WASMER SCHROEDER

Munis in the Time of Coronavirus

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A lot has happened over the past month and that's an understatement. With coronavirus becoming a global pandemic, drastic measures have been imposed on social interactions which will have a significant impact upon the economy, especially in sectors like travel and tourism. We have been getting numerous questions about the safety of the municipal market over the past couple of weeks. We continue to view the municipal market, as a whole, as one of the most resilient parts of the fixed income market in a recession, regardless of how it begins. While, like all recessions, rating downgrades will occur, we do not believe that there will be material defaults in the investment grade municipal space. It is also important to be aware that we expect Federal and state stimulus and we have already seen the beginning of these discussions in DC. It is our belief that stimulus will continue until this crisis is over and that state and local governments will be direct beneficiaries.

It is important to note that we are less sanguine about the high yield market. These issuers tend to have more leverage, less revenue flexibility, and less essentiality. While many will make it through this crisis just fine, it is possible default rates in the high yield and non-rated space will rise over the next 12 to 24 months.

Below is a brief summary of the major municipal sectors and our analysts' general opinions about their sensitivity to a coronavirus-led recession. They are by no means comprehensive and we continue to look at our holdings on a bottom up, issuer by issuer basis. As always, in times of volatility, please reach out to us as we are happy to discuss any particular questions you may have.

Most Stable	
General Obligations	– The timely payment of debt service is among the highest priority of state and local governments. – Debt service is typically not a large percentage of expenses, normally less than 5% of a budget and many times far less than that. – General fund reserves have been building for ten years with many issuers in better shape than they were going into 2008. – State and local issuers have diverse revenue sources and many levers to pull to maintain liquidity in the event of an economic downturn.
Water/Sewer	– Water and sewer systems are one of the most essential services in the municipal market. Water and sewer usage typically do not rise or fall greatly in recessions or expansions. – Water and sewer systems tend to have strong balance sheets, rate setting authority, and diverse customer bases. – Even when businesses and/or individuals have financial distress, these bills typically get paid due to the low cost and essentiality.

Most Stable (continued)	
State Housing Agencies	– Housing agencies tend to be highly overcollateralized with most loans guaranteed by the Federal government or its agencies. – During a crisis such as this, the need for social distancing creates more essentiality for homes and we believe that the Federal government, as they have already announced with HUD, will support housing agencies.
Dedicated Tax	– While there will be revenue declines in sales and personal income taxes, most deals have extremely strong coverage, many times higher than 10X debt service, so even large declines in revenues should not be a source of strain for debt service payments. – Areas of concern are single source revenues without diversity such as hotel taxes.
Utilities	– Utilities are one of the most essential services in the municipal market. While manufacturing will likely fall, most businesses and homes will continue to use electricity at similar rates. – Utilities tend to have strong balance sheets as well as rate setting authority, in addition to a diverse customer bases.
K-12 Education	– Education is a primary responsibility of state and local governments and to impair it would be inconsistent with one of its primary missions. – School districts have strong support from the state and local authorities where they reside, primarily through grants, capital and operating resource allocations, adequate per-pupil funding with stable property tax revenues.

Moderately Stable	
Higher Education	– Public universities have the advantage of generally strong direct state support in the form of annual appropriations and oversight. Given the broad emergency response we believe states would take extraordinary actions to support their universities if necessary. – Private school endowments represent a significant potential source of liquidity, assuming restrictions allow for the use of funds, or can be modified to allow for it. – The move to online education has been happening in the sector for years and is the foundation for how they've been able to deploy the technology as quickly as they have, often taking place during spring break (the timing for COVID-19's arrival in the US was somewhat fortuitous in this regard). – We see longer-term (fall 2020 and beyond) risks related to Room & Board revenues and international student enrollment. Any university with above-average reliance on either of these factors could potentially experience depressed revenues.
Sea Ports	– Given that ports, unlike airports, have comparatively minimal number of people working at them, the risk of coronavirus spreading is far lower. – Additionally, the need for global trade to continue is of the utmost importance and seaports play a vital role.

Less Stable	
Airports	– Airports are one of the most affected sectors. Estimates are that traffic could fall 70% or more. This pandemic has created a situation far worse than air travel declines post-9/11. – On a positive note, major airports have large reserves, diverse operating streams, and are essential to the functioning of the US economy. Despite virtually all major airlines defaulting post 9/11, no airports defaulted, although it took three years for air traffic to rebound.
Hospitals	– Large, diverse hospital systems have ample liquidity to weather an economic downturn. – There are concerns about rising unreimbursed care and worker shortages in the short-term. – Due to the fact that coronavirus is a medical related event, we would expect significant aid from state and Federal governments for hospitals to make sure they can maintain the quality of care during this period of crisis, as can already be seen by the recently passed bill funding coronavirus tests. – Revenue could be unfavorable due to prioritizing coronavirus victims over higher margin elective surgeries and other procedures.
Mass Transit	– The essentiality of mass transit makes it one of the most likely to see aid from state and Federal governments. Many large urban areas cannot function without a working mass transit system. – Mass transit systems all rely on revenue outside of farebox revenue, and this is a mitigating factor to ridership declines. – Downgrades in this space are likely, despite outside support, due to current and expected ridership declines for some period of time.
Toll Roads	– Toll roads will undoubtedly see lower traffic as all but essential service vehicles are on the road. Despite this fact, most major toll systems have significant liquidity to weather a long period of lower toll revenue. – In the long run, if gasoline prices stay low, traffic could increase thereby mitigating some of the short-term financial pressure in the toll road sector. – Small and single toll road systems will likely come under the most pressure in the short term and will likely have ratings downgrades sooner rather than later.

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Justin Land is President and is responsible for developing and monitoring the firm's tax exempt strategies, as well as overseeing the Municipal Research Department. Justin is a member of the firm's Executive, Portfolio Management, and Investment Committees, and the Municipal, Corporate, and High Yield Investment Committees. He also serves as a client resource for investment solutions.

Justin earned his BA in History from Florida State University. He was awarded the CFA Charter from the CFA Institute in 2003, and is a past board member of the CFA Society of Naples, where he served as President.

About the Firm: More than 30 years ago, Wasmer Schroeder was founded on the principles of an unwavering commitment to service and a dedication to managing fixed income the right way. From its beginning, the firm has held steadfast in its spirit of collaboration—doing what's right for the advisors, investors, and institutions for whom we manage money. We do right by doing right by them—knowing their businesses, understanding their goals, and consistently finding solutions to meet their needs. As an active fixed income manager with a team of investment professionals across tax exempt and taxable strategies, we are dependable, collaborative, and insightful in our approach. Backed by research and emboldened by technology, our hands-on team is a true partner to the advisors, investors, and institutions who give us their trust.