investments are those rated from highest down to BBB- or Baa3.

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