The current state of affairs

While the world has changed since the start of the year, so have investment outlooks. With a notable increase in fiscal pressure facing states and local governments, some may wonder if municipal bond exposure still serves a purpose. With the right approach and a long-term perspective, the answer is yes, according to Dan Rabasco, head of municipal bonds at Mellon.

While the world has indeed changed, the reasons investors looked to municipal bond exposure in the past have not. For instance, it's still an asset class with less prevalent defaults than its corporate counterparts and one of the few fixed income areas that can offer tax exemption, according to Rabasco.

“Even with the impacts of the pandemic on revenues, municipal bond default rates going into this are exceptionally low—much lower than comparably rated corporate bonds,” Rabasco says. “Additionally, states and local governments do have the ability to raise taxes and cut expenses. Revenue issuers can levy charges and fees, most independent of regulatory oversight, so there are some inherent strengths there.”

The big picture

Aside from certain fundamental advantages of municipal bonds, the Federal Reserve (the Fed) has provided liquidity to the muni market place by expanding its bond buying program and, in addition to the earlier legislative CARES Act, there is currently hundreds of billions of dollars in proposed federal funds aimed at states and local governments.

In late April, the Fed announced it would expand its municipal bond buying program by purchasing up to $500bn in state and local government bonds. This consisted of an expansion of its eligible purchases to include debt from counties and states with populations of at least 500,000 and cities with populations of at least 250,000.

While a lot of states have exceeded budgets and will likely need to draw on reserve funds to deal with blowback from the pandemic, as well as suffered large revenue loss due to associated lockdowns, there is the possibility of additional Federal help on the way. In fact, Congress seems to be considering current projections that state budget shortfalls could total roughly $185bn in 2020 and up to $370bn in the following fiscal year.

As a result, the House of Representatives passed a $3trn coronavirus relief bill called the HEROES act, on May 15, which includes nearly $1trn to be deployed for state and local governments. Of that—$915bn has been designated as “flexible aid”, which can be used to backfill revenue losses.

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2 The Center on Budget and Public Priorities. May 2020.
Although the bill was passed in the House, it still has to pass in the Senate—at which point, changes may be made to the exact amount deployed further delaying when it would go into effect.

“Maybe the proposed capital in the HEROES Act will match up with the budget deficits and will help diminish the extent of draws on state reserve funds,” Rabasco says. “Federal aid will be key—however, states also have the ability to use other measures in combination to reduce fiscal stress, like expenditure reductions.”

A closer look

Despite outside factors (the Fed’s liquidity aid, new relief bill etc.) having the potential to bolster the asset class, the right approach and detailed analysis will be necessary to tap into the full potential of municipal bonds.

Mellon has favored revenue bonds over general obligation bonds since before the pandemic, Rabasco says this preference has not necessarily changed. However, what has changed is which sectors are showing more resilience as well as the areas where revenue bond exposure makes sense.

“The revenue bond story is even more compelling as it relates to essential services,” Rabasco says. “Such issues for water and sewer projects and power bonds. People will do everything they can to pay those bills—to keep the lights on and keep the water running.”

“We favor revenue bonds that have strong coverage, strong service territories and diverse economies. On the flipside, the non-essential service revenue bonds—like a convention center, hotel backed bonds; those seem a bit more risky right now.”

That said, the sector-by-sector evaluation is not so black and white. For example, one might assume airports would be an area for muni investors to avoid due to a 96% reduction in air travel and a significantly weakening revenue picture. However, strong analysis can help to break past the surface, providing alpha generating insight that might otherwise be missed.

“The airports we own had strong liquidity going into this,” Rabasco says. “They have between one and three years’ worth of cash on hand, which is really helpful as we go forward. Also, the CARES Act allocated about $10bn to airports.

“Airports still tick some of our boxes when it comes to liquidity and essentiality, and additionally, they are well-positioned as travel restrictions start to lift and lockdown measures ease.”

Rabasco and his team have always prioritized a healthy level of liquidity for the credits they invest in and have continued to do so as volatility has increased in recent months. He says

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3 The Bond Buyer: HEROES Act would provide $915 billion in state, local aid. May 13, 2020.
4 CNN: Airlines and TSA report a 96% drop in air travel as pandemic continues. April 9, 2020
liquidity, both within the actual credits they own as well as the ability to transact within their portfolios, has become increasingly important.

“Now is the time to stick with fundamentally sound credits; especially in the lower-rated investment grade and the high-yield segments of the market,” he says. “While the possibility of defaults may increase for bonds within these rating categories—the issuers we currently hold, as well as those which we will look to purchase—should, on a whole, weather the credit impact of the pandemic”

“As the perception of the municipal market ideally improves with a potential federal aid package, these rating categories may also partake in a subsequent rally and generate attractive excess returns,” he says.

**Getting back to normal**

As the pandemic continues to shake markets, Rabasco says several developments will determine whether the muni environment returns to how it was before the public health crisis: the extent of Federal support for state and local governments, the macroeconomic landscape, whether a vaccine can be found or enhanced testing can be rolled out and the depth and impact of state and local government fiscal decisions in addressing the burdens of the pandemic on their budgets.

Rabasco says, “Investor confidence has to be bolstered along with liquidity conditions in our market. How does that happen? It starts with the passage of a phase four stimulus bill to complement what the Fed has done and the stimulus provided earlier by the CARES act. Also, it will depend on the pandemic curve: does it flatten, does testing become universal, and is there a vaccine?”

“Then there’s the macroeconomic picture. When does the economy come back, making up for revenue loss and helping states cover Covid-19 costs? All of this will determine the return of confidence in the market,” he concludes.
**Alpha** is defined as the excess return of an investment relative to the return of a benchmark index.

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