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Potential Impact of COVID-19 on the Municipal Bond Market

Executive Summary

- Municipal bond issuers likely will experience varying effects from the economic consequences of the COVID-19 pandemic, depending on their sources of revenue.

- Many issuers, including those with property- or essential services-backed revenues, could be well-positioned to weather an economic downturn. Issuers with exposure to discretionary spending, such as hotels, convention centers and stadiums, could have the most economic risk exposure.

- Recent large muni bond fund outflows, including a record $12.2 billion last week, have led to severe liquidity constraints and significant price discounts — creating potentially attractive investment opportunities.

- In this environment, fundamental credit analysis and active security selection are likely to be even more important for maintaining high-quality muni bond portfolios.

Impact of the COVID-19 pandemic on the economy at large

The length and depth of the economic slowdown caused by efforts to stop the Coronavirus from spreading will depend upon multiple factors, including, but not limited to: the public's adherence to social distancing, the healthcare system's ability to keep up with the drastic increase of patients needing specialized care, and the many, varied monetary and fiscal programs that will help support general economic activity, displaced workers and struggling businesses, large and small.

The Federal Reserve and the Treasury Department have been aggressive in their measures so far to help support both the economy and the proper functioning of the capital markets. Measures to shore up the availability of credit to individuals and businesses, as well as programs to maintain liquidity in both the real economy and the capital markets, are having some positive effects, but they may be nearing the limits of their efficacy.

It is aggressive fiscal policy that will be looked to for the heavy lifting to support economic activity. Congress is expected to adopt a $2 trillion fiscal stimulus package with provisions that will provide individual tax rebates, funding for small business loans and loan forgiveness, liquidity assistance/loans/grants for industries under duress, such as airlines, along with significantly increased public health spending and assistance to state and local governments.

Effects on municipal bond issuers vary by their sources of revenue

Municipal bond issuers likely will experience greatly varied effects from the economic consequences of the coronavirus. While many of the issuers in this market are well-positioned to weather the financial turmoil, given the decade-plus-long economic expansion, it is logical to assume, at least at this early point, that some will face more difficult headwinds than others.

For instance, property tax-backed issues in localities with strong excess reserves and more controlled pension obligations, as well as essential service revenue-backed debt, could be expected to fare reasonably well in a downturn.

State governments may face more pressure from significantly increased expenditures on things such as unemployment insurance and healthcare payments, but have the potential benefit of an offset from federal programs designed to ease the economic shock. Institutions of higher learning are quickly adapting, as best they can, by moving classes and instruction online. But, they are feeling pain from the refunding of room and board and seeing the potential for outright class cancellation and diminished enrollment, depending on the length of the crisis.

The issuers that may face the largest headwinds are those whose revenues come more from discretionary economic activity. Oil-producing states and localities will feel the pinch from both lower demand and materially lower prices. Sales and income tax-backed debt may feel pain as diminished economic activity drags on, but the aggressive fiscal measures may provide enough support to keep consumers spending.

Issuers with exposure to travel, transit and leisure activities, such as hotels, convention centers and stadiums, are most exposed to a drastic and potentially extended slowdown in the volume of economic activity. The manner and magnitude of support given to these industries and their consumers, as well as the length of time they are required to endure significantly decreased revenue levels, likely will determine their final outcomes.

Lastly, the healthcare industry will need special consideration, given its exposure to the full effects of the pandemic. While the ultimate outcomes for the many issuers will likely depend on their locality and their workload versus capacity, larger, multi-system entities with significant financial flexibility and cash-flow could be expected to fare better than others. As well, similar to the impact on state and local government finances, the extent to which the federal government bears COVID-19-related costs through its proposed fiscal stimulus package will be a key driver for the sector’s outlook and credit risk profile.

While the current environment will be challenging for all municipal issuers generally, their strong financial positioning, built-up reserves and rainy-day funds should afford them some time to withstand these pressures. In trying times, it is worth remembering that defaults for agency-rated municipal bond issuers are extremely rare. However, credit rating downgrades may pick up as the full effects of the downturn become more quantifiable. Measured and focused credit surveillance will be ever more important to building and maintaining high-quality portfolios and avoiding problems.

Massive selling leads to liquidity constraints and significant price discounts

The waves of selling that washed across the municipal bond market over the last 3 weeks have been as stunning as they have been large. After 60 consecutive weeks of mutual fund inflows into the market, we have now had three consecutive weeks of outflows, topped off with last week's record breaking $12.2 billion outflow. These cash drawdowns, combined with broker/dealers stepping away from providing market liquidity, has led to severe liquidity constraints and significant price discounts, with the price hit only getting larger as trade size decreases.

As a consequence, interest rates have jumped an historic amount across the maturity spectrum, as AAA-rated bonds maturing in two years jumped from 0.45% to 2.52%, in ten years from 0.78% to 2.79%, and in thirty years from 1.38% to 3.37%, as investors are demanding cash and bonds are being liquidated at unusually depressed prices, leading to the worst rout in the market since 1984.

The typical relationship of municipal bond yields trading as a percentage of the effect of tax rates on Treasury bond yields has completely broken down. The decoupling of this relationship has led to rates on the highest-rated municipal issuers in the market reaching 400% of two-year Treasuries and 200% of ten-year — levels not even reached at the height of the 2008 crisis.

While the aggressive adjustments taking place have been painful, the market is still operating as buyers and sellers — ready, able and willing to transact, search for a new equilibrium that will, to the extent possible, discount expectations for the full effects of the virus.

Glenmede's conservative investment approach favors high credit quality

Glenmede plans to continue managing municipal bond portfolios in a manner that achieves participation on the upside and protection on the downside. We remain focused on maintaining our double-A (AA) average credit quality, with no holdings rated below single-A (A), a moderate level of interest-rate risk and ample exposure to liquid issuers and securities in unconstrained portfolios. Even before the effects of COVID-19 came tearing through the capital markets, our preferences generally had been steadily sliding towards the highest-quality municipal issuers with more access to capital market liquidity. As rates fell in the early part of the year and relative value became more and more unattractive, our willingness to own lower-rated bonds generally diminished, as did our interest in taking on interest-rate risk beyond that of our benchmark.

Now, with the drastic increases in interest rates to absolute levels we have not seen in years, municipal bonds have become significantly more attractive on an absolute basis and relative to taxable fixed-income alternatives. As the market panic settles, extreme selling pressure subsides and we can more adequately assess both the economic damage and financial support that will be given, we will actively reevaluate our approach to market conditions. We do not view this current market stress as a time to abandon the asset class. Rather, we see it as a time when investors should consider moving cash into high-quality municipal bonds to take advantage of this historic dislocation. The decision will depend on individual investors' needs and appropriateness in the context of their overall investment strategy.

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