Timely insights on the issues that matter most to investors.

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Municipal Bonds | Volatility

Amid the coronavirus outbreak, are municipal bonds still a "safe haven"?

New York  - As volatility in the equity markets persists due to the expansion of the coronavirus outbreak, investors have turned to the relative safety of US Treasuries, driving yields lower. What does this mean for investors in municipal bonds?

Despite the Federal Reserve’s emergency 50-basis-point rate cut on March 3, the biggest one-time rate cut since the financial crisis in 2008, there’s still a great deal of uncertainty around how the bond market will react. Bond yields remain very low, and markets don’t seem to have faith that the Fed has done enough. As I evaluate the muni landscape, I observe three key things.

Municipal bonds may provide diversification, and they’re doing that now

Muni bonds can be a valuable building block of investor portfolios due to their tax advantages, low historical default rates and diversification benefits. Thus far, they’ve again exhibited negative correlation during the coronavirus outbreak, delivering a positive return as equities have plummeted.

As a result, investors owning muni bonds could have unrealized gains in their portfolios. We think they should carefully consider any attempt to reposition their holdings. Realizing these gains, especially net of taxes, may not be prudent if the reinvestment goes back into a "safe-haven" asset class.

For investors with long time horizons, it may be more advantageous to stay invested and focus on the book yield of existing holdings, that is, the rate at which they’ve put their money to work. Generally higher book yields will continue to offer some cushion against higher rates, while also helping to provide the relatively safe haven many investors still look for.

Lastly, with respect to new-money investments, patience may be appropriate, along with slowly taking advantage of more attractive entry points into the market.

Technical factors and retail sentiment may weigh on bond valuations

Once fear subsides, muni bond market technical factors may garner more attention. Historically, March and April tend to see a resurgence of new-issue supply from lighter issuance at the start of the year. That may be particularly elevated this year as issuers take advantage of record-low yields.

However, retail investors may begin to lose enthusiasm for the same reason, causing tax-exempt municipal bond funds to see accelerating outflows. While shifting such safe-haven assets doesn’t make sense, if equity markets erode further, investors may reallocate to risk assets. All this means that we’re likely to see some volatility in the muni bond market in the short to intermediate term. We view this as an opportunity.

The coronavirus outbreak will affect individual municipal sectors

One of the principal concerns of muni investors is credit quality. Depending on the
direction the coronavirus outbreak takes, it has the potential to affect some issuers' credit ratings. Let's look at how this could play out in five muni sectors.

**Hospitals**
If the coronavirus outbreak turns out to be similar to the typical seasonal flu, it could be modestly positive for hospitals. A bump in patient volumes could lead to revenue increases, assuming that hospitals effectively minimize the length of patient stays and treat more patients with good commercial health coverage than those with poor or no coverage.

Credit concerns depend on the extent of the impacts from the following factors:

- Cancellation or postponement of more profitable elective procedures and diagnostics out of contagion fears
- Disruption of the health care-related supply chain and consequent scarcity of such items as pharmaceuticals, medical supplies and protective gear
- Higher unbudgeted wage costs related to overtime

Large-scale, well-capitalized health care systems are more insulated from these concerns than stand-alone academic medical centers, community providers and rural hospitals with limited cash reserve cushions and weaker payer mixes.

**Transit**
With more companies imposing work-from-home mandates, public transit could be affected by less commuter travel. Other types of trips could also decline, since people will have more incentive to shop online to avoid crowds. Keep in mind that on January 20, public transit was suspended in Wuhan, China, due to the outbreak.

**Hotels**
The US economy continues to be robust. However, an economic downturn stemming from the coronavirus outbreak could have a deep negative impact on hotels and convention centers. A potential decrease in room prices and occupancy levels could reduce net operating income and thus stress coverage of debt obligations.
Bottom line: There continues to be a lot of uncertainty about the coronavirus outbreak, from how severe it will become to whether the monetary and fiscal response will be effective. The epidemic is a fast-developing story, and more volatility in risk-on asset classes may ensue. That’s why we believe that investors looking to their existing municipal bond holdings to provide a relatively safe harbor in the storm should stay the course. For new investors, it may be wise to invest patiently, since the prospects of weaker market technicals may lead to better buying opportunities. Finally, negative long-term trends may affect specific credits, reinforcing the need for professional due diligence in investors’ muni bond portfolios.

Diversification does not guarantee a profit or protection against a loss.

An imbalance in supply and demand in the municipal market may result in valuation uncertainties and greater volatility, less liquidity, widening credit spreads and a lack of price transparency in the market. There generally is limited public information about municipal issuers. Investments in income securities may be affected by changes in the creditworthiness of the issuer and are subject to the risk of non-payment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer’s ability to make principal and interest payments. As interest rates rise, the value of certain income investments is likely to decline.

Investments involving higher risk do not necessarily mean higher return potential. Diversification cannot ensure a profit or eliminate the risk of loss. Debt securities are subject to risks that the issuer will not meet its payment obligations. Low rated or equivalent unrated debt securities of the type in which a strategy will invest generally offer a higher return than higher rated debt securities, but also are subject to greater risks that the issuer will default. Unrated bonds are generally regarded as being speculative.

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