16TH AMENDMENT ADVISORS LLC℠

State Municipal Bonds and Bankruptcy

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Earlier this week in a radio interview, Senate Majority Leader Mitch McConnell indicated that he saw no reason why states should not be allowed to declare bankruptcy. Not surprisingly, this set off an alarm among municipal investors and caused a lot of financial professionals to brush up on their understanding of the US Bankruptcy Code and how it pertains to US States. *Although we believe that select states and municipalities could be under some rating pressure and heightened media coverage over the next year or so, we do not believe there will be a systemic risk to defaults and we don't see bankruptcy as a realistic scenario for states.* In addition, we suspect there will be some liquidity pressure on select credits and structures in the market. To this end, we view this as a strong argument for the return to active management of municipal portfolios from passively managed ones.

Our current view is that McConnell's statement is designed to position himself for the future debate with the Democrat party regarding aid rather than actually setting policy. He seems to be focused on limiting Federal help to coronavirus relief as opposed to solving state's long-term pension problems. As a legal matter, US states cannot declare bankruptcy as there is no provision in the US bankruptcy code. As a result, it would likely involve an act of Congress which we suspect is highly unlikely. The idea of state bankruptcy was brought up after the last recession and was met with heavy criticism and was dropped after a single hearing in the House.

There are other considerations which make declaring bankruptcy difficult. For a state to declare bankruptcy, it would have to fail a solvency test. Currently 49 out of 50 states have balanced budget requirements which make this prospect difficult. States and municipalities have diverse revenue streams that have been historically well insulated from economic shocks. States and local governments have the ability to raise taxes and set higher rates on many essential services which provides the ability to raise revenues when needed. States also have the ability to reduce spending and to borrow as necessary.

We would also point out the moral hazard involved in permitting states to pursue bankruptcy. The municipal market is one characterized by stable finances, balanced budgets and low defaults. To allow a state to wipe away these obligations would have a grave impact on the market and the future of municipal finance and political decision making.

During these times of crisis, we find it useful to look at history and how municipal credits have changed over nearly 50 years. The table below is highly instructive. It looks at the average change in municipal credit rating over a one-year time horizon. The "Y-axis" is the "From" rating and the "X-axis" is the "To" rating. So, the probability of a "Aa" credit going to "A" over the course of a year is 1.04%, to "Baa" is 0.2% etc.

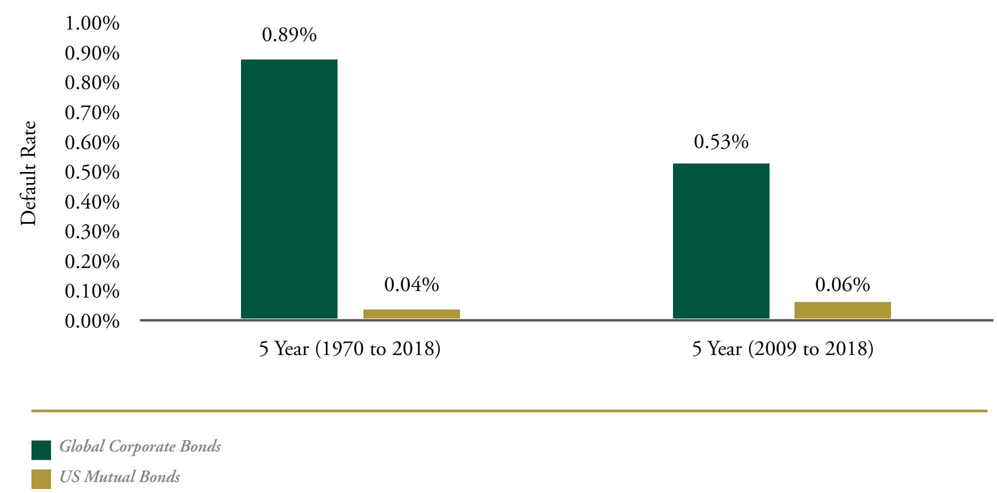
MUNICIPAL BOND RATINGS: AVERAGE ONE-YEAR TRANSITION RATES, 1970 TO 2018

FROM/ TO	COUNT	Aaa	Aaa	Aa	Baa	Ba	B	Caa-C	w/ DRAWN	DEFAULT
Aaa	1,008	94.80%	1.19%	0.11%	0.03%	0.01%	0.00%	0.00%	3.86%	0.00%
Aa	6,981	0.32%	94.65%	1.04%	0.20%	0.01%	0.00%	0.00%	3.96%	0.00%
A	4,877	0.03%	1.79%	92.77%	0.60%	0.13%	0.01%	0.00%	4.65%	0.00%
Baa	672	0.02%	0.07%	3.35%	89.47%	1.72%	0.22%	0.04%	5.07%	0.03%
Ba	111	0.04%	0.23%	2.14%	4.77%	80.35%	2.76%	0.65%	8.83%	0.23%
B	23	0.00%	0.25%	0.94%	1.05%	5.52%	76.09%	5.32%	8.11%	2.71%
Caa-C	11	0.00%	0.00%	0.73%	0.25%	1.55%	2.62%	72.61%	13.74%	8.50%

Source: Moody's

In the graph below, Moody's charts the 5-year default for Global Corporate Bonds and for US Municipal Bonds. The story is much the same. Municipal bonds are monopolies often with taxing and rate setting power. This drives their exceptionally low default history.

MUNICIPAL INVESTMENT GRADE CUMULATIVE 5-YR AVERAGE DEFAULT



So how are we responding? Across all our portfolios, we are looking to upgrade credit quality and structure where necessary. This means to avoid or sell those credits that may be most vulnerable to credit downgrades and buy/replace with essential service credits and certain general obligation bonds. As of March 31, 2020, approximately 97% of our bonds were rated AA or higher in our flagship Long Relative Value Strategy.

Once again, the market volatility brought upon by the COVID-19 pandemic is an important reminder of the value of having a professionally managed portfolio where proactive management is a key element.

We are happy to answer any questions you may have.