WASMER SCHROEDER

Honey, I Shrunk the Municipal Bond Market

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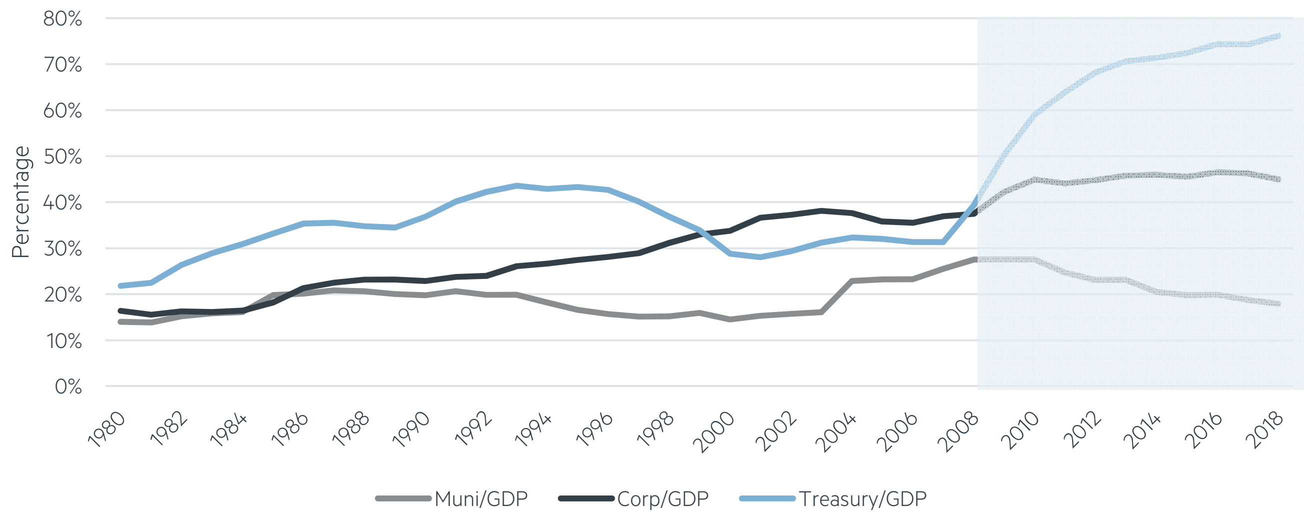
The 1989 comedy film, *"Honey, I Shrunk the Kids,"* is the story of a scientist father who accidentally shrinks his kids with an electromagnetic shrinking machine. Shrinking kids with an electromagnetic shrinking machine seems farfetched from reality. Deleveraging in the fixed income markets in the post-financial crisis era would also seem farfetched.

US Treasury debt, US corporate debt, sovereign government debt and student loan debt have soared since 2010. In 2019, the world is indeed awash in debt. However, during this same period, there has not been even a modest uptick in municipal debt. Remarkably, this market has *shrunk* over the past decade. This means that the many headlines detailing debt-driven municipal distress over the years in Jefferson County, Alabama; Detroit, MI; Hartford, CT and, of course, the Commonwealth of Puerto Rico do not represent the norm. As usual, the municipal bond market marches to its own drummer.

The Municipal Bond Market is Smaller No Matter How You Measure

Federal Reserve data shows outstanding municipal debt hitting a high mark of $3.96 trillion in Q4 2010 before declining to $3.82 trillion today. Similarly, the chart below shows the dramatic drop in municipal debt as a percentage of the economy, compared to the debt in the US Treasury and corporate markets:

Municipal Debt Versus US Treasury and Corporate Debt – Trends in the Past Decade



The chart above does not consider other liabilities such as public or corporate pensions, or federal entitlements.
12/31/1979 – 12/31/2018; Source: SIFMA

The dynamic driving the reduction in debt is relatively simple—there is more municipal debt maturing than is being issued. This mismatch has not always been consistent from year-to-year but it was the prevailing trend from 2018 through the first six months of 2019.

Dynamics Supporting Reduced Debt Outstanding in the Municipal Bond Market

	2018 Issuance	2018 Redemption	2018 Net Supply
January	18.70	-25.13	-6.43
February	17.52	-26.32	-8.80
March	21.34	-18.50	2.84
April	28.83	-22.90	5.93
May	26.90	-24.20	2.70
June	28.94	-43.07	-14.13
July	26.31	-43.67	-17.36
August	26.72	-44.89	-18.18
September	21.41	-19.60	1.82
October	35.54	-23.49	12.05
November	19.65	-24.66	-5.00
December	19.06	-27.73	-8.67
Total	290.92	-344.15	-53.23

6/25/2019; Source: Bloomberg

Why Has Muni Debt Fallen?

The reduction in municipal market debt is pretty remarkable considering the growth of debt in other areas of the economy. It is particularly remarkable when viewed against the backdrop of the infrastructure needs at the state and local level. We believe that there are a combination of factors that have resulted in less borrowing. Federal and state regulatory debt restrictions, which aim to protect taxpayers from imprudent debt issuance, certainly play a role, as detailed in the sidebar to the right. However, there are likely other reasons, as regulations have been in place for decades. Perhaps frugal taxpayers recovering from the scars of the Great Recession and loathe to approve debt-funded new projects is a consideration. Other factors such as the 2017 tax law that limits debt refinancing options for municipalities and economic conditions that have led to significant tax revenue growth have reduced the need to borrow. Deferring critical infrastructure costs typically funded with debt is also likely a factor. Another reason—though minimal, given the size of the tax exempt market—is that municipalities have made increasing use of direct lending from banks. Other factors, which do not provide for exciting headlines, include measured restraint by municipal government finance officers.

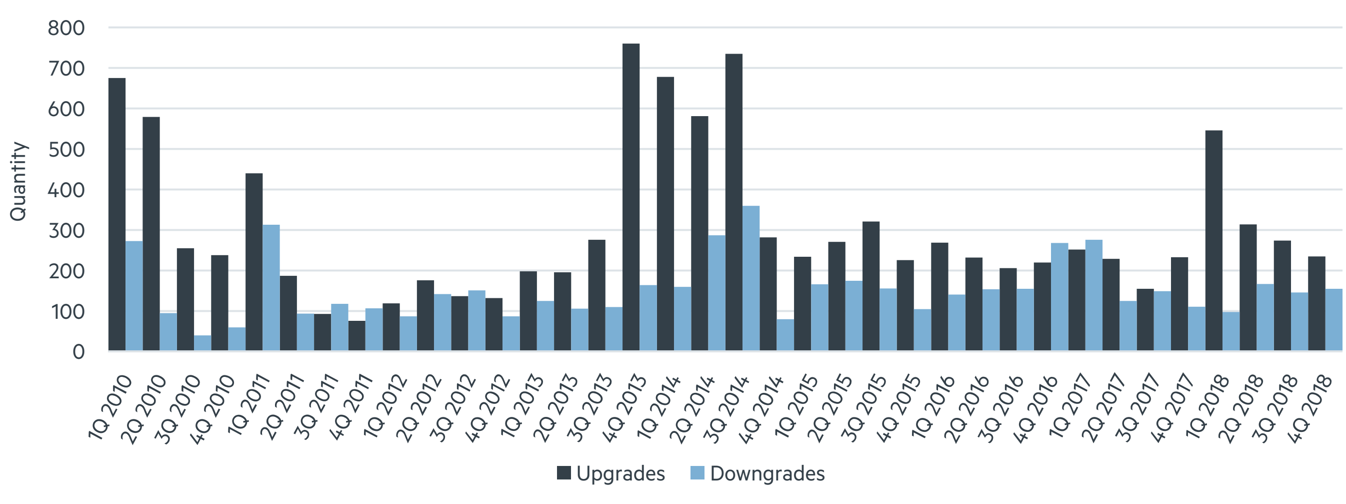
Is Reduced Debt a Credit Positive for the Municipal Market?

In the aggregate, we would view a lower debt level as a credit positive for obvious reasons—less debt means more financial flexibility. If public ratings are any indication, credit conditions have remained very stable in this period of frugal debt issuance. Specifically, the vast majority of S&P's municipal ratings are in the 'AAA' and 'AA' category, while upgrades continue to meaningfully exceed downgrades since 2010.

Federal and State Governments Regulations Limit Municipal Debt Issuance

The municipal bond market benefits from many so-called "belts and suspenders" which serve to limit municipal debt issuance. For example, almost all state and local governments are restrained by statutory debt caps. IRS regulations further limit the use of municipal tax-exempt debt to fund public purpose projects only. As a result, municipal debt tends to fund capital improvement projects, supported by financing structures that conservatively match the useful lives of the assets they finance. This matching of assets and liabilities stands in stark contrast to the methods used in the US Treasury and corporate markets. In those markets, debt is utilized for many different purposes, including financing working capital, dividends/entitlements and / or operating deficits. Unlike municipal bond amortization periods, these structures tend to mature in large bullets that are continually refinanced—often in perpetuity—which leads to higher leverage over the long term.

S&P Municipal Market Upgrades Versus Downgrades Since 2010



3/31/2010 – 12/31/2018; Source: Standard & Poor's Financial Services, LLC

There are situations, however, where maintaining a lower debt profile in lieu of funding critical priorities can be problematic. For example, we have observed instances where high legacy costs related to pension and healthcare have crowded out critical long-term infrastructure investments that are typically funded with long-term debt. Like ignoring maintenance on your car, putting off inevitable infrastructure costs will cost you more in the long run. These municipalities may appear to have lower debt in the traditional sense, as hidden liabilities associated with infrastructure needs will not be found on municipal balance sheets. Consequently, we continue to emphasize that the municipal market from a credit perspective is not a one trick pony. Credit analysts must take a deep dive to fully analyze the spectrum of credit metrics that support overall creditworthiness, including demographic, economic, legal, financial, and debt-related factors. This includes determining the affordability of a municipality's long term capital improvement needs.

Conclusion

The reduction in municipal debt during a period where the US has experienced a rapid economic rebound speaks to the regulatory, management and credit discipline associated with the municipal bond market. This is particularly notable when compared to the substantial increase in leverage in the US Treasury, corporate, and sovereign markets over the same period. In our experience, based on following our own municipal portfolio of more than 2,000 credits, we believe—with some notable exceptions—that the more conservative debt profiles of municipalities continue to support a market that is stable, strong, and enduring from a credit standpoint.

The other good news is that there is no evidence of an electromagnetic shrinking machine honing in on the municipal bond market.

But we will keep you posted on that one.

Reid Tomlin
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Reid Tomlin holds the position of Senior Municipal Analyst and is responsible for supporting the day-to-day functions of the Research department, as well as establishing and overseeing credit policy for Wasmer Schroeder (WS) municipal credit function. Mr. Tomlin has been a municipal credit analyst since his career began in 1989, and has held various senior positions at Standard & Poor's and several insurance companies.

Mr. Tomlin earned his M.S. in Financial Management from New York University and is a graduate of the University of California, San Diego. Mr. Tomlin serves as a board member for the Southern Municipal Finance Society, and Sailing Heals, a 501(c)(3) non-profit organization.