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Alert: Like Palm Trees Surviving Hurricanes

Muni Issuers Proving Their Resilience

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Optimism in the Bond Market

It's been a full year since the COVID-19 pandemic crashed onto American shores. In a few short weeks, the longest economic expansion of modern times gave way to lockdowns, uncertainty, and fear. The resulting economic devastation shocked markets, spurring extreme volatility in many asset classes as investors adjusted to the grim new reality (see ***Fixed Income Alert: Market Illiquidity vs. Credit Defaults***, 3/23/20).

The municipal bond market endured a particularly sharp selloff, battered by both fundamental concerns (worries of plunging tax revenues and increasing expenses) and technical factors (a temporary liquidity crunch that disrupted all fixed income). Pundits and politicians added fuel to the fire by cynically speculating some state and local governments were "broke" or near "bankruptcy." The harsh spotlight on this normally calm and unassuming corner of the bond market created an opportunity to aggressively add munis at attractive yields (see ***Politics Is A Contact Sport: The Empty Threat of State Bankruptcies***, 4/25/20).

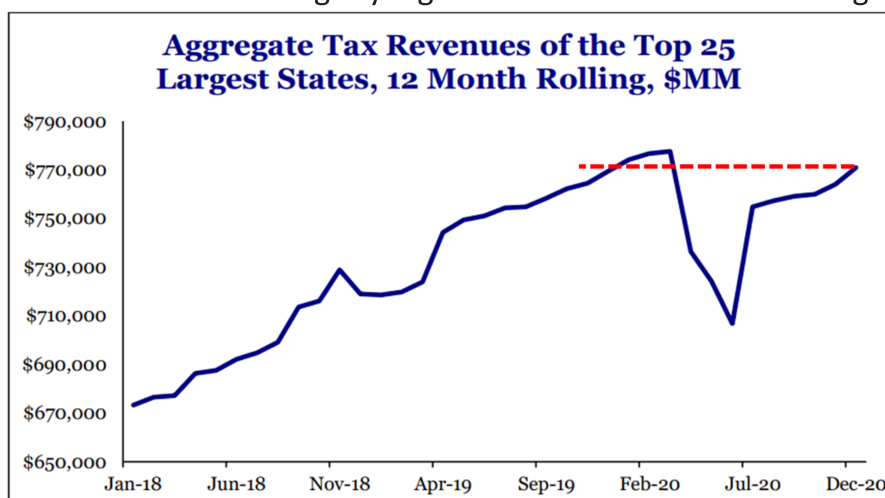
In the face of such dire headlines, our optimism seemed quite contrarian; we pounded the table that high-quality muni issuers are built to 'bend, not break' during storms. Like palm trees surviving hurricanes, their flexibility and strong fundamental 'roots' outlast even the strongest fleeting headwinds.

Time has shown our optimism wasn't misplaced; the overwhelming majority of municipal issuers successfully defended their already-strong credit quality through the crisis. Read on for a brief review of the financial health of our overweight sectors.

State and Local Governments Stand Tough

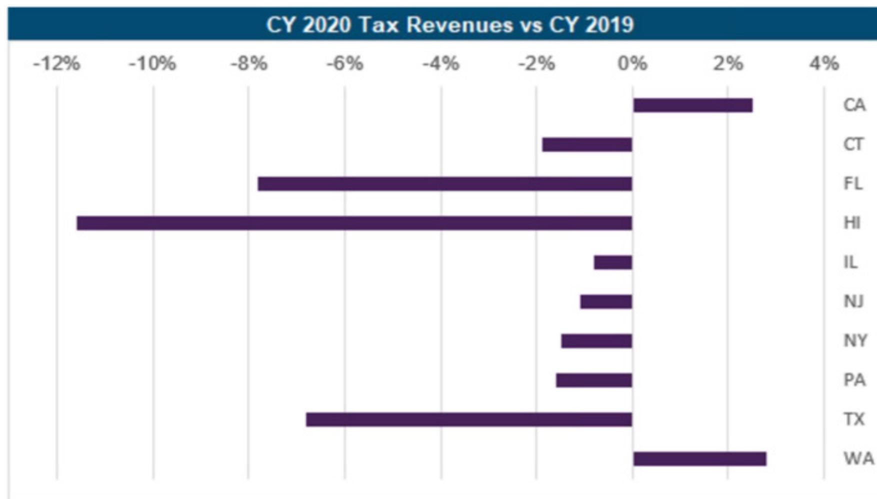
States depend on various combinations of income and sales taxes for most of their tax revenues. When pandemic-related lockdowns and job losses first started last March/April, estimates of sustained 10-20% declines in these key funding sources quickly became common. The impact of these dire projections was magnified due to then-ongoing budgeting negotiations (nearly all state fiscal years end June 30th), since full-year spending decisions had to be made during the depths of the uncertainty and panic. Furthermore, shifting 2020's income tax filing deadline from April to July added extra wrinkles around the timing of revenues vs. expenses.

Although the situation required politically unpopular spending cuts and deferrals, there was never any serious doubt every state had the means and flexibility to take appropriate action. Fortunately, the financial reality turned out vastly better than anticipated. Looking at the top 25 largest states' tax revenues over a rolling 12-month basis (which smooths out timing mismatches), receipts for the 12 months through December 2020 were slightly higher than the 12 months through December 2019!



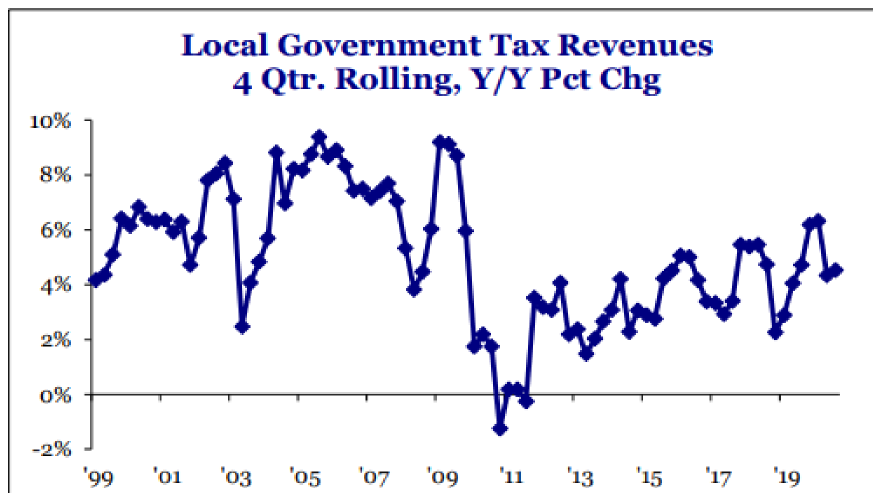
Source: Strategas

There's more dispersion when looking at individual results, as California's massive size skews the aggregate numbers. The chart below has some representative examples. As a rule of thumb, states more dependent on sales tax collections (Florida, Texas, Hawaii) suffered more than those more dependent on income tax receipts (California, New York, Connecticut). But declines were manageable and nowhere close to worst-case projections.



Source: CreditSights

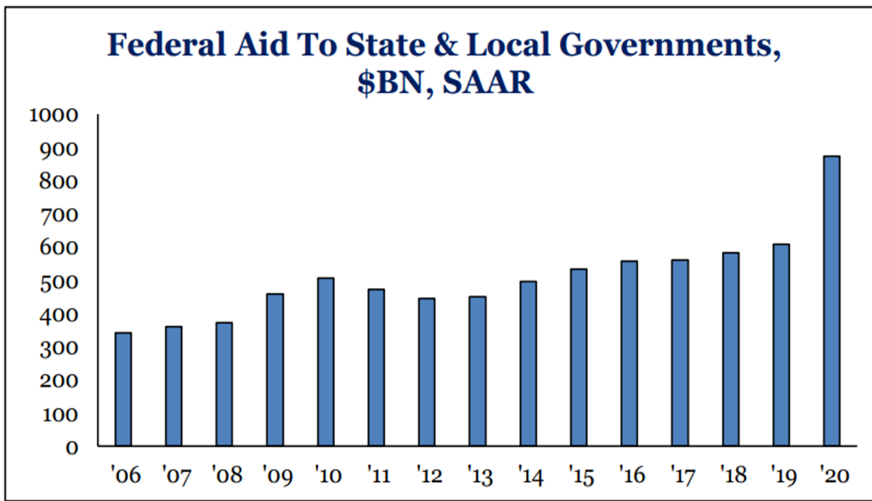
Local governments generally fared better throughout 2020. The lion's share of their revenues come from property taxes that are billed only a handful of times a year, with infrequent revaluations of the underlying home values. Property tax collections typically held up well even during past recessionary environments, and actually increased in this unusual downturn with rising home prices in many areas.



Source: Strategas

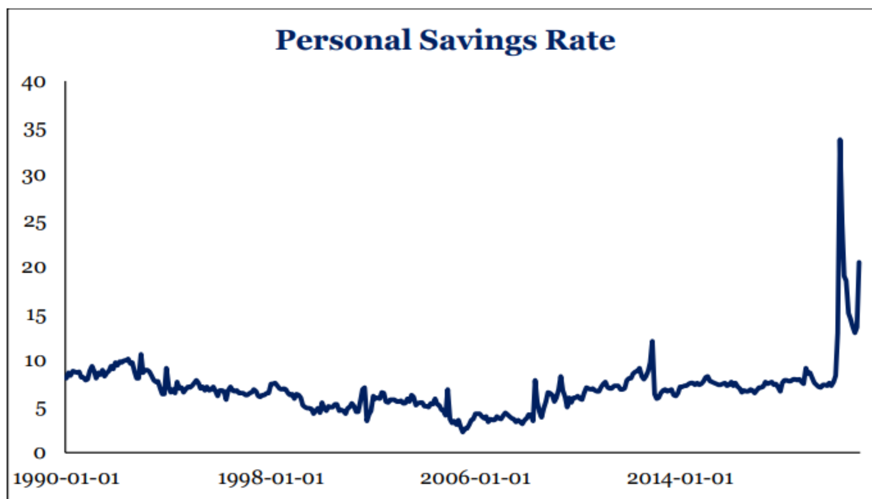
But tax receipts aren't the whole story. As we've shown many times (see ***2020 Review and 2021 Outlook***, 1/11/21), the federal government has provided massive stimulus to support the economic recovery, benefitting state and local governments both directly and indirectly.

Direct federal aid is already significant during normal times, subsidizing spending on healthcare, education, transportation, and other programs. In 2020, federal aid jumped over $250 billion (>40% vs. 2019), and *an additional $350 billion* is now on the way with the latest stimulus package. It's enough to cover every single state's pandemic-related revenue losses, *and then some*.



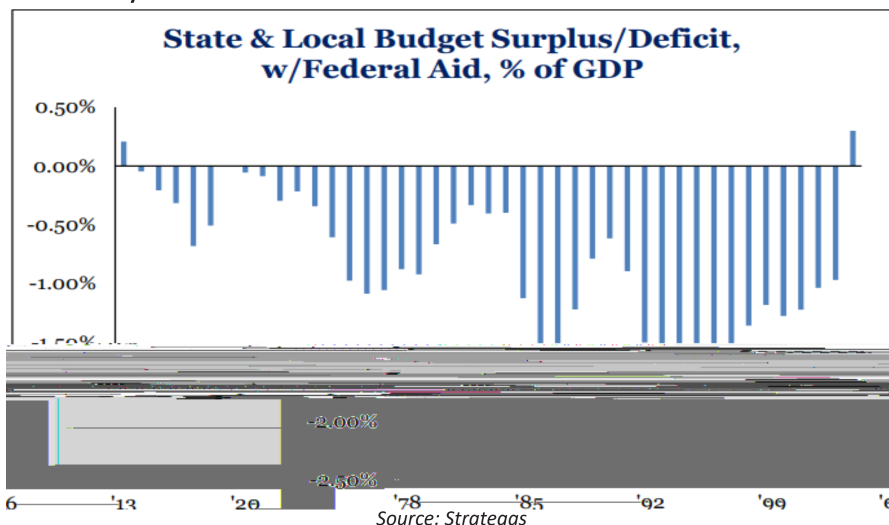
Source: Strategas

Indirectly, federal support for individual consumers (stimulus checks, enhanced unemployment benefits, PPP loans preserving jobs, etc.) translates into enhanced tax receipts. After all, unemployed workers barely making ends meet aren't paying sales taxes on discretionary purchases, have less income tax withheld on their meager earnings, and aren't driving home prices (and property taxes) higher.



Source: Strategas

Altogether, state and local governments in the aggregate ended 2020 with a calendar-year surplus for the first time in over 40 years.

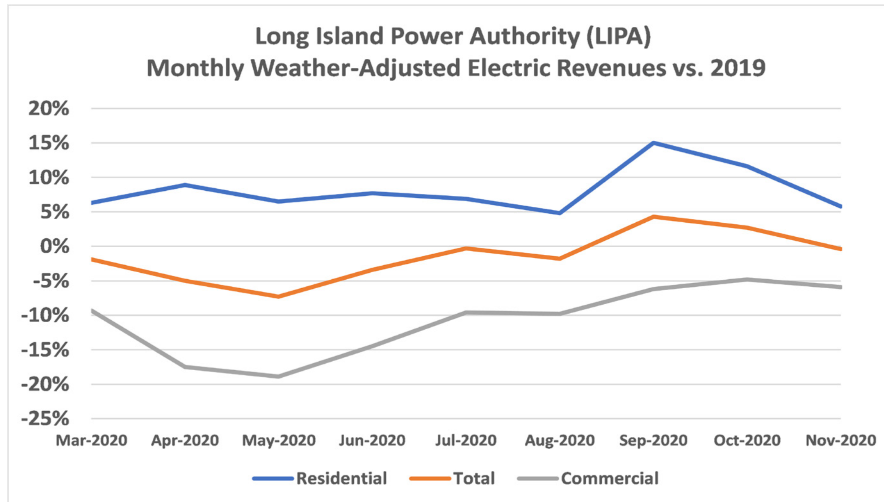


Source: Strategas

Revenue Credits Holding Fast

Many muni bonds are secured by specific public enterprises and revenue streams, rather than the general funds of a state or local government. We focus on those tied to 'essential' service providers such as utilities and large transportation networks, credits we've long believed are 'anti-fragile' to economic turmoil.

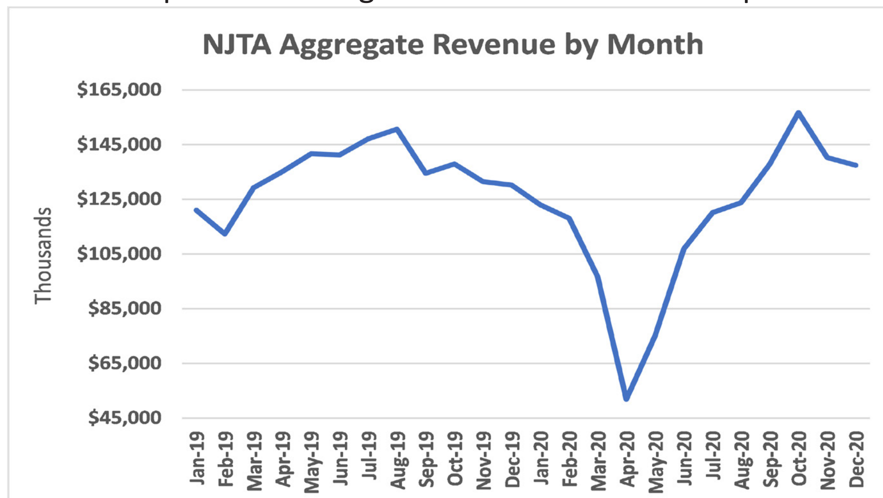
- **Utilities.** Modern life is impossible without basic utilities like clean water, sewers, and electricity. The need for these services is well established, and both individual consumers and commercial businesses rarely cut back usage to a significant degree. Utilities also typically enjoy monopoly privileges within their service areas, which allows them to weather shifts in demand patterns and raise fees as necessary. For example, during lockdowns we've seen several large electric utilities partially offset declines in commercial energy usage with increases in residential usage.



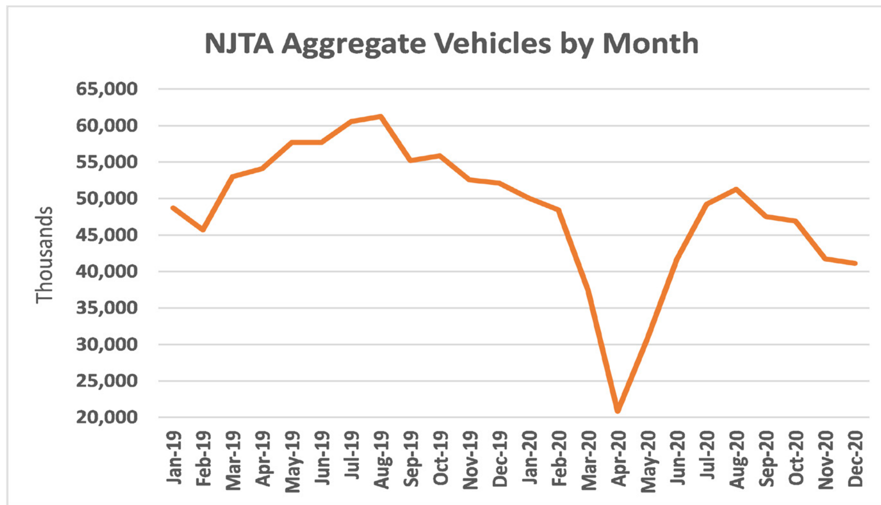
Source: LIPA 2021 Budget Message

- **Major Toll Roads.** Large and long-established toll roads are vital to certain regional transportation networks, acting as indispensable arteries for the efficient movement of both people and goods. As a result, they frequently enjoy relatively inelastic demand and consistently generate significant free cash flow. Consider the experience of the New Jersey Turnpike Authority (NJTA). NJTA owns and operates the NJ Turnpike and Garden State Parkway, critical roadways serving the New York City and Philadelphia metro areas.

  As the Northeast locked down, monthly revenue and vehicle traffic both initially tumbled over 60% Year-on-Year, but retraced most of the loss by August. The majority of the initial declines were because of decreased passenger traffic; commercial traffic fell far less and rebounded much quicker, providing an important financial offset due to its disproportionate contribution to revenues (only 5-8% of vehicle traffic but 25-30% of toll income). Although vehicle traffic remains down 20%, a toll hike in September brought YoY revenues back into positive territory.



Source: NJTA Investor Relations Data

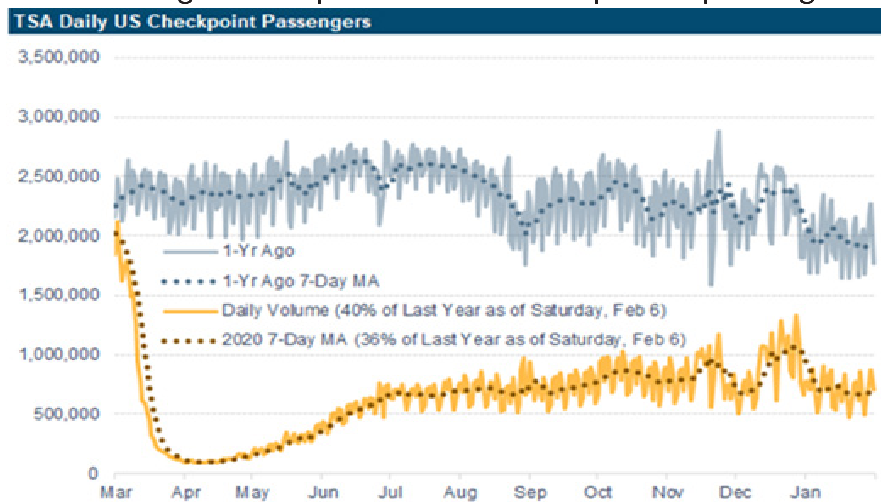


Source: LIPA 2021 Budget Message

Altogether, 2020 full-year revenues declined just 14%. NJTA began the pandemic with enough cash reserves to fully cover appr. 2 years' worth of operations, and maintained this already-large cushion. Currently, they're exceeding pre-pandemic monthly income totals despite lingering vehicle traffic declines; the picture should improve even more once NYC and Philadelphia office workers finally resume their regular commutes.

- **Airports.** We've frequently argued large metro airports are a hidden 'essential service.' They serve a critical long-term need and are controlled by public monopolies with no prospect of competitive pressures. For example, large numbers of people will always fly to and from New York City, and the Port Authority of New York and New Jersey owns and operates every major NYC area airport. Airlines wishing to offer NYC routes have no choice but to strike a deal with the Port Authority; both sides know this and plan their finances accordingly.

  This fundamental reality drives our favorable view on select airport issuers' long-term financial stability. We focus on large "hub" airports, which serve as major destinations, logistically-vital connecting flight centers, and aircraft maintenance facilities for one or more of the major airlines. These airports earn most of their revenues from airlines, which pay contractually-mandated variable fees that effectively cover the airport's net operating costs. This passing-along of expenses has been critical in offsetting the steep and sustained drop-off in passenger traffic.



Source: CreditSights

Airports have responded by cutting expenditures and easing the burden on beleaguered airline partners. Federal aid has also been significant; in addition to billions of dollars in direct grants to airports, massive federal assistance to airlines indirectly allows them to continue meeting downstream financial obligations to airports.

Importantly, airports were already well-prepared for a downturn when COVID lockdowns hit. Most large hub airports came into the pandemic boasting cash reserves totaling nearly 2 years' worth of typical expenditures. With the help of cost-cutting and federal aid, that's still generally the case today – a full year into a pandemic with an over 50% decline in utilization.

- **Tax Securitizations.** State and local governments sometimes create revenue credits that are solely backed by a priority claim to specific tax revenues (that is, debt service must be paid before the sponsoring government can use those taxes for general expenses). Sponsoring governments usually do this to lower their overall cost of financing core public infrastructure, as they can obtain a higher credit rating for the securitization. With a well-designed structure, bondholders can be relatively insulated from the ebb and flow of the sponsoring government's general credit.

  For example, both New York State and New York City finance a portion of their infrastructure spending by issuing bonds backed solely by income and sales tax revenues. In the case of NYC's income tax securitized bonds (issued by a captive agency called the NYC Transitional Finance Authority), bondholders are paid in full before excess income tax receipts flow to the City's treasury. This credit maintains very high ratings because it's structured to withstand nearly unthinkable declines before default becomes a possibility. Even in the wake of a pandemic that's hit NYC particularly hard, ongoing debt service coverage should still cover bondholder repayments at least 5 times over.

Treasury Partners View

Since the pandemic began, we've urged readers to look past alarmist headlines and political spin; the high-grade municipal market wasn't facing anything remotely close to an existential crisis. State and local governments, along with essential service providers, have survived numerous economic downturns, and the COVID-related slowdown will be no different. As always, various combinations of cutting expenses, raising taxes/fees, and tapping reserves would prove more than sufficient to weather any passing hurricane. Massive federal stimulus and aid has served to make this process less painful, and caused the storm clouds to lift faster than anticipated.

We aggressively added exposure to municipals at the height of last year's market turmoil, when highly creditworthy issuers were trading at undervalued prices relative to our internal criteria. We continued to add municipal exposure through the long summer and fall, as the broader market slowly adjusted its views on municipal credit stability and repriced to more reasonable levels. Data like we've highlighted above reassures us that our foresight wasn't misplaced optimism. Municipals have delivered solid proof of their financial resilience.

The events of the past year have been incredibly informative to our process and thinking. We're extremely grateful for the trust and confidence you place in us and appreciate the opportunity to manage your assets.

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