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Munis Holding Up Better Than Most Amid COVID-19 Crisis

Introduction

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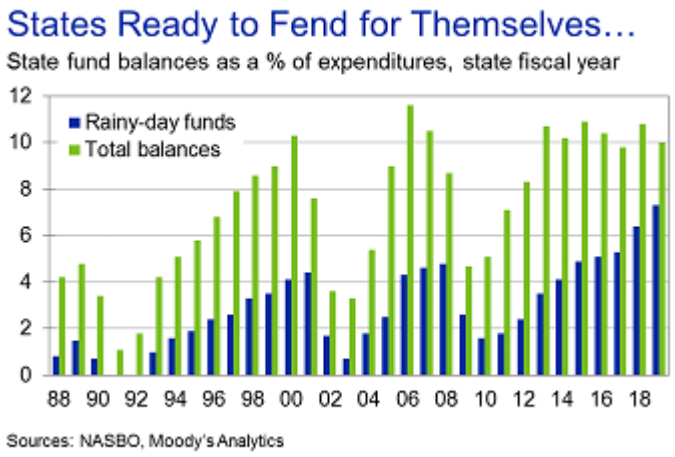
From an economic perspective municipal issuers have been riding high. Real tax revenues have more than fully recovered in virtually every state, and as a result state and local government employment just recently surpassed prerecession peak levels. As a result, governments in the U.S. are generally in a good position to withstand a COVID-19 recession.

Bottom-line impacts

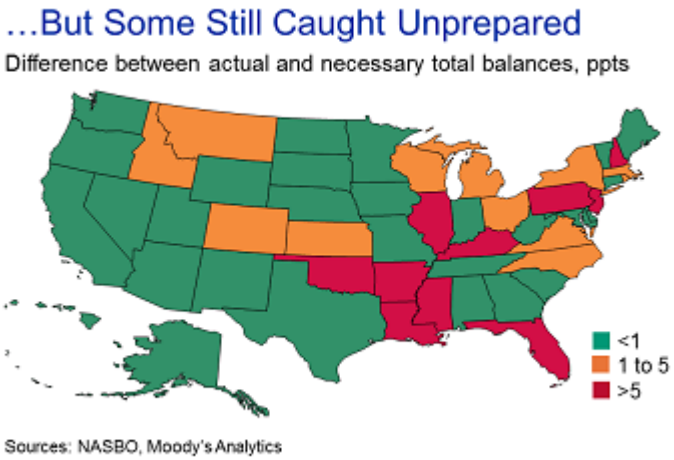
Aside from the immediate increase in demand for many government services during this national emergency, the most visible impact to most municipal issuers will come via lower revenues. The demand shock resulting from what is likely to be at least several weeks of social distancing and travel limitations will pull overall economic activity materially lower in the second quarter of 2020.

This will in turn result in lower sales and personal income tax collections as consumers pull back on spending and workers see their hours reduced or eliminated. Enterprise issuers such as transportation agencies and convention authorities will also see operating revenues fall significantly, potentially putting some in a perilous near-term position.

Even though the majority of the economic disruption will occur in fiscal 2020, July 2019 to June 2020 for most states, the revenue impacts will extend well into the first half of fiscal 2021. The length of the downturn will matter a great deal, but our preliminary analyses estimate that the amount of fiscal shock to state governments alone in the next few quarters could be as much as 10% of overall general fund revenues. This would be roughly in line with the types of moderate recession scenarios that states have been stressing their budgets with as part of their annual budgeting processes.



The good news is that most states, in large part because of their newfound use of stress-testing in the budget process, are well prepared for an economic downturn of that magnitude. In our most recent 50-state stress-testing exercise, we found that 28 states had sufficient money set aside to handle the impacts of a moderate recession without having to raise taxes or cut spending. An additional 12 states were relatively close to having sufficient funds set aside, while only 10 were substantially unprepared.



That preparation will come in handy over the next few quarters as revenues decline and demand for social services increases. Those states that have set aside sufficient reserves will be able to continue on without having to make any contractionary policy decisions that could lower aggregate demand even further. Those not prepared will likely have to impose spending cuts or tax increases at a time when their economies can least afford them. As a result, look for those economies with state budgets best situated for the current crisis to outperform those whose governments are least prepared through at least 2021.

Benefits for borrowers

Helping to ease some of the budget pain for states and local governments is that borrowing costs are at all-time lows. Municipal yields are falling as investors fly to safer assets. Outside of Treasury securities, highly rated munis are among the safest bets around. As a result, it has never been cheaper for most municipal issuers to borrow money.

This could be particularly useful as part of the fiscal policy response to the COVID-19 demand shock. As the federal government looks at stimulus spending to offset any full-blown recession, lower state and local government borrowing can help augment that stimulus with matching funds for new projects. With borrowing costs across all levels of government at record lows, increased infrastructure spending makes more sense now than ever before.

The timing also couldn't be better, since transportation bonds have been among the hardest-hit in recent weeks.

Winners and losers

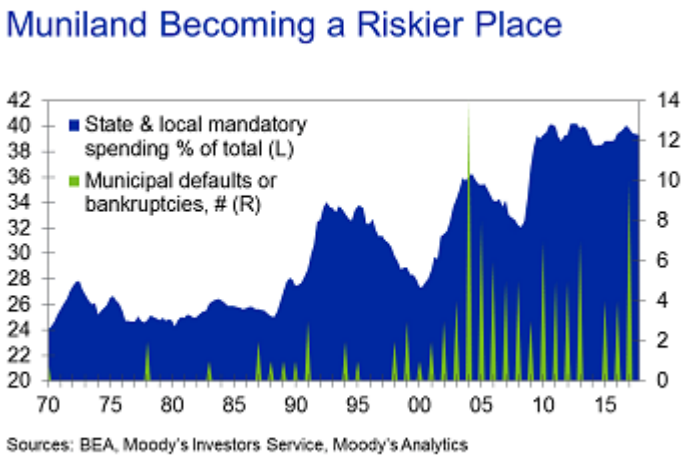
Munis, especially those with superior credit, will continue to do well in the midst of the financial chaos of COVID-19, but not everyone will come out a winner.

States and the federal government will need to ensure sufficient liquidity for some issuers in those segments most impacted by quarantines and social distancing. Some large issuers are well enough capitalized to survive an extended shock, but many transportation authorities, airports, and convention center issuers, especially those most reliant on user fees and sales taxes, are going to need some help.

Similarly, general government bonds in economies that rely more heavily on tourism and hospitality will become more risky the longer the current restrictions are in place. Their borrowing costs are likely to increase accordingly as investors view them as more risky. States, especially those less prepared for a downturn, are also likely to begin passing some of the fiscal stress on to local governments and municipalities.

Once the dust has settled on the spread of COVID-19, don't be shocked to see a handful or more of defaults among some of the more at-risk issuers in these categories.

If the downturn increases in magnitude or duration, expect the impact on the muni market to be much more severe. The baseline assumes a meaningful, but not unprecedented, increase in the number of municipal defaults or bankruptcies resulting from the current crisis. However, given the way that municipal bankruptcy and defaults have become more common since the last recession, it is possible that the response to this downturn will be much greater than we've seen before.



Within the Moody's Investors Service-rated universe, there were only 20 municipal defaults or bankruptcies in the 30 years from 1970 to 1999. In the two decades since there have been more than 80. Default and or bankruptcy has become a more palatable outcome for policymakers in the last 20 years. This first real shock to the economy since the Great Recession will provide a telling example of exactly how acceptable those outcomes have really become.