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Muni Credit and COVID-19: The Long-Term Impact of Municipalities Under Pandemic

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Part 1 of a two-part series.

The impact of the COVID-19 pandemic is unprecedented in the modern era. Second-quarter projections from Goldman Sachs show US GDP experiencing a decline of 24%. This is more than double what had previously been the largest drop on record, a decline of 10% in the first quarter of 1958. Goldman economist David Choi also predicts that jobless claims will reach 1 million, topping the previous record of 695,000 unemployment claims in 1982. Economic downturn of this magnitude greatly impacts the overall economy, but what effect does it have on individual municipalities?

Unlike the federal government, states are required to balance their budgets. When the economy contracts due to problems such as the pandemic caused by the COVID-19 outbreak, states are forced to pull back as well. This often creates a challenge because of the increased demands placed on governments when taxpaying jobholders become laid-off benefits seekers. In a period of dramatic contraction as demand for goods and services declines, revenue issuers will suffer as well.

Fortunately most tax-exempt issuers—perhaps chastened by the 2008 financial crisis—seem to have avoided excesses during the long economic expansion that followed. This shows in the modest growth of the municipal market over that period. According to St. Louis Fed data, the collective municipal securities liabilities of state and local governments was $3.06 trillion at the beginning of 2019—down from $3.1 trillion at the beginning of 2009.

While we're likely to experience a significant economic contraction in the second quarter of 2020, we believe a prolonged and sustained economic downturn is unlikely. This is particularly true if there's a substantive fiscal response to match the monetary measures being undertaken by the Fed. When it comes to navigating the risks associated with municipal credit, investors have been wondering if it'll get any worse.

Let's explore this by looking at the long-term impact of municipal credit following economic turmoil.

Municipal debt following the Great Depression

The life cycle of cities and states is best measured in centuries, not years. General Electric is the only remaining company from the Dow 40 of 1920, but all 40 of the largest US cities from 1920 still remain intact. In the investment-grade space, many municipal issuers are natural monopolies and consequently have tremendous recourse. This may explain why, according to Moody's, the 10-year cumulative default rate for A-rated municipals is 0.11%, compared with 2.10% for A-rated corporates.

In trying to gauge a worst-case outcome, we can look at the most extreme economic crisis in our nation's history—the Great Depression. The market was much different at the time. In 1927, revenue bonds were 1% of outstanding par. By 1937, they were 5%. Most debt was general obligation debt.

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There were no defaults of debt issued as general obligations of a state. The closest occurrence was Arkansas defaulting on $91.5 million in highway bonds that were backed by a dedicated revenue stream in 1932. In 1971, economist George Hempel found that 16.2% of all municipal bonds defaulted during the Depression era.

In his research Hempel divides local debt into five main categories: counties, incorporated municipalities, towns, school districts, and other districts, including reclamation, levee, drainage, and irrigation. His data shows that every type of issuer had difficulties during the Great Depression. The data implies that more heavily indebted issuers were more likely to default. For example, while 8.8% of incorporated municipalities defaulted on their debt, it represented 19.9% of all the debt for that issuer type.

In 1933, a total of $2.8 billion in municipal debt was in default. By 1939, only $200 million remained in default. No city with a population over 25,000 remained in default after 1938. Depression-era loss of principal and interest are estimated to have been $100 million, which is 0.5% of the average outstanding state and local debt.

Municipal risk depends on outbreak response

While it's likely that we're entering a recession—one in which thousands of businesses and millions of people will need assistance—the decline in economic activity is being precipitated by a need to slow the pandemic's spread. If the period of suppression is limited to a few months and adequate lifelines can be provided, it's quite possible that economic growth can rebound quickly.

While the length of the suppression period is uncertain, we're heartened by an odd piece of data based on the European Space Agency's satellite imagery. The Copernicus Sentinel-5P satellite monitors the level of nitrogen dioxide emissions in the environment. Data from northern China shows a rapid drop in emissions beginning in January, coinciding with local suppression efforts. While levels aren't as stable as they were in 2019, emissions are beginning to climb again. This is a convincing indicator of a resumption of manufacturing activity. It's possible that the period of suppression could be no more than two or three months. This indicates that the economy might be facing a short-term suppression rather than a full-scale depression.

The bottom line

In regard to adequate lifelines, much will depend on the fiscal response that comes from Congress. While the final legislation is still being drafted, there are encouraging signs that bold and new initiatives will be implemented. On March 22, Senator Mike Crapo, the chairman of the Senate Banking Committee, said the legislation would expand the Fed's authority to lend and buy debt directly from state and local governments. Goldman's forecast for full-year growth is a manageable -3.8%. This gives us confidence that even if we haven't seen the worst of this pandemic's impact on the market, our thriving economy will eventually return to form.

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