



Community Bank Views – Municipal Bonds & COVID-19

May 29, 2020

In this month's installment, we explore COVID-19's financial impact on state and local government. We are pleased to introduce Brian Musielak, CFA, Director of Fixed Income Portfolio Management of the Commerce Trust Company. In addition to managing Institutional client portfolios & the Commerce Funds Municipal Mutual Fund complex, Brian is also responsible for the management of Commerce Bank's own \$1.1 billion municipal bond portfolio. We hope you enjoy what follows:

Q: What are your general thoughts on the municipal market?

- We believe municipal bonds will prove to be resilient as we navigate this current recession. Default rates on investment grade issuers will move higher but likely stay well below 1%.
- Municipal credit trends follow the broader economy with a significant lag, sometimes as long as a year or more. Unless we experience a rapid, V-shaped economic recovery, the worst is yet to come.
- Troubled credits and negative trends in place before COVID-19 will only be exacerbated by the pandemic and ultimately lead to the highest concentration of distress.
- Headline risk will intensify and persist throughout this cycle. Public sector narratives frequently are pessimistic. Why else would any voter/taxpayer support higher taxes or less services, the hallmarks of balanced budgets?
- It is a bond picker's marker – choose carefully and you will be rewarded.

Q: What sectors are you most concerned about?

Local governments: Lease, special tax or limited tax General Obligation (GO) bonds issued by city governments. Cities tend to have a high reliance on sales and use taxes, which are more volatile than revenue derived from income or property taxes. More concerning to us though is the incentive for cities to fund local economic development projects as a means to boost those sales taxes. If these projects fail to cash flow, this can put significant pressure on the city's finances. While investors may only buy the *unlimited* tax GOs, be aware of all the debt structures outstanding, including those obligations funded indirectly through bank loans.

Small to mid-size universities, single purpose non-profits, and unaffiliated single-site hospitals: Challenges typically include lack of resources and narrow revenue streams. Of particular concern now are the smaller private universities. High debt loads, inflexible cost structures, and weaker student demand have specifically plagued this sector prior to COVID-19. Now that fall semesters without students in dorms and classrooms are a real possibility, some longstanding institutions may be unable to recover.

Q: What sectors are you most constructive on?

Unlimited tax GO debt of wealthy counties and school districts, even in troubled states: Debt is generally secured by stable local property tax revenues with little reliance on the state.

Lease debt of highly rated state and local governments: We are willing to accept a less secure debt structure only in cases where we have a high degree of confidence in the issuer.

Large multi-state hospital systems: Sizable balance sheets, geographically diverse revenue sources, and strong management teams generally provide a cushion to handle inherent challenges facing health care providers today.

If you would like assistance in reviewing your municipal portfolio, please reach out to your Commerce Investment Representative at 800-548-2663. For additional information, please access <https://emma.msrb.org/>.

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