State bankruptcies unlikely, despite McConnell remarks

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On Wednesday, Senate Majority Leader Mitch McConnell stated that he favors letting states file for bankruptcy rather than providing bailouts. Our municipal bond team put together some points addressing these comments and how they pertain to our municipal bond portfolios.

• McConnell’s statement is pure political rhetoric, emphasizing that federal assistance would be confined to COVID-19 related issues. A likely trigger for McConnell was a request earlier in the week by the Illinois State Senate President for $41 billion in federal aid, which included $15 billion to be used for funding the state’s sharply underfunded pension liabilities. In this current hyper-partisan environment, McConnell was establishing a boundary in refusing to give states a blank check to spend on anything they want.

• The idea of allowing states to go bankrupt would require an overhaul of the legal framework governing states. The rights and sovereignty of states are protected under the 10th and 11th amendments. In other words, creditors can’t put states into Chapter 9. Laws would have to be rewritten for this to occur. Even if it were legal, there is zero chance of the U.S. House passing legislation allowing it. Accordingly, it’s a dead issue.

• Not all municipal bonds are debt obligations of states. State general obligation (GO) bonds only make up approximately 14% of the total market value of the Bloomberg Barclays Municipal Bond Index. Even considering the trickle-down effects to local governments, local GOs only make up an additional 14% of the total market value of the Bloomberg Barclays Municipal Bond Index. The municipal bond universe is much more diverse and complex, consisting of bonds backed by revenues from hospitals, water & sewer projects, and higher education and school boards, just to name a few.

• Letting states fail is a high-risk option from a political perspective. Corporations, which issued record amounts of debt since the last financial crisis to buy back stock to boost their share prices, will get bailouts, but the states which provide employment for police, firefighters, teachers, and many blue-collar workers will not? That would be a lightning rod for political rhetoric, and politicians whose jobs depend on the support of their constituents would be on the hot seat quickly.

• Many municipalities had record cash and reserve balances heading into 2020. It’s important to remember that most states were well positioned heading into this crisis.

• The crux of the issue is the pension shortfall crisis for certain states, something we have highlighted in our commentaries for years. Even assuming laws were rewritten, there are only a handful of states that Senate Majority Leader McConnell’s comments apply to, most notably Illinois. It’s easy to say, “let these states fail for mismanaging their finances,” but think about the other side. You would snub municipal bondholders, arguably some of the more conservative investors. It’s a bit counterintuitive. To rewrite law, smite political constituents, and harm municipal bondholders would be a heroic undertaking and one we think is unlikely to occur.

“McConnell’s statement is pure political rhetoric.”

— Eagle Municipal Fixed Income Team

Portfolio Positioning

State & Local GOs only represent about 23%, 18%, and 7% of our High Quality Tax-Free, MMIS, and Tax-Aware programs, respectively, as of April 2020. We have a preference toward essential service bonds (e.g. water & sewer, electricity, etc.). Of the State & Local GOs that we own, we have a preference toward high-quality issuers. The municipalities that are going to be most impacted are states with significant pension obligations, such as Illinois, Kentucky, and Connecticut. These are states we have had very little exposure to across our programs.
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Risks Associated with Fixed Income Investing

Many investors consider bonds to be “risk-free” investment vehicles. Historically, bonds have indeed provided less volatility and less risk of loss of capital than has equity investing. However, there are many factors which may affect the risk and return profile of a fixed-income portfolio. The two most prominent factors are interest-rate movements and the creditworthiness of the bond issuer. The risk of a change in the market value of the investment due to changes in interest rates is known as interest-rate risk. Interest-rate risk is subject to many variables but may be analyzed based on various data (e.g., effective duration). The risk that the issuer may default on interest and/or principal payments is often referred to as credit risk. Credit risk is typically measured by ratings issued by ratings agencies such as Moody’s and Standard & Poor’s. Bonds issued by the U.S. Government have significantly less risk of default than those issued by corporations and municipalities (see below for a discussion of the risk associated with convertible securities). However, the overall return on Government bonds tends to be less than these other types of fixed-income securities. Finally, reinvestment risk is the possibility that the proceeds of a maturing investment must be invested in a lower yielding security, all other things held constant, due to changes in the interest-rate environment. Investors should pay careful attention to the types of fixed-income securities which comprise their portfolio, and remember that, as with all investments, there is the risk of the loss of capital.

The Bloomberg Barclays Municipal Bond Index is a rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market.

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