Rising U.S. Savings Rate:

Navigating the Municipal Bond Market

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Just when you think you know the ending, life abruptly rewrites the script. Until recently, America was the star of what Hollywood calls a “feel-good movie”: unemployment at historic lows, the stock market at historic highs, and soaring consumer confidence. Now because of a mutating, microscopic virus, sickening and killing a myriad of people worldwide and infecting the global economy, this country is in Act I of an unprecedented disaster film: a combination of *Outbreak* and *Titanic.* Suddenly, the federal government is fighting to contain the COVID-19 pandemic while feverishly bailing with both hands to try to right the listing ship of state. Numerous prognosticators predict a bleak economic future, perhaps the *Greater Recession*, the sequel nobody wants to the Great Recession, the financial catastrophe that took years to overcome. Besides groceries, a panicked populace has begun hoarding cash, which could ultimately affect select issuers of municipal bonds. Below, we examine the potential implications of the rising personal savings rate in the United States.

Personal Consumption Expenditures– April 2008-April 2020

Personal Savings Rate– April 2008-April 2020

Source: Bureau of Economic Analysis, St. Louis Fed, Data Report 30 April 2020

Saving: A Consumer Response to Crisis

Even in the Digital Age, this antique proverb still applies: “A penny saved is a penny earned.” Through his flimsy 18th century spectacles, Benjamin Franklin, the patriot and pithy “wealth manager” who made that adage famous, saw the virtue in safeguarding cash for contingencies, a valuable lesson instilled in Americans, usually in childhood. As the impact of the coronavirus crisis intensifies, however, we believe that an increasing U.S. personal savings rate (PSR) may endanger the already shallow revenue streams of many state and local governments and cause a drag on economic growth during the recovery period. The scale of the corona-virus emergency conjures frightening images of 2008, when the collapse of the U.S. economy, virtually overnight, caused a sharp selloff in the equity market, raising levels of fear. Such traumatic events have typically meant less spending and more saving among U.S. consumers. The Personal Consumption Expenditures chart shows deep declines in consumer spending, a major component of U.S. Gross Domestic Product, in response to the downturn 12 years ago. The Personal Savings Rate chart shows the erratic fluctuation of the PSR and its notable uptrend during the same period. Fearful households spent significantly less on goods and services and set aside larger portions of their disposable incomes as cushions against layoffs or other crisis-driven financial pressures. After peaking in December 2012, the PSR has normalized since then to relatively range-bound levels (between 6.5% and 9%). If the historical pattern recurs, as it seems to be, the economy may buckle anew from the far-reaching effects of this latest calamity.

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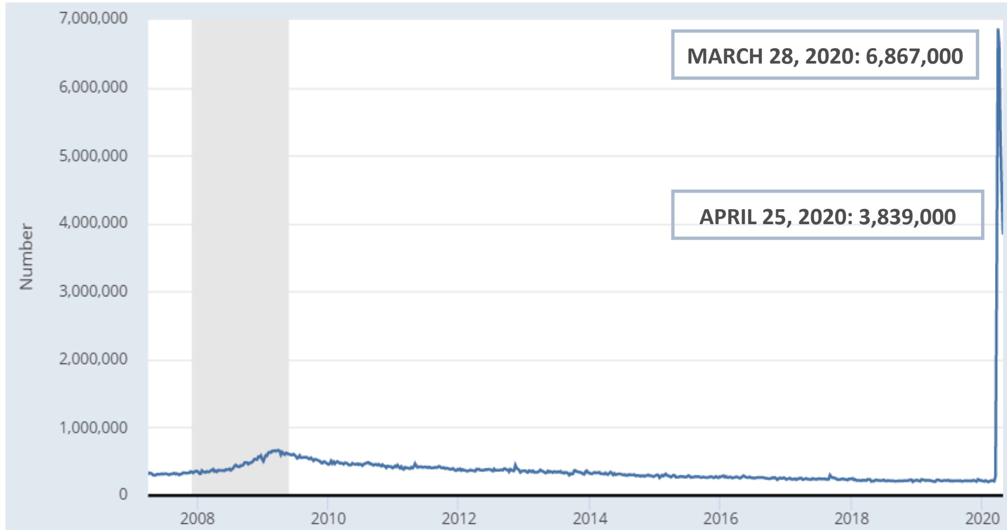
As restaurants, hotels, gyms and other local business shuttered nationwide in an attempt to limit contact and exposure, thus slowing the spread of the deadly virus, 3.8 million Americans filed for unemployment benefits during the week ending April 25th. This brings the rolling six-week total to 30.3 million as COVID-19 pressures have resulted in a deep unemployment crisis in the U.S. Combined with those that were already unemployed before the shutdown, the figures indicate a real unemployment rate above 20%, the highest level since the Great Depression.

Initial Jobless Claims; April 2007– April 2020



Source: Bureau of Economic Analysis, St. Louis Fed, Data Report 30 April 2020

To support workers and businesses, large and small, and prevent another economic cave-in, Congress and President Trump have approved four stimulus packages totaling $3 trillion of injected relief. Most notably, The Coronavirus Aid, Relief and Economic Security (CARES) Act provides direct payments to individuals and couples based on various factors and also supplements unemployment benefits. The results of recent polls indicate that many Americans primarily plan to save the funds or pay down debt. But as unemployment rises, expect consumer spending to fall considerably, thereby significantly reducing sales taxes, the lifeblood, along with property taxes, of state and municipal governments. Despite passing the largest stimulus measures in U.S. history to help contain the economic damage from coronavirus, state and local governments still require funding in an effort to avoid deep spending cuts that may further impact unemployment claims if governments are forced to cut workers from their payrolls.

"states have the ability to make adjustments to their budgets in an effort to satisfy their bondholders"

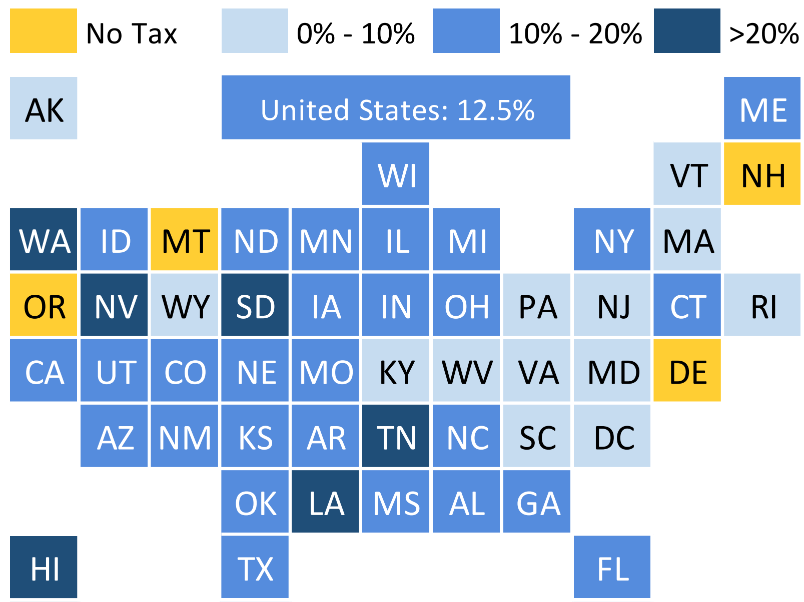
It is important to note that if states don't receive the federal grants they've been lobbying for, they have the ability to make adjustments to their budgets in an effort to satisfy their bondholders. Assuming their access to public debt markets remains intact, states can raise short-term funding to meet liquidity needs potentially bridging any gaps until income taxes are received in July. In addition, the Fed serves as a backstop through the Municipal Liquidity Facility, which enables the Fed to purchase short-term notes directly from states and some local governments. Outside of Fed assistance, state and local governments may also utilize certain tools to stave off bankruptcy, such as the ability to furlough or layoff workers, shelve capital plans, and cut or delay funding to downstream governments and agencies. For instance, the City of Cincinnati recently furloughed 20% of its workers in an effort to offset expected declines in tax revenues associated with COVID-19 pressures. Generally, states and cities do not run budget deficits like the federal government. New York City, as with many state and larger city governments, has an annual requirement to balance its budget and extends its budget planning process over a several-year period making both short and longer-term adjustments to address any budgetary shortfalls. State and local governments are used to making difficult budget decisions. Absent the granting of new congressional authority, bankruptcy is not an expected option for most states to address COVID-19 impacts and resulting budgetary shortfalls.

Implications of Sales Tax Slowdown

Even trillions in stimulus money, anticipated backstop measures by the Fed and aggressive budgeting tactics may not sustain the financial health of select municipal issuers. A significant loss of sales tax revenue may impair the credit and financial stability of some municipal and state governments, particularly those with a higher reliance on sales taxes, and where revenue shortfall is projected in part due to massive closings of restaurants and bars, the cancellations of lucrative events, and the disruption to tourism. Also, declining investment returns likely will make it harder for states with enormous pension liabilities to meet those obligations. However, to offset reductions in revenue, those states and municipalities are likely to resort to unpopular solutions like cutting spending, accessing reserves, or raising property taxes.

General Sales Tax Revenue

Share of State and Local General Revenues; FY 2017



Source: Data from U.S. Census Bureau Annual Survey of State and Local Government Finances; April 4, 2019

Navigating the Municipal Bond Market

Situations such as these, underscore the importance of professional, active management and in-depth credit research. Within this environment, APA continues to remain highly selective; focusing on issuers with strong reserves, above average Days Cash on Hand (DCOH) and low levels of debt, and particularly within sectors that we believe may be more insulated from the potential for credit deterioration and credit rating downgrades. Additionally, select municipal securities have additional backstops for investors, including state guarantees, backing by permanent school funds, etc. *For more information on this topic, read our recent white paper, "Sector Selectivity", published April 2020.*

In uncertain times, when investors require reassurance and want sanctuary for their portfolios, municipal bonds are generally considered a safe-haven asset class, given their lower default rate relative to other asset classes, such as corporate bonds. It is our belief that an emphasis on high-quality, investment-grade municipal bonds, in a professionally managed account, can reduce the risk of default and exposure to the dynamics of mainstream markets. As always, APA will continue to focus on preserving the wealth of our partners and clients.

For more information about Asset Preservation Advisors customized portfolio management, please contact: ContactUs@AssetPreservationAdvisors.com, (404) 261-1333