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The Global Pandemic's Impact on U.S. Municipal Bonds

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The impact of the coronavirus (COVID-19) on U.S. financial markets has not been a subtle one. Municipal bonds, like their counterparts in equity and taxable bond markets, have been tossed about in the sudden uncertainty that quickly took hold of investor sentiment. The following highlights the challenges as well as the potential resilience of the U.S. muni bond market and its credit quality in a period of extraordinary volatility and economic shock.

Credit Research Process

Lord Abbett's municipal bond team is spending a significant amount of time on calls with issuers, industry experts, rating agency analysts, and dealers to gather information. We continue our deep granular research on all holdings and sectors. But with the new issue market quiet, we are focused more on surveillance of our holdings and closely following developments in all muni sectors. Our analysts are considering the effects of the coronavirus pandemic on credit quality and are identifying those holdings that may be at most risk or may be less affected. This includes running stress tests for sectors to determine how credit quality would be affected under multiple downside-revenue and increased-expenditure scenarios. Each type of stress test needs to be unique to the sector that we are looking at.

Our research has resulted in the following assessment:

State and Local Governments

In our opinion, there is no question that state and local governments will face reduced revenues as sales and income taxes decline for an unknown period following business shutdowns and rising unemployment. Revenues will be further squeezed as states face higher expenditures for healthcare and social services. And, unfortunately, volatile financial markets are likely to dampen pension returns for 2020, forcing states to bear the burden of higher annual pension fund contributions in the future. We believe that states with the weakest public pension funds, such as Illinois and New Jersey, will be pressured the most. We will be looking to see if they are able to continue their recent trend of making their annual pension payments.

On the positive side, heading into this economic storm, state and local governments were in a historically strong position in terms of revenues. State and local tax receipts have grown more than 3% annually since the 2008-09 financial crisis, allowing most state governments and municipalities to build up a financial cushion over the past several years.

Moreover, all states have sources for short term cash needs including the new Coronavirus Aid, Relief and Economic Security Act (CARES Act), signed into law on March 27, which adds up to $280 billion of direct stimulus to municipal bond issuers. In addition, on April 9, the U.S. Federal Reserve established the Municipal Liquidity Facility that, through a special purpose vehicle, will purchase up to $500 billion of short-term municipal notes to help state and local governments manage cash flow stresses.

Local Governments

As with the states, local governments have amassed a significant amount of liquidity over the past five years, which we expect will cushion the impact of negative economic growth.

Moreover, most local governments draw a significant amount of revenue from property taxes, and as such are less exposed to temporary economic activity swings. Historically, property tax revenue generally provides a buffer during an economic slowdown because:

- In most cases, assessed values are only reassessed every few years.
- The annual increase in assessed value is capped each year, so in many cases, the assessed value is well below market values.
- This means that even if market values go down, the assessed value would not be impacted.

In short, it would take a couple of years for property taxes to be meaningfully affected by an economic shock such as the current pandemic.

For the most part, we expect that higher credit-rated counties and cities with positive demographics and wealth levels and robust reserve funds should perform best. New York City, for example, is a high grade credit because they have reserve funds, financial controls and diverse sources of revenues, including income and real estate taxes.

Those local governments that are highly reliant on state funding or sales tax revenues, have less liquidity, and have sizable unfunded pension liabilities will face the most credit pressure. On the positive side, we believe the CARES Act will provide relief to many local governments; the states may also provide some level of support.

The economic shock resulting from COVID-19 has also had significant impact on specific sectors of the muni market:

Transportation

Although downgrades are likely, *mass transit systems* are natural monopolies and essential service providers. Nonetheless, transit systems are experiencing significant declines in ridership as more and more employees are working from home. After the virus slowdown, we may see a shift toward commuting by car rather than mass transit, at least in the short term. The recently passed CARES Act provides $25 billion as a buffer to a short-term decline in ridership.

Toll roads will be affected as the volume of car traffic has fallen with state and county stay-at-home orders. Mitigating risk is that many have good debt service coverage and capital spending flexibility. The strongest credits are roadways in and out of major cities while weaker ones are roads with cheaper or free viable alternatives. Overall, the toll road sector tends to have strong liquidity, which we believe will help absorb short term disruption. Some systems have the additional security of sales tax or motor fuel/rental tax pledges.

Seaports will face volume pressure as worldwide output will decline. Some ports charge rents and have minimum payment guarantees which allow them to withstand a short term downturn. Cruise terminals will be negatively impacted as bookings are likely to remain soft.

Health Care

The pandemic is triggering challenges for the health care sector, spurring operating issues and balance sheet pressure. We anticipate that higher patient volume and revenue related to COVID-19 will probably be offset by higher expenses especially for labor and the loss of more profitable elective procedures.

Highly rated systems may experience near term challenges but, in our opinion, should recover considering balance sheet strength and purchasing power. Small stand alone and rural hospitals are more exposed to volatility in performance but many have adequate liquidity levels to make it through. The federal government has shown its strong support through the CARES Act, dedicating $100 billion of funds to this sector.

Airports

The reduction in air travel levels will increase financial pressure on all U.S. airports, at varying levels. Airport revenue bonds are secured primarily by payments made by airlines through terminal rentals and landing fees, not directly by passengers traveling through the airport. We believe it is unlikely that an airline would make a decision to pull out of an airport that serves a vibrant economic base.

Stimulus relief, robust liquidity, and reserve funds are expected to support the credit quality of airports. Federal support for airlines will also lessen the stress, allowing airlines to free up more resources to pay increased airport costs.

The funding relief in the CARES Act provides $10 billion to U.S. airports. The money will be dispersed to most airports with the amount determined by flight volume. Large airports will receive stimulus grants in amounts ranging between 15-38% of 2018 revenues.

Higher Education

We also think most universities are well positioned financially to withstand the Covid-19 crisis in the short term. Nonetheless, the prospect of lower enrollment exists for this fall due to recruiting challenges and lower international enrollments.

Schools with already negative enrollment trends and higher dependence on student tuition will be most at risk. Schools with sizable endowments and lesser dependence on student tuition revenue will be able to withstand possible enrollment declines best. Supportive to the sector, the CARES Act will provide $14 billion to universities.

Public Power and Water/Sewer Utilities

Public power and water/sewer utilities are not expected to face immediate credit pressures, as they are monopolies and are an essential service. Those few utilities with a higher concentration of industrial customers are most at risk as businesses remain closed. On the other hand, increases in residential electric demand could offset the decline in commercial and industrial sales. There also could be systemic "limited credit pressures" such as customer late payments or non-payments.

However, most of the systems have high debt service coverage and reserve funds. And most public power issuers maintain robust cash balances that we believe should further buffer any near-term disruption in cash flow.

Opportunity through Active Management

There is still much uncertainty regarding markets. And we do not know precisely how the COVID-19 crisis will affect municipal credit because it will depend upon the length of time that the economy needs to be partially shut down. However, we are confident that our team of municipal credit analysts has the experience and the proficiency to identify those factors that will determine how individual credits will perform during this time period. Although there will be some pockets facing distress, we believe that most sectors and credits will hold up well during the crisis. With our disciplined fundamental credit analysis process, in our view, we are positioned well to identify those issuers who face the most risk and those that have the best potential to perform well. It's our belief that there will continue to be good investment opportunities in the municipal market, but to find them in this environment, we think there will likely be a big advantage in having active management supported by strong credit research.

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