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Municipal fixed income in a post-COVID-19 world

MUNICIPAL FIXED INCOME IN A POST-COVID-19 WORLD

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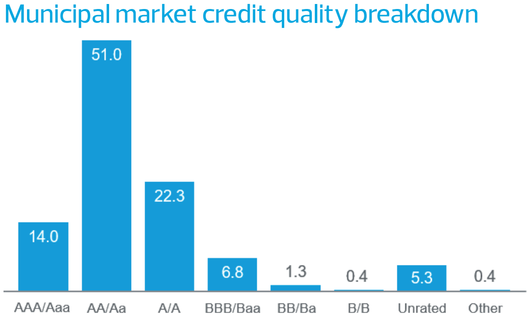
June 2020

High-quality municipal bonds have long played a key role as a source of stability and tax-exempt income in a well-diversified portfolio. However, investors have questioned whether economic and budgetary stresses resulting from the COVID-19 pandemic will upset the historical safety and soundness of municipal bonds. While the economic slowdown will certainly have an impact and will test some segments of the municipal market, we believe that municipal bonds have a long history of capital preservation in stressful periods and enjoy a number of foundational strengths that support their role as a core part of a strategic asset allocation.

Underpinning our confidence is the high credit quality of the broad municipal bond market, as well as its capital preservation record. The broad market is highly rated; in addition, default rates for municipal bonds have been favorable relative to similarly rated corporate bonds. In fact, cumulative 20-year default rates for investment-grade municipal bonds could increase by a factor of almost 30x (5.61%/0.19%) before matching those for investment-grade corporates. Per Moody's, municipal defaults and bankruptcies have become more common in the last decade, but are still rare overall. The average five-year municipal default rate since 2009 was 0.16%, compared to 0.09% for the entire study period. In contrast, the average five-year global corporate default rate was 6.2% since 2009, and 6.6% since 1970.

Municipal market credit quality breakdown



Data source: Nuveen, Standard & Poor's for the S&P Municipal Bond Index as of March 31, 2020. Ratings shown are the highest rating given by one of the following national rating agencies: Standard & Poor's (S&P), Moody's Investors Service, Inc. (Moody's) or Fitch, Inc. (Fitch). Credit ratings are subject to change. Aaa, Aa, A and Baa are investment grade ratings; Ba, B and Caa/Ca/C are below investment grade ratings. Certain bonds backed by U.S. government or agency securities are regarded as having an implied rating equal to the rating of such securities. Holdings designated N/R are not rated by these national rating agencies. High yield or lower-rated bonds and municipal bonds carry greater credit risk and are subject to greater price volatility. Totals may not add up to 100% due to rounding.

Moody's 20-year cumulative default rates, average over the period from 1970-2018, municipal vs corporate issuers

Rating	Global corporate	Municipal	Difference
Aaa	0.78%	0.00%	0.78%
Aa	2.18%	0.04%	2.14%
A	5.48%	0.26%	5.22%
Baa	9.30%	1.95%	7.35%
Ba	27.76%	6.33%	21.43%
B	47.56%	20.50%	27.06%
Caa-C	51.58%	26.71%	24.87%
Investment grade	5.61%	0.19%	5.42%

Data source: Special Comment: U.S. Municipal Bond Defaults and Recoveries, 1970–2018, Moody's Investors Service. Past performance is no guarantee of future results. The universe represents 16,000 bonds rated by Moody's in this study. All investments carry a certain degree of risk, including possible loss of principal, and there is no assurance that an investment will provide positive performance over any period of time. High yield or lower-rated bonds and municipal bonds carry greater credit risk and are subject to greater price volatility. Aaa, Aa, A and Baa are investment grade ratings; Ba, B and Caa/Ca/C are below investment grade ratings.

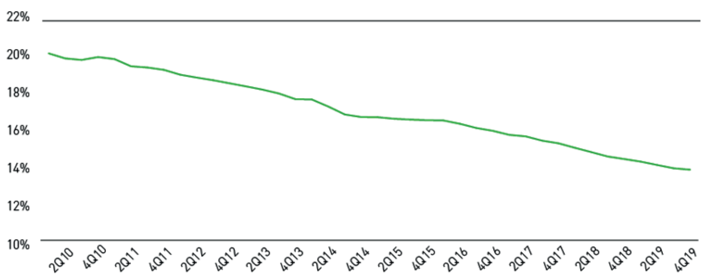
While history is supportive, the current environment is clearly unique. Both the Congressional Budget Office and RSM's economics team predict a Q2 annualized GDP decline near 40%. With such a degree of economic stoppage, one would expect municipal finances to weaken and state budget deficits to widen meaningfully. Some service sectors, notably hospitals and universities, may see interruptions in revenues in the face of higher costs. Airport revenues from landing, parking and terminal rentals have plummeted. Falling stock prices and interest rates may have a negative effect on pensions, nonprofit issuers' endowments and state permanent funds.

Despite those challenges, we do not anticipate broad defaults or permanent losses, especially among high quality general obligation and essential service revenue bonds. We do expect more ratings downgrades reflecting the real economic impact ("S&P Global Ratings has placed all U.S. public finance sectors on 'negative outlook' "), but it is important to recognize that downgrades do not automatically indicate that timely payment of interest and principal is in question.

Past periods of extreme economic stress demonstrate municipal bonds' resilience. During the Great Depression, state and local governments demonstrated a strong determination to avoid default, and an eagerness to repay past due obligations in the rare cases when default could not be avoided. Permanent losses totaled only about 0.5% of the amount of debt outstanding, and those losses were mostly attributable to small units of government, particularly special purpose districts.[1] Following the 2007–2009 Great Recession, several pundits called for widespread municipal defaults stemming from property tax declines and pension liabilities. While Puerto Rico became a major headline default, the anticipated wave of delinquencies did not materialize.

One of the reasons for our confidence is that municipalities broadly entered this crisis in good financial health, with debt broadly at lower levels, providing flexibility to deal with temporary deficits.

State and local debt as percent of U.S. GDP



Source: Breckinridge Capital Advisers, Federal Reserve Flow of Funds data, March 2020.

A second critical factor is federal government support. While political rhetoric over state vs. federal responsibility heats up and makes headlines in times of crisis, actual announced support programs from the federal government have been swift and meaningful. These include provisions in the CARES Act and other direct and indirect support programs, along with municipal lending facilities and Federal Reserve programs designed to improve municipal market liquidity and maintain municipalities' access to capital. To date, Congress has appropriated $2.8 trillion (13% of U.S. GDP in 2019) to address the pandemic through four relief bills. Direct aid to essential service municipal issuers comprises $447 billion of this total.[2]

Most important are the structural underpinnings inherent in state general obligation and essential service municipal bonds (e.g., water and sewer, public utilities). Unlike corporations, municipalities enjoy "monopoly" pricing power to raise taxes or rates and cut services (with little to no near-term competition), stable and inelastic revenue streams, and assumed perpetual existence (states and cities do not "go out of business"). In addition, while certain high profile defaults (e.g., in Puerto Rico) have tested the infallibility of some pledges, states, cities and essential service providers widely adhere to both a legal precedent and moral obligation to pay timely interest and principal.

Positive outlook notwithstanding, municipal bond investors should note that there will very likely be negative headlines and downgrades. Our contacts among municipal bond managers and analysts point to elevated stress in lower-credit quality bonds, and in areas such as nursing homes, senior living, certain university systems, speculative industrial development projects, areas that depend on tourism or oil/gas, and those with increased public health care costs or declining pension assets.

These stresses and headlines may also persist after the economy has recovered more broadly, as trends evolve slowly in the municipal bond world. At the same time, certain high-yield municipal bonds may offer attractive opportunities for skilled municipal bond professionals. We do maintain allocations to high-yield municipals in our portfolios and have relationships with a number of teams we believe are highly skilled.

Lastly, investors should be aware that even very high-quality municipal bonds are prone to occasional bouts of stress and reduced liquidity. This was very evident in the early stages of the COVID-19 crisis, when trading across the municipal bond market (and other fixed income markets) was extremely challenged. For this reason, core, strategic allocations to municipal bonds should be viewed as long-term investments, not as a source of immediate cash akin to a checking account or money market. Your RSM advisor can work with you to determine the appropriate level of liquidity and long-term investments for your needs.

1 Municipal Bond Defaults: Depression, Recession and Pandemic, May 2020.

2 Breckinridge Capital Advisors: COVID-19 and Muni Credit: Essential Service Municipals are More Resilient Than Appreciated, May 2020.

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 TL-NT-WMS-ALL-0620

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