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How COVID-19 may affect your bond portfolio

Many retirees position Municipal Bonds as a form of income and balance to their overall portfolio. Historically, muni bonds have experienced a very low default rate. In fact, over the past 100 years, there has been one state that went bankrupt, Arkansas. This was in 1933, which occurred during the Great Depression.

Today is very similar to 1933, our debt to GDP is greater than 1933, the US is running a $3trillion dollar deficit and the Federal Reserve is printing money to try and reflate the economy.

In the middle of all of this, states and cities across the nation are struggling financially due to the cost of COVID-19. Many states and cities had issues even prior to COVID. COVID, however, hits municipalities from several directions. Real estate delinquencies rise and sales tax revenue falls.

Toll road and mass transit revenue also decline significantly. Meanwhile, the governmental cost of dealing with COVID is rising. Without some help from the Federal government, those municipalities that were already running deficits and/or had large debt burdens can find themselves in more dire financial straits fairly quickly.

Those managed more conservatively may not have similar problems right away, and can last longer, but ultimately will confront the same fate despite those conservative fiscal policies without help or an economic rebound.

The size of a bail-out for state and local governments is a major sticking point to cutting a deal between the Democrats and the Republicans. Here is where the differences lie:

The Democratic proposal (HEROES Act) includes about 1$ trillion to bail out strapped state and local governments burdened with COVID expenses and significant declines in revenue.The Republicans are of the opinion that $1 trillion is far more than is needed to offset COVID costs and lost revenue.

The issue here is that Republicans are determined to prevent COVID relief from being used to solve existing funding problems that have nothing to do with COVID, such as structural deficits and underfunded pensions. Republicans are currently offering no new funding for state and local government but would expand the existing CRF (Coronavirus Relief Fund) availability for local governments through fiscal 2021. However, these funds cannot be used for replenishment of rainy-day funds or state pensions.

Reality likely lies somewhere in between. Our municipal market contacts indicate that any package in the $300 to $500 billion range would be well received by the market. In addition, Moody's, a major bond rating agency, says:

*"Under baseline economic assumptions, we project that Congress and the White House will need to enact approximately $500 billion in additional flexible aid to states and local governments over the next two fiscal years to avoid major damage to the economy."***[1]**

In speaking to many large municipal bond money managers, they all seem to have the same tone; "Default will never happen". A lot has occurred financially over the past twenty years that many said would never happen, and it did happen.

We are certainly not suggesting to outright sell your municipal bonds, but it is extremely important to take the time to understand and assess what you own and the role it plays in your overall financial plan and portfolio. While we do not expect widespread defaults, we do expect the recent volatility in municipal bonds to continue until the issue of state and municipal funding improves.

Evaluate with your advisor if there is a risk of default on each bond you own if a stimulus deal is or is not passed. An additional step might be to consider diversifying your portfolio amongst some of the more financially healthy states versus being concentrated in one single state.

While you may lose the triple tax-exempt status on some bonds within your home state, protecting the principal from extreme volatility through diversifying the portfolio would be more important.

If you have a passive and/or laddered strategy that you or a broker have been managing, where you just "set-it and forgot it", you may want to take a more active approach going forward.

We are advising clients to work with us in conjunction with professional municipal bond managers that oversee the credit and interest rate risk simultaneously. At the same time, we are updating our due diligence on these managers. In any event, we suggest reviewing your municipal holdings through your advisor to ensure that your retirement savings is protected over the long-term.

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[1] Moody's Analytics published June 25, 2020