Investment Insights

Stabilization in the Municipal Bond Market

Kevin Akinskas
Head of Municipal Bonds

Phyllis King
Head of Municipal Bond Research

John Mitchell
Municipal Bond Credit Analyst

Highlights

- Municipal bond market volatility has largely returned to normal levels since our last update.
- The market is exhibiting a much healthier tone as primary and secondary markets normalize.
- Credit concerns are warranted, but the federal stimulus is significant for the sector.
- Bessemer maintains a constructive outlook for high-quality municipal bonds.

Update on Municipal Market Dynamics

Municipal market volatility declined significantly in the two weeks since our March 23, 2020, *Investment Insights*, "Addressing Municipal Market Volatility." Following the leverage-induced selling pressure of the first several weeks of March, municipal bond valuations had cheapened to levels not seen in decades and had done so absent fundamental rationale. As the selling pressure subsided, the market experienced a significant uptick in interest from real-money investors (retail, banks, insurance companies, etc.) looking to capitalize on high-quality bonds selling at fire-sale valuations, and the asset class regained much of the ground it lost in March.

Today, the municipal bond market feels much healthier than it has for the past several weeks. The primary market for new bond issuance has begun to reopen (issuers had been reluctant to issue into the market given higher volatility), with several deals pricing this week and approximately $10 billion in backlog that may reenter the market beginning as soon as next week. Furthermore, the secondary (trading of existing securities) market is exhibiting much better tone; bid/ask spreads (the difference between sale and purchase price quotes) have narrowed, particularly for high-grade bonds; two-way flow in the front and intermediate portions of the curve has improved; and the market depth of bidding (the number of bids received and dispersion among those bids) is moving toward more normalized levels. Finally, even with the recovery experienced over the past two weeks, valuations relative to Treasuries remain attractive and should continue to provide a tailwind to municipal bond market performance.

Bessemer maintains a constructive outlook for the asset class, particularly in high-quality municipal bonds that are well positioned to weather the forthcoming macroeconomic headwinds. As described below, the CARES Act provides additional financial stability for many of these already well-capitalized issuers, and we believe that the combination of (1) a high-quality bias in portfolios, and (2) continuous credit scrutiny, will help investors withstand any future volatility and allow us to capitalize on forthcoming opportunities.

Credit Review and CARES Act for Municipals

Given the unprecedented nature of the COVID-19 outbreak in the U.S., concerns about municipal credit and default are understandable. The seeds of recovery from the "economic shutdown" and concurrent rise in unemployment are dependent on a leveling off of COVID-19 cases, which will likely vary regionally, and the development of a vaccine and/or treatment — timing is subject to considerable uncertainty. An additional unknown is how the COVID pandemic will influence behaviors over the long term (e.g., will more people work at home; will business travel decline, including for large gatherings, such as conventions; will online supplant in-store shopping at a more rapid pace). These are just a few of the concerns that municipal bond investors are grappling with.

Not unexpectedly, revenues for a broad swath of municipal issuers have fallen/are projected to fall — in some sectors, precipitously (e.g., airport, toll facilities, and mass transit). In addition, governmental expenditures are projected to rise as the effects of the COVID-19 virus on communities across the nation are addressed. That said, Bessemer's view, shared by the vast majority of municipal market participants, is that high-grade governmental issuers with solid pre-pandemic credit characteristics will not witness widespread defaults. In combination with strong management, liquidity and reserves built up during the lengthy expansion should help these issuers withstand the crisis and hasten recovery post-pandemic.

Moreover, the record speed with which the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) was passed and the direct/indirect aid earmarked for governmental entities and enterprises (e.g., airports) are noteworthy. CARES funds (along with federal supplemental appropriations to support small businesses and public health agencies and enhance Medicaid funding and unemployment insurance), in effect, provide "a bridge" to offset dislocation caused by the pandemic. Already there is discussion of the next package, which will most likely include additional aid targeted to the municipal sector. This clearly demonstrates that the federal government will step in to aid state and local entities during periods of "disaster," both financial and otherwise, and appropriately targeted federal aid will be key to the successful navigation of the pandemic and the provision of services to constituents.

In terms of municipals, the CARES Act (which, per a recent Kroll report, represents roughly 10% of GDP, twice the amount deployed during the global financial crisis) provides direct financial support to a number of sectors of the market that are most immediately impacted by the COVID-19 pandemic. Interestingly, there is no aid specifically earmarked for certain enterprise issuers, such as municipal water/sewer utilities. Water/sewer issuers are projected to maintain more stable revenue streams associated with their provision of an essential public service. The same holds true, to an extent, for public power providers. However, "the devil is in the details," and revenue loss could be meaningful depending upon the composition of the customer base; systems with an industrial concentration tend to exhibit greater revenue volatility and could be more prone to customer loss than those with a more residential focus.

Allocations under the CARES Act for traditional governmental issuers include the following:

- **State and Local Governments:** The act appropriates $150 billion as reimbursement for costs of dealing with COVID-19, including $8 billion for tribal governments and $3 billion for Washington, D.C., Puerto Rico, the U.S. Virgin Islands, Guam, and the Northern Mariana Islands. The allocation is based on population, with a floor of $1.25 billion. Up to 45% of a state's allocation may be requested by local governments; in order to be eligible, a local government must have a population greater than 500,000 — which would exclude, for example, cities such as Atlanta and Miami. On a percentage of revenue basis, according to external research, the minimum allocation (55% of each state's total) ranges from about 2% of state revenue for New York and Connecticut to 16% of state revenue for South Dakota. The formula does not consider a state's COVID-related expenses and is generally biased (on a % of revenue basis) toward states with small populations. At the very least, the aid is a "down payment" in terms of the coverage of COVID-19 costs.
- **Airports:** The allocation for airports is $10 billion, which according to external research, is about 40% of total operating revenue for Moody's rated airports — as compared to the state/local allocation of 5%-8% of total state/local revenue of $3 trillion. The allotment formula is complex and is based upon individual airport enplanements,

debt service, and unrestricted reserves. This allocation (in addition to aid for airlines, which should indirectly help airports) highlights the importance of a functioning aviation system. Despite the headline risk associated with extremely steep passenger declines, Bessemer's airport holdings (even pre-distribution of CARES Act monies) are actually well-positioned to deal with the disruption wrought by the pandemic — with days cash ranging from about 350 days to over 1,000 days.

- **Transit Agencies:** Transit agencies are allotted $25 billion, which according to external research, is about 35% of total transit funding. Monies are allocated based upon existing funding formulae — which would indicate an 85% distribution to the Urbanized Area Formula Grant,[1] although there is a degree of uncertainty regarding the allocation. Systems with high fare box recovery ratios (i.e., that derive a greater percentage of revenue from fares versus tax/other governmental subsidies) are unlikely to fully recover lost revenue attributable to very steep ridership declines. For example, New York's Metropolitan Transportation Authority (MTA) has experienced accelerating ridership losses, which as of April 2, stood between 92% and 98% on a year-over-year basis, depending upon the division. Estimates of the associated revenue shortfall are between $5.56 billion and in excess of $7.4 billion, depending upon the length of time before ridership resumes a gradual recovery. Although the MTA is projected to receive $3.8 billion of CARES funds (nearly equal to the funds requested), a revenue gap remains. Mitigating, to an extent, the risks associated with sharp fare box revenue declines, is the extremely crucial role of the MTA to the entire metro area — even during the pandemic, it is mainly off-peak service that has been reduced as essential workers (e.g., healthcare) need the system to commute to their jobs. Highlighting its importance, the authority has a strong history of governmental support from the state/the city, including the creation of new revenue streams, such as congestion pricing.
- **Hospitals:** The allocation for hospitals is $140 billion, which according to several sources, is more than 10% of total operating revenue. Unlike some other sectors, the hospital support provisions remain largely undefined. The health and human services secretary, via the Public Health and Social Services Emergency Fund, has broad latitude to distribute the vast majority of funds. Despite the ad hoc processes that will govern distribution of funds, the few details included in the act are supportive of hospitals engaged in treating COVID-19; Medicare will pay for coronavirus cases at a higher than usual rate for respiratory infections, and payments can be accelerated to bolster liquidity. In Bessemer portfolios, the credit selection process for hospitals focuses on facilities that are necessary for access to care in their communities, are well capitalized and liquid, and are efficiently managed such that they can be profitable in a government payor-heavy environment. This leaves our holdings well positioned to weather this storm and others.

Outlook and Portfolio Implications

Given the unprecedented nature of the COVID-19 virus and the associated effects on the U.S. and global economies, what is the outlook for municipal bonds held in Bessemer client portfolios? While all governmental entities are certainly confronting major, well-documented challenges arising from the crisis, we believe issuers held in client accounts are well situated to navigate these challenges and maintain at least satisfactory credit characteristics, even in the event of ratings downgrades, should downgrades occur. Bessemer's focus in municipal portfolios has always been on well-managed

[1] The Urbanized Area Formula Funding program makes federal resources available to urbanized areas and to governors for transit capital and operating assistance in urbanized areas and for transportation-related planning.

governmental/essential enterprise issuers with diverse economies and solid management. Furthermore, many of these issuers tend to be large/economically significant, which should allow a greater voice in shaping public policy — including the COVID-19 response. During this turbulent period, Bessemer will be continually monitoring municipal holdings and conducting in-depth reviews on selected issuers. If, as a result, we feel long-term prospects for a given issuer have deteriorated, we may consider sale, subject to price versus credit quality considerations.

Finally, while unsettling, the current market may also provide opportunities for knowledgeable investors to purchase high-quality bonds at "bargain" prices; Bessemer's independent, in-depth review process will be instrumental in assisting our portfolio managers in the identification of "undervalued" issues.

Our thoughts are with all of our readers during these challenging times. We encourage you to reach out to your Bessemer team for any support you may need.

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