COVINGTON
CAPITAL MANAGEMENT

Please enjoy this update on the Municipal Bond Market from Katrin Doyle. Katrin has over 30 years of fixed income experience within the corporate and financial services industry. She is responsible for leading Covington's municipal bond research efforts.

Dear Valued Clients and Friends,

Historically, the municipal bond market or the "muni market," has remained fairly quiet and stable. That was until March 2020 when investors, worried about the impact of COVID-19 on the markets sold a record amount of muni bonds and muni bond funds. With investors enjoying tax-free income, state and local governments issue bonds to finance projects such as roads, airports, bridges, and schools in this $3.8 trillion municipal bond market. One difference separating the municipal market from other sectors of the bond market is that it is largely driven by retail investors who can be headline dependent. Retail investors account for 72% of municipal bond ownership. The selling caused by the headlines of the potentially detrimental economic effect of COVID-19 created significant dislocation and liquidity issues as well as opportunity. Subsequent intervention by the Federal Reserve Bank, as well as the U.S. Government, has stabilized that liquidity dislocation to the point where it is hard to believe we ever experienced the tremendous volatility in March.

Are My Muni Bonds Safe?

Most state and local governments are in much better financial condition than they were in 2008 (during the Great Financial Crisis) having added to reserve funds during this long economic expansion. California, for instance, has continued to build up its rainy day reserve fund, while paying down its wall of debt and retains its highest credit rating in decades. While the under-funded pension issues are a concern, these are long-term liabilities and the state continues to be proactive in addressing the shortfall and working on solutions (i.e. tiered retirement benefits, greater employee contributions). These solutions will take time to make an impact, but again, these are long-term liabilities. Municipal bonds do not default overnight. They deteriorate over time. Generally, before a credit rating downgrade occurs, bonds are issued a negative outlook which looks at the potential direction of an issuer over the next 6 months to 2 years. Keeping abreast of a municipal obligator's financial stability is what we do.

Can States File for Bankruptcy?

There are two reasons why state governments currently cannot use the federal bankruptcy system to reorganize their debt. First, the federal bankruptcy code does not allow state governments to declare bankruptcy. The second reason stems from the U.S. Constitution. Congress would have to amend the federal bankruptcy code to authorize states to repudiate debt, which we see as extremely unlikely. It is important to remember that municipal defaults are rare. During the period from 1970–2018, cumulative municipal defaults were approximately 0.1% compared to corporate defaults during the same period of 6.6%.

Covington's Municipal Bond Strategy

At Covington, we have always focused on high quality and highly-liquid municipalities with solid revenue flows and stable tax bases. We generally buy individual bonds with maximum maturities of 10-12 years, while also ensuring we are well diversified across many different segments of the municipal bond sector. We remain intensely focused on all of our municipal bond credits by reviewing each obligator, the specific revenue stream, and its current financial environment. The primary investment objectives are always principal preservation, stable income, and tax efficiency.

Our Outlook

We believe the current situation lends itself to be more of a downgrade story than a default story. While credit rating downgrades by rating agencies are likely to occur given the expectation of lower revenues in the near term, we may not necessarily need to sell bonds. One benefit of buying individual bonds in portfolios is that we can wait out any temporary price dislocation and receive the par value upon maturity. Having said that, we will continue to closely monitor each municipality we own, given this unprecedented economic situation and will be carefully trimming and exiting positions that we anticipate may experience significant challenges.

Be well and stay healthy!

Katrin Doyle

Managing Director & Portfolio Manager

Covington Capital Management is a SEC registered investment management company with over $3 billion under management, as of December 31, 2019, serving high net worth individuals and families as well as foundations, endowments, corporations, and retirement plans.

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