



# How Politics Makes the Difference Between Municipal and Corporate Bonds

by the Standish US Municipal Bond Team

Many of the factors that analysts consider when evaluating the credit quality of a municipal-bond issuer are similar to those used in corporate-bond analysis. These include the sources of the issuer's income, the strength of its balance sheet, its vulnerability to changing economic conditions and the quality of its budgeting and oversight processes. Corporate analysts must focus on stock repurchases and the potential for a merger or acquisition, while municipal-bond analysts must pay close attention to politics. While the fortunes of corporations can sometimes rise and fall due to the actions of policymakers, the political risks that corporate bonds are exposed to are smaller than those of municipal securities issued by government entities that are creations of the political process itself.

Unlike countries where national governments provide most public services, the US is a federal system with a complex and decentralized structure of states, counties, cities and public agencies, which may issue bonds to fund capital projects and which are usually headed by elected officials. Understanding the unique political dynamics of these issuers and how they affect creditworthiness is essential for investors who are considering allocations to US municipal bonds. Gaining this knowledge requires painstaking fundamental research by

managers, rather than mere reliance on rating-agency reports or financial statements.

While financial managers employed by governments seek fiscal stability, budget flexibility and lower borrowing costs, they must balance these objectives against the competing political priorities of elected officials. These may include cutting taxes, minimizing fare hikes or improving services that result in lower revenue or increased spending. The tension between maintaining fiscal restraint and providing constituents with services is designed to be reconciled through an established budget process. In practice, however, political agendas can also influence the decision-making process. Understanding the confluence of these rival priorities is a key corollary to the financial analysis performed by municipal-credit analysts. For example, the margin of support from voters or municipal officials for an initiative can give insight into the priorities of the community.

Regardless of their state of fiscal health, cities, towns and school districts must always balance many competing demands in their budgets. Parents want more educational programs, property owners want lower taxes, and municipal workers want job security and retirement benefits. All tend to be organized and vocal in expressing these wishes.

The more that elected officials recognize the importance of conservative fiscal practices, the more likely the municipality will maintain its financial good health in the long run. To evaluate whether officials are following good budget practices, analysts compare operating budgets with actual spending and revenues, as well as assess whether required 'rainy day' reserves have been funded and whether multi-year capital budgets are in place. Reviewing the ability of financial managers to maintain budget discipline and establish strong reserve policies gives insight into the political and managerial climate of the municipality. We have witnessed the result of a lack of financial conservatism in the current pension crisis where short-term contract agreements have created long-term budget problems.

Another key factor that municipal-credit analysts look at is fiscal status and the nature of relations between levels of government. Many local governments receive substantial financial support from state governments. When the fiscal and social priorities of the governor and the legislature are closely aligned with those of local leaders, it is less likely

that the state government will try to pass down costs to local governments through unfunded mandates. In Illinois, the Republican governor and the Democrat-led city of Chicago have clashed, which has contributed to the continuing financial distress of Chicago public schools. States experiencing fiscal stress may also choose to balance their budgets by cutting state aid to local governments or school districts.

On the state level, political influences can also play a major role in improving financial results. In California, the governor and the state legislature made it easier to approve budgets and convinced voters to pass temporary sales and income tax increases earmarked for paying down accumulated debt. As a result, the state's general obligation (GO) rating rose from BBB to AA-. In New Jersey, on the other

hand, many years of unfunded pension obligations have produced a difficult political situation where GO ratings have dropped from AA to A- with a negative outlook. New Jersey's governor has promised not to raise taxes, painting himself into a corner politically and forcing the state to cut services in order to address pension underfunding; the fiscal uncertainty may be causing businesses and individuals to leave the state.

In unusually severe fiscal distress, political considerations can become even more pronounced. Demands from voters for tax relief can clash with government responsibilities to provide services and maintain infrastructure. In those cases, evaluating the government's credibility with citizens and how well it has historically used its reserves will be important in determining its creditworthiness.

While both municipal and corporate-bond analysts consider economic and financial factors, municipal analysts must look at the willingness of issuers to make politically tough choices between fiscal conservatism and service delivery. Issuers with firm policies regarding funding reserves and clear parameters for utilizing them can demonstrate that they have institutionalized that conservative approach. The municipality's financial statements may attest to its leaders' willingness to do this in the past, but analysts must also gauge its willingness to continue doing so in the future in order to provide a complete credit analysis of the state or local government.

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