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Alert: Politics Is A Contact Sport

The Empty Threat of State Bankruptcies

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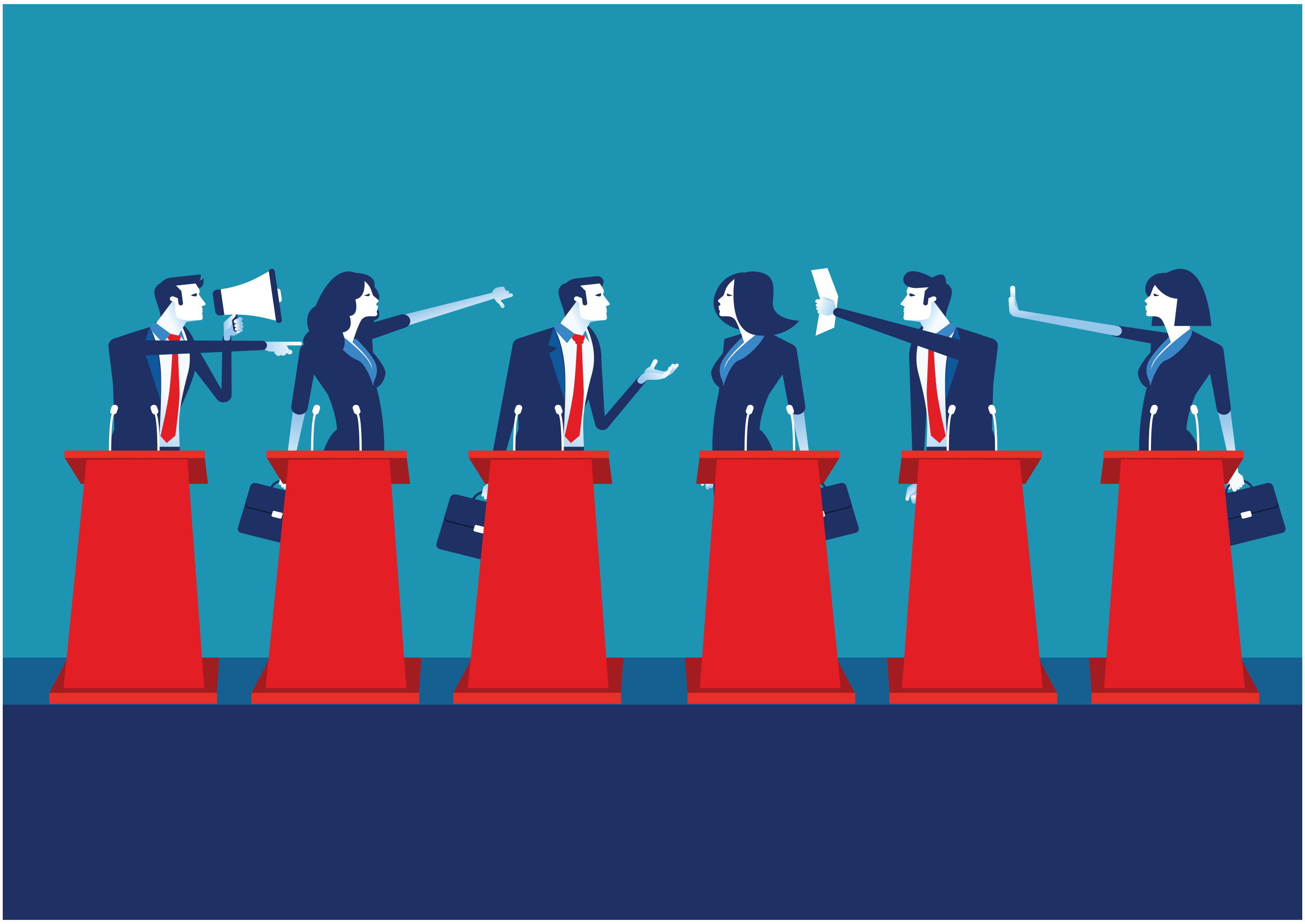
Executive Summary

- State bankruptcies would face significant legal and practical hurdles
- States neither need nor want to declare bankruptcy
- Flareup due to political negotiations over aid, checks are not going to start bouncing
- Given our lower-for-longer rate outlook, we're still adding long-dated municipal bonds



In a widely-publicized Wednesday 4/23 radio interview, Republican Senate Majority Leader Mitch McConnell caused a stir with comments suggesting he's open to allowing state governments to file for bankruptcy to navigate the financial impact of the COVID-19 pandemic:

> *"I think this whole business of additional assistance for state and local governments needs to be thoroughly evaluated… There's not going to be any desire on the Republican side to bail out state pensions by borrowing money from future generations."*
>
> *"I would certainly be in favor of allowing states to use the bankruptcy route. It saves some cities. And there's no good reason for it not to be available. My guess is their first choice would be for the federal government to borrow money from future generations…"* [1]

In this Alert, we'll discuss the practical hurdles that would arise in any potential state bankruptcy, why it's unlikely, and the motivations behind the Majority Leader's public remarks.

[1] https://www.nytimes.com/2020/04/22/us/coronavirus-mcconnell-states-bankruptcy.html

Theory vs. Practice

Here are several reasons why we think the possibility of pandemic-related state bankruptcies is an empty threat:

- **Questionable Legality:** States can't currently file for bankruptcy; the section of the federal bankruptcy code which covers local municipal governments (Chapter 9) doesn't apply to states. Any attempt to do so would require changing federal laws, which seems highly unlikely in the current environment.

Practically, it's dubious whether it's even theoretically possible to have a federal process for state bankruptcies; without getting into the weeds, there are several legal hurdles that arise from our federal system of government, in which the national and state levels coexist as "dual sovereigns."

Given the limits of federal authority over many state powers, it's a thorny dispute as to whether and to what extent the federal government could intervene in such a situation. Since no state has defaulted on any of its obligations since the Great Depression, there's no modern precedent.

- **Bankruptcy Not Needed**: Of course, legal constraints aren't the whole story; "tails don't wag dogs" and the strongest legal protections imaginable can't protect bondholders if a state simply doesn't have enough money to pay its debts.

Although the pandemic's impact has been swift and severe, the challenges facing states aren't nearly that drastic. It's true that major revenue sources such as income and sales tax receipts have been greatly delayed and/or reduced, while at the same time expenses are accelerating – but that's a familiar pattern that's apparent at the outset of every economic recession.

Over the preceding decade-long economic expansion, many states took the opportunity to replenish and increase rainy-day reserves; these funds are now being deployed to partially offset the current financial blow. The recently-passed CARES Act will send up to $150 billion of crisis-expense reimbursements to be split among state and local governments. In addition, the Federal Reserve is newly empowered to extend cash-flow loans to states. This adds up to a lot of financial resources that are already helping.

Theory vs. Practice

Although the full fiscal impact of this crisis isn't yet known, every state has experience working through and surviving many previous economic downturns. Recessions take their toll, including the potential for credit rating downgrades, but they don't make states insolvent. History tells us that states tend to react to downturns by cutting discretionary spending from their budgets, which usually involves painful reductions in politically-popular programs and services. Naturally, raising taxes is also possible, but it's usually not the first lever to be pulled.

Recently we've heard from certain governors that their states are "broke." But they're not broke in the sense of being fundamentally insolvent – rather, what they mean is that business as usual is no longer possible and unfortunate sacrifices will be needed. Discretionary programs will invariably land on the chopping block long before "mandatory" spending – such as debt service payments on bonds.

- **Bankruptcy Not Wanted:** A bedrock principle in municipal analysis is that creditworthiness is a function of both ability and willingness to pay. Regardless of merit, if a sovereign entity digs in its heels and refuses to pay its debts, even an eventual bondholder victory in the courts will prove costly and time-consuming. It's far better for both bondholders and issuers to be on the same page.

In that regard, it's noteworthy that Senator McConnell's remarks have been roundly condemned by state-level officials of both parties. Here are a few selected quotes from governors of the hardest-hit states:

New Jersey Governor Phil Murphy (Democrat): *"Completely and utterly irresponsible… You have my word. We won't go bankrupt. But you know what will happen? We will gut the living daylights ... out of the services — the exact services — that our citizens need right now."*[2]

New York Governor Andrew Cuomo (Democrat): *"It's one of the dumb[sic] statements of all time…how are we supposed to reopen if you want me to declare bankruptcy? It makes no sense on any level"*[3]

Maryland Governor Larry Hogan (Republican): "*Mitch McConnell probably regrets saying that. If he doesn't regret it yet, I think he will regret it…the last thing we need in the middle of an economic crisis is to have states all filing bankruptcy all across America and not able to provide services to people who desperately need them."*[4]

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2 https://www.politico.com/states/new-jersey/story/2020/04/22/murphy-mcconnells-suggestion-states-declare-bankruptcy-utterly-irresponsible-1279126
3 https://www.cnn.com/videos/politics/2020/04/23/andrew-cuomo-mitch-mcconnell-blue-state-bailout-coronavirus-intv-cpt-vpx.cnn
4 https://www.washingtonpost.com/powerpost/mcconnell-takes-flak-after-suggesting-bankruptcy-for-states-rather-than-bail-outs/2020/04/23/f70311fe-8560-11ea-a3eb-e9fc93160703_story.html

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Senator McConnell's comments weren't unprompted speculations; they were a calculated opening gambit in the political negotiations for the next round of federal handouts.

Although significant state and local aid has already been provided under the CARES Act, it's common knowledge that both Congressional Democrats and prominent state and local leaders are pushing for more. The day prior to Senator McConnell's comments, the National Governor's Association sent a public letter to Congress requesting a staggering $500 billion in additional aid that "allows for replacement of lost revenue."[5] *For context, $500 billion would represent over 50% of combined state general fund spending over the previous fiscal year.*[6] Although it's still too early to gauge the full scope of the pandemic's impact on finances, asking for over 50% "revenue replacement" is an aggressive ask in its own right. The goal posts have been set.

Given this context, it's apparent Senator McConnell's remarks the next day were a countervailing response –a pushback to set the boundaries of the debate. High-stakes negotiations often involve brinksmanship and trading (particularly in an election year), and this is likely an attempt to set up a trade of more state and local aid in exchange for also funding the priorities of Congressional Republicans (e.g. a payroll tax cut).

Indeed, in a different set of comments on Wednesday 4/22, Senator McConnell softened his language and walked back portions of his previous ones, clearly opening the door to a compromise:

"We'll certainly insist that anything we'd borrow to send down to the states is not spent on solving problems that they created for themselves over the years with their pension programs." [7]

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5 https://www.nga.org/policy-communications/letters-nga/governors-letter-regarding-covid-19-aid-request/
6 National Association of State Budget Officers, November 2019, Fiscal Year 2019 general fund spending statistics: https://higherlogicdownload.s3.amazonaws.com/NASBO/9d2d2db1-c943-4f1b-b750-0fca152d64c2/UploadedImages/SER%20Archive/2019_State_Expenditure_Report-S.pdf
7 https://www.nytimes.com/2020/04/22/us/coronavirus-mcconnell-states-bankruptcy.html

Treasury Partners View

In the coming days and weeks, look for both sides' future quotes on the issue to focus on finding common ground – establishing the size of future aid payments, setting boundaries on permitted uses of funds, etc. It's very likely additional direct federal aid to states will be forthcoming, although its magnitude and conditions on permitted use of funds may generate sharp public debates. In any case, further talk of state bankruptcies, a red herring from the start, should soon fade.

In the meantime, our overall outlook for fixed income remains the same. The stage is set for rates to stay "lower for longer" after this crisis, as an interventionist Fed, recessionary economic conditions, and the carryover effects of a massive global overhang of debt will combine to make rising rates an unwelcome prospect that central bankers will aggressively seek to prevent. But in the meantime, both corporate and municipal yields are elevated and present attractive opportunities to lock in higher yields.

In particular, for those clients who can benefit from the tax-exemption, we've been aggressively extending maturities and buying longer-dated municipal bonds. Although absolute levels have come down considerably from their liquidity-crisis spike of several weeks ago, high-quality munis with long final maturities but 5-10 year call options are still available at tax-exempt yields 1.5-2% higher than the yield on federally taxable 10-year Treasuries. For context, in more normal times, yields on such munis typically yield (at most) 0.25-0.75% more than 10-year Treasuries. We expect this temporary dislocation to slowly normalize before the end of the year.

As always, we thank our clients for your continued support, and appreciate and confidence and trust you place in us in managing your assets. Please feel free to reach out to your advisor if you wish to discuss how this, or any other developments during this unprecedented time, impact your portfolio.

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