The municipal market calm before the storm

By David L. Dubrow

The municipal market was in a state of disarray in March due to a “rush to safety” but has recovered sharply over the past few months. Money has flowed back to municipal bond funds, rates have decreased to historical lows and bond issuance has risen.

It has been a quick and remarkable turnaround, at least in part due to various actions taken by the Federal Reserve Board.

After only about four weeks of dislocation, many observers are already beginning to put March in the rear window. But should we assume this quick turnaround will persist?

Since the pandemic hit our country in late February, within a mere 4 months, businesses have been devastated. Unemployment continues at rates twice as high as those during the Great Recession. Companies have filed for bankruptcy at a pace similar to the height of the Great Recession.

While the economy showed some temporary improvements as States loosened their restrictions on business activities, the spread of the virus is reaccelerating at record rates. Consequently, States are rolling back the opening of more economic activities. All indications are that the economy will continue to contract. As states and municipalities cut their budgets and lay off public employees the economy will worsen even more. These trends will likely result in a prolonged economic downturn worse than the Great Recession.

What does all this mean for the municipal market? There will be a growing uncertainty and instability for the following reasons.

Most significantly, sectors of the municipal market that were stressed prior to the pandemic due to underlying long term trends will face significant challenges.

1. Notwithstanding a record 10-year recovery, the United States territories, municipalities in industrial states such as Michigan and Pennsylvania, and municipalities in Illinois, New Jersey and Connecticut, have faced growing financial challenges due to a steady economic decline. These public entities are likely to face severe crises resulting in a number of bankruptcies that may match or surpass the number during the Great Recession.

2. Higher educational institutions have faced growing financial stress on account of declining admissions. A few small- and medium-sized colleges have had to liquidate. In addition, there have been defaults on bonds financing on-campus student housing. The pandemic and economic downturn will pose serious challenges to higher educational institutions and on-campus financed student housing projects. On an immediate basis, universities face the challenge of conducting business in the midst of the pandemic. While many universities have decided to open their campuses this fall semester, it is likely that these decisions will be reversed as the virus spread is not appropriately controlled. This will cause severe financial strain. In addition, the economic downturn will accelerate long term financial challenges.

3. During the recovery the senior living sector financed with tax-exempt debt has also struggled. The pandemic will pose more severe challenges. The senior living sector is likely to undergo a major transformation on account of the virus. While the form of this transformation is unclear, it seems certain that major changes in the industry will be forced to take place. Projects financed with tax-exempt bonds are likely to be caught in the cross-winds of these changes and will face growing financial challenges.

4. Multifamily housing, shopping malls, office buildings or similar projects financed with municipal bonds that were substantially completed but struggling to lease up prior to the pandemic will also be very vulnerable due to the economic downturn.
The unknowns of when the pandemic will come under control in our country and when a vaccine will effectively address the disease creates many uncertainties for the municipal market. These uncertainties include:

- Convention centers, sports arenas, shopping malls and hotels financed with tax-exempt debt will be stressed as restrictions on public gatherings continue. Airports, mass transit, ports and toll roads will also face challenging times the longer people are not permitted to or are reluctant to travel. The same is true for hospitals unable to benefit from lucrative elective surgery. The longer containment of the virus is not achieved, the greater the financial stress on these sectors.

- The deeper the economic decline and the longer it takes to recover in a meaningful way, the more uncertainly it will create for municipalities and projects financed with municipal bonds. Weaker credits that may not be presently apparent will be exposed over time and a prolonged recovery will create broader stress.

- Certain municipal entities have and will issue bonds to finance their deficits. However, if the downturn results in a slow and prolonged recovery, paying off such financings may become difficult.

- As States struggle with their own fiscal issues on account of the downturn, there is likely to be less funds provided to municipalities. In particular, States like Illinois and New Jersey may lower state aid and other forms of support to municipalities thereby exacerbating stress on municipalities in those States.

In light of the above, while continuing to be a relatively safe investment haven, the municipal market faces an upcoming period of increased stress and unpredictability. Pockets of prior instability will be exacerbated and new areas of stress will emerge. The municipal market will become more differentiated by credits and interest rate differences will likely widen between credits. Depending on the length and difficulties of the recovery, bond issuances are likely to decline on account of municipalities not being able to carry increased debt load.

Another panic may occur if the stock market tumbles again due to another significant market event. This could turn the municipal market upside down once again. At a minimum there will likely be greater caution and a slow but steady withdrawal from and differentiation of credits in the market as credit risk becomes more apparent.

While the municipal sector may lag in visible financial distress, it cannot be and is not separate from the economy as a whole. A very bumpy journey lies ahead.