Resiliency Through Uncertainty: Staying with Municipals

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The dual objectives of most municipal investors are safety of principal with a commensurate level of tax-free income. Yet, achieving these has never been more challenging than in the current environment. The economic shutdown in response to Covid-19 negatively impacted tax revenues and the Fed's zero-rate policy has made obtaining even a modest level of income more difficult. With interest rates low and credit uncertainty high, what is an investor to do?

Low rates, but investing is all relative

The current level of rates is certainly uncharted territory for U.S. investors. Never have market rates been this low and provided so little income. Both Treasury bonds and higher-quality municipal bonds currently offer less than 1% yields out to 10 years. Yet, while we can hope for higher rates, Fed Chair Jay Powell has stated – "**We're not thinking about raising rates, we're not even thinking about thinking about raising rates."** His other recent announcement at the Jackson Hole Economic Symposium confirming that the Fed is shifting to an "average" inflation rate of 2% further suggests a zero-rate policy is likely here for quite a long time. Unfortunately, sitting in cash offers very little return for investors; even with low rates, investors are incentivized to extend along the curve and accept a modest amount of interest rate risk. They will, in addition, also benefit from the curve roll-down opportunities.

For taxpaying investors looking at the short to intermediate segment of the curve, tax-free municipals remain an attractive option relative to other fixed income choices. Not only are tax-free yields higher than comparable maturity (taxable) Treasuries at virtually every point along the yield curve, even before grossing up yields for an appropriate income tax rate, they also compare favorably to similarly rated taxable corporate yields. Federal tax rates are likely to rise over time regardless of the outcome of the November election, given the already large and growing budget deficit, which enhances the value of municipals. Another important benefit of municipals is typically less volatility in a rising rate environment.

Municipal credit – downgraded from Very Strong to Strong

There is no doubt that the credit quality of municipalities has been negatively impacted by Covid-19, but the data can be misleading, if not overstated. According to a study by the Urban Institute's State and Local Finance Initiatives, state revenues fell on average 29% YoY in the three-month period from March-May across all 50 states. Yet, the divergence among states was significant. Oregon and California, for example, were hardest hit. Their state tax revenues fell 53% and 42%, respectively, during this period. In North Dakota and South Dakota, on the other hand, revenues *rose* by 8% and 1%, respectively, YoY.

Importantly, the revenue data over this period does not reflect the fact that the tax filing deadline was extended to July 15th from April 15th. So, the March – May period referenced, when most of the country was in lockdown, excludes April tax payments that were made in July. Adjusting for that, California's total tax revenues through July were down just $4B from their pre-pandemic high in February, or just 2% of the state's total annual budget. California also had $20B in reserves coming into the pandemic. In another example, Georgia was estimating a decline in state revenues of $1.0 - $1.5B in Q2. Instead, actual revenues were off just $260 million and the state still had the $2.8B in reserves they held at year end 2019.

None of this is meant to imply that the challenges state and local governments face are not real or insignificant. They are, and many municipalities will have to make meaningful budget adjustments to work through this period. If there was ever a time to be careful in your security selection, to sort through the likely winners and losers across the credit spectrum, it is now. But more current data suggests that the negative revenue impact has been less than expected. In our view, municipal credit has taken a step down, broadly speaking, due to the Covid-19 challenges, but only to "strong" from "very strong" prior to the pandemic.

Municipalities also have many financial levers at their disposal that they can pull to help them get through period of fiscal stress and uncertainty.

Municipal Levers:

Draw on Reserves – Most municipalities set aside reserves during the record long economic expansion that ended in February. According to the National Association of State Budget Officers, total reserves among states were 8% of expenses at the end of 2019, nearly double the level prior to the 2008-09 Great Recession. While the reserves alone may not be sufficient to completely offset lost revenues, they do help cushion the revenue decline and allow time for revenues to improve.

Cut and/or delay expenses – More public sector employees have already been laid off or furloughed during the pandemic than occurred during the Great Recession. Labor savings are often more difficult in the public sector than in private enterprise, but some flexibility exists. Many municipalities have already implemented (or plan to implement) across the board budget cuts of 5 – 15%.

Borrow and/or refinance debt – Level debt service spread out over 30 years is the typical debt structure for municipalities, so refinancing risks during difficult economic times is less of a concern. And debt service costs generally represent a relatively small portion of total expenses, perhaps ranging between 2 – 20%. The public markets are open and readily absorbing new debt for issuers who need to borrow to boost liquidity, and the Fed's Municipal Liquidity Facility (MLF) serves as a backstop for the largest municipalities. To date, just the State of IL and the Metropolitan Transit Authority of NY have borrowed a total of $2B, out of a total lending capacity of $500B.

Postpone capital/infrastructure spending – While the infrastructure needs in the U.S. are massive and well-known, municipalities can delay or reduce capital spending as needed.

Defer/reduce pension contributions – Unfortunately, this has too often been used by policymakers during periods of financial stress, but if used appropriately and catch-up payments are ultimately made, it does provide flexibility for municipalities.

Raise taxes/fees – Tax or fee hikes are never easy or welcome but are occasionally necessary to help bridge revenue shortfalls. They are typically easier with Revenue bond sectors where voter approval is not required, unlike General Obligation debt, where it is.

Federal support/aid – When a natural disaster occurs, the federal government has historically stepped in, especially since the creation of FEMA in 1979. Covid-19's impact has been compared to a natural disaster just on a much broader scale. Similarly, the unprecedented size of the $2.2 trillion CARES Act provided fiscal support for municipalities, including direct aid to state and local governments, as well as funds for hospitals, schools, airports, transit authorities, and more. More federal aid is likely although the size and time remain uncertain.

Stay the course

Different investors will understandably choose different paths in response to the challenge of low rates and high credit uncertainty. Some may want to fight the trend by taking on more risk, extending duration and/or lowering credit quality, even going into below investment grade credits, to achieve a target level of income or return. For these risk-seekers, if interest rates and/or default rates rise, then the volatility in their portfolio and risk of actual principal loss may exceed their expectations, leading to unwanted pain and disappointment. Others may have a flight-to-safety response, retreating to the perceived comfort of cash. Unfortunately, while the cash option may allow the investor to sleep better by eliminating portfolio volatility, they will very likely earn almost nothing for quite some time, and even a negative return once adjusted for inflation. Either choice may be rational if aligned with the risk tolerance of the investor, yet actual risk may be higher than perceived risk for each option.

We think the better choice for most investors is simply to stay the course if already invested in the municipal market, but to make sure you are within your target risk parameters. If not currently invested in municipals, then moving out from cash or even taking some winnings from a rising equity portfolio may also be prudent moves. Investing in a liquid, higher-quality fund or portfolio of securities focused on the short-to-intermediate segment of the curve remains, in our view, a prudent way to optimize risk and return. Safety and income can still be achieved for investors today with hopes that rates will one day rise, enhancing portfolio returns. Until then, the resiliency of the municipal market will prevail once again through this period of uncertainty.