COVID-19 Leaves Munis Bowed But Not Broken

By Greg Ortman, Aditi Gupta, CFA®, and Neil Amirtha
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Declines in employment, output, and consumption caused by the coronavirus pandemic and subsequent economic shutdown have left many states and municipalities struggling with funding just as they face higher spending needs. Nonetheless, the rarity of municipal bankruptcies and defaults—considered alongside the federal support pledged to date and possible in the future—suggests there’s room for optimism in the municipal bond outlook.

REVENUE IMPACT ON STATE AND LOCAL GOVERNMENTS

State government revenues, derived in large part from sales and income tax, have dropped considerably since the pandemic began. Across all state and local governments, total revenue shortfalls for fiscal year 2020 could top $141 billion (see figure 1). Looking ahead to 2021, estimates range from $171 billion to $350 billion.

Many states have sought to lessen the overall impact of lost revenues with the use of budget stabilization funds, also known as rainy-day funds, which entered the pandemic at historically high levels. However, some states may exhaust their rainy-day funds entirely. On the other hand, state and local governments have the flexibility to raise revenues and cut expenses to offset these challenges. Many issuers also have had access to support from the Federal Reserve and from Congress.

Although the economic crisis of 2020 was unprecedented, it’s important to note that, historically, municipal bankruptcies have been rare compared with corporate sector bankruptcies. States are not able to file for relief under Chapter 9 of the U.S. Bankruptcy Code, and filings by counties and cities typically have numbered 10 or fewer per year (see figure 2). Notable examples from the past decade include the city of Detroit and Jefferson County, Alabama.

As for defaults, they typically number less than a dozen in most years (see figure 3). Historically, nearly 50 percent...
of the municipal bond market was insured. That insurance helped insulate investors from concerns about defaults and insolvency. Following the Global Financial Crisis of 2008, however, most bond insurers stopped issuing insurance policies and the insurers were downgraded. Now, insured bonds represent less than 10 percent of the market. Despite the lack of insurance, municipal bonds have demonstrated resilience. In 2020, rated municipal bonds experienced just one default versus 51 for U.S. corporates.

**Figure 3**

**HISTORICAL MUNICIPAL DEFAULTS BY RATED ISSUERS (NUMBER ACROSS ALL STATES)**


**Table 1**

**HOW MIGHT DEMOCRATIC CONTROL AFFECT THE MUNICIPAL BOND MARKET?**

<table>
<thead>
<tr>
<th>Policy area</th>
<th>Potential impact</th>
<th>Bottom line</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal stimulus</td>
<td>• More expansive aid</td>
<td>Tax increases would boost the appeal of tax-exempt income, and more federal aid would improve the health of state and local budgets</td>
</tr>
<tr>
<td></td>
<td>• Larger state and local aid package</td>
<td></td>
</tr>
<tr>
<td>Corporate taxes</td>
<td>• Increase in corporate tax rate from 21% to 28%</td>
<td></td>
</tr>
<tr>
<td>Individual income</td>
<td>• Increase in highest individual income tax rate from 37% to 39.6%</td>
<td></td>
</tr>
<tr>
<td>Infrastructure</td>
<td>• Broad plans to repair or rebuild roads, bridges, etc., potentially in partnership with states</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Increase in mass transit funding</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Increase in issuance for new money projects in the tax-exempt and taxable muni markets</td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>• Restoration of SALT deduction and/or return of tax-exempt advance refundings</td>
<td></td>
</tr>
</tbody>
</table>

Source: Capital Group. SALT = state and local taxes.

**Figure 4**

**STATE GENERAL FUNDS: REVENUE SOURCES AND EXPENDITURES**

**REVENUE SOURCES FOR STATE GENERAL FUNDS**

- Personal income tax: 45%
- Sales tax: 30%
- Corporate income tax: 7%
- Gaming tax: 18%

**EXPENDITURES FROM STATE GENERAL FUNDS**

- K-12 education: 36%
- Medicaid: 20%
- Higher education: 10%
- Public assistance: 7%
- Corrections: 7%
- Transportation: 1%

Source: NASBO. Data as of May 13, 2020.

**SUPPORT FOR STATE AND LOCAL GOVERNMENTS**

Early in the pandemic, state and local governments received federal support in the form of liquidity from the Federal Reserve and funding from Congress, which appropriated more than $500 billion to state and local aid under the Coronavirus Aid, Relief, and Economic Security (CARES) Act. Following prolonged partisan negotiations, additional stimulus was enacted in December 2020 as part of the Consolidated Appropriations Act for 2021. Limited aid was provided to colleges, schools, and transit agencies, but the package did not include direct state and local aid.

With Democrats now in control of Congress and the presidency, additional federal stimulus is a near certainty. The Biden administration recently proposed the $1.9 trillion American Rescue Plan, which includes $350 billion in direct state and local government aid. Although this figure is on the lower end of prior expectations, many state and local governments have received better than expected tax revenues since the depths of the pandemic as the economy has begun to recover. They still face budget shortfalls, but some of those deficits may be more than offset with the fiscal stimulus and improving economy.

The implications of a blue wave go beyond fiscal stimulus (see table 1). To start, the chances look better for Biden’s tax agenda, with its income tax hikes for corporations and high earners,
THE PATH AHEAD

There are many unknowns as we move ahead, but it’s clear that the market’s tone has improved materially since March 2020. Yields are significantly lower across the curve, with investment-grade yields back to pre-pandemic levels and the high-yield segment off the highs. Spreads have also declined off the April highs and continue to move lower. Primary market issuance has returned to normal, with new supply increasing and plenty of deals being many times oversubscribed. Given ongoing questions around the short- to intermediate-term financial health of states and other municipal issuers, it’s perhaps not surprising that lower-quality muni credits are feeling the most impact. That said, it’s important to note that even at their April peak, high-yield to triple-A spreads were about half a percentage point below their five-year high (see figure 5).

**The combination of higher pandemic-related expenses and a recession may add further pressures to an already stressed sector.**

At the sector level, municipal bonds continue to exhibit dislocation. For selective investors, we see many opportunities where valuations appear to compensate well for the risks entailed. Yield and total return potential look favorable, especially because the timing and scope of further federal support for states and municipalities should become clearer in coming months. Some of the
Figure 6

YIELD-TO-WORST RANGES BY SECTOR

YIELD-TO-WORST SPREAD (%)

Source: Bloomberg. Data as of October 31, 2020. IDR & PCR = industry development revenue and pollution control revenue.

hardest hit sectors during the March 2020 selloff now offer fertile ground for selective investors (see figure 6).

Are there still risks in the market? Yes. Are investors being compensated adequately for these risks? Members of our municipal fixed income investment team believe so. The dislocations in the municipal bond market have created many potential opportunities for municipal bond investors with the right resources. With interest rates expected to remain low and tax rates potentially increasing in the future, municipal bonds can offer attractive, high-quality, tax-efficient income. Through active research and by discerning among credits, our investment team has determined that now may be a good time to add value to investors’ portfolios for the long term.

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