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U.S. Municipal Bond Market

Rating Agencies - Assessing Ability and Willingness in the New COVID-19 Normal

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Summary

- For now, the new COVID-19 normal and social distancing will continue. Uncertainty in the near team remains for the status of the health of citizens nationwide and the economy.
- The events of recent weeks have sent most state and local governments and other municipal entities into overdrive. The priority for governments has been to concentrate on the most basic but important issues for its citizens. It is only when these needs are able to be met that governments are then able to move on and assess the potential financial impact of the new COVID-19 normal.
- This is just the beginning of the new COVID-19 normal, and the rating agencies are charged with the responsibility of defining and assessing issuers' abilities and willingness as it unfolds.
- The internal process each rating agency uses is different, and we also should recognize that not only are the rating frameworks each agency uses unique, but the methods each agency uses to collect and ultimately assess issuer credit quality are also unique.
- We anticipate that in the coming days, weeks, and months, analysts from the rating agencies will continue trying to make sense of the new COVID-19 normal.

The New COVID-19 Normal

The global pandemic coronavirus (COVID-19) outbreak has caused widespread action throughout the U.S. It is a global healthcare crisis the modern world has not seen and only contemplated in movies and in doomsday scenario preparations. Last weekend, the White House's Coronavirus Task Force forecast U.S. casualties could be between 100,000 and 240,000.[1] President Trump said the U.S. is, "In the midst of a great national trial unlike any we have ever faced before" and that the next two weeks would be "painful."[2] There have been a total of 400,549 coronavirus cases reported in the U.S., 12,857 deaths, and 21,711 recoveries to date.[3]

The events of recent weeks have sent most state and local governments and other municipal entities into overdrive. The priority for governments has been to concentrate on the most basic but important issues for its citizens. It is only when these needs are able to be met that governments are then able to move on and assess the potential financial impact of the new COVID-19 normal.

Much of the country's 330 million citizens are under some sort of shelter-in-place guidance. Therefore, mostly only essential services are up and running as many others work from home. The impact to the U.S. economy has been significant and unprecedented. About 10 million workers in only two weeks have hit unemployment, more than during the entire Great Recession of 10+ years ago. The Federal Reserve Bank of St. Louis wrote that total unemployment could rise to 32%, making almost 53 million people unemployed by the end of the second quarter of 2020.[4] This would be more than the U.S. saw in the Great Depression of the 1930s. The St. Louis Fed wrote, "These are very large numbers by historical standards, but this is a rather unique shock that is unlike any other experienced by the U.S. economy in the last 100 years." Former Vice President and current Presidential candidate Joe Biden said, "the economic recovery from the coronavirus would likely be the 'biggest challenge in modern history,' suggesting it could surpass what the country faced after the Great Depression."[5]

There are few details about how or when the economy could ramp back up. For now, we are left with Dr. Anthony Fauci's (director of the National Institute of Allergy

Please see disclosure starting on page 4.

and Infectious Diseases) guidance, who last week said, "You've got to be realistic, and you've got to understand that you don't make the timeline, the virus makes the timeline."[6] This week, Dr. Fauci noted that whatever getting back to normal looks like is going to be different than before the COVID-19 contagion.[7]

For now, the new COVID-19 normal and social distancing will continue. And uncertainty about what the near-term holds remains.

Governments Scrambling in New COVID-19 Normal

The events of recent weeks have sent most state and local governments and other municipal entities into overdrive. The recent priority for government is responding to the immediate health crisis. Current priorities mean concentrating on even the most basic but important issues like access to information about health guidelines, general security, food access, housing, and primary, secondary, and higher education. It is only when these needs are able to be met that governments are then able to move on and assess the potential financial impact.

The events of recent weeks have sent most state and local governments and other municipal entities into overdrive. The recent priority for government is responding to the immediate health crisis.

Many municipal entities were ramping up or already in the process of preparing for the current budget cycle. Some, like Virginia, are calling a, "time-out" on spending in order to assess the accumulated damage and project what may be coming down the path.[8] The impact to date (remember, only a few weeks so far) of the grind of the U.S. economy is more known in some sectors than others. We already know for example that mass transit ridership is taking an extreme hit, airports are virtually empty, and convention centers and anything related to tourism are also highly pressured. We are also expecting that state government budgets will be dented. Sales taxes make up about one-third of state revenues and they are going to fall. Fort Worth, Texas is expecting sales tax revenue could fall 30% in 2020, for example.[9] Income taxes make up about another third of state revenues, and this source is going to fall at potentially an unprecedented pace as a result of the mass layoffs we have already seen, and will see. Stock market losses mean there will be capital losses on quarterly tax returns reducing revenues in states more dependent upon this stream. This state pain will flow through to other sectors, such as local governments and higher-ed, as state aid is reduced or eliminated. And those sectors are going to have their own revenue issues to track. There is also a strong potential for late budget adoption at the state level, which would absolutely impact the budget and planning process for entities in sectors such as local government, school districts, healthcare, and public higher-ed.

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Ratings Agencies Assess Ability and Willingness in the New COVID-19 Normal

That is where the rating agencies come into the picture. The first and second quarter of the year is typically considered audit season for municipal analysts and for those at the major rating agencies. For those entities who ended their fiscal year in June 30, 2019, it is during the first quarter when audited financials are finally released.[10] Audit season is typically a busy time at the rating agencies.

When the new numbers come in, the analysts update their models. If additional information is required because the complete picture is not clear, then sometimes an email is sent and/or a phone call made. From time to time an additional request for information comes as a result or clarification when new items are asked for. In practice, the majority of the time an entity's economic, financial and debt profile remains "Stable" and the current rating is affirmed. Other times, it is necessary for the ratings analyst to recommend an outlook or rating change because credit fundamentals have changed since the review. This is how a rating outlook could be raised or lowered or how upgrades or downgrades assigned. We should point out that the internal process each rating agency uses is different. And we also should make sure to recognize that not only are the rating frameworks each agency uses unique, but the methods each agency uses to collect and ultimately assess issuer credit quality are also unique.

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All things being equal, this is the time of year when many issuers have a better chance of receiving a phone call from one of the four rating agencies, just because of audit season. Now, the chances of receiving a phone call or inquiry from the rating agencies is heightened because of the new COVID-19 normal.

The new COVID-19 normal has already resulted in unprecedented rating agency action (see below for the sector guidance). We anticipate that in the coming days, weeks, and months, analysts from the rating agencies will continue trying to make sense of the new COVID-19 normal. This is just the beginning of the new COVID-19 normal, and the rating agencies are charged with the responsibility of defining and assessing issuers' abilities and willingness as it unfolds.

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Relevant Recent Moody's Investor Service Activity

- Moody's lowered its outlooks on the: Non-Profit, U.S. Ports, Toll Road, Airport, Non-Profit and Public Healthcare, and Higher Education sectors to "Negative" in recent weeks.

SP Global: "Negative" Outlook for All U.S. Public Finance

- SP Global Ratings assigned "Negative" outlooks to each of its U.S. Public Finance sectors, April 1, 2020.

Fitch Ratings

- Outlooks for U.S Public Finance sectors are mostly "Negative," March 27, 2020[11]

Kroll Bond Rating Agency

- Coronavirus (COVID-19): States Delay Income Tax Collections - Can They Afford It?, April 1, 2020.

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[1] Oprysko, Caitlin; Coronavirus task force presents a bleak landscape with 100k deaths as best-case scenario; Politico; March 31, 2020.
[2] Ibid.
[3] Please see Worldometers.info/coronavirus for data updated hourly, last accessed 4/8/20 3:12am central time.
[4] Faria-e-Castro, Miguel; Back-of-the-Envelope Estimates of Next Quarter's Unemployment Rate; Federal Reserve Bank of St Louis; March 24, 2020.
[5] Pager, Tyler; Biden Says Coronavirus Damage Could 'Eclipse' Great Depression; Bloomberg; April 7, 2020.
[6] Budryk, Zach; Fauci: 'You don't make the timeline. The virus makes the timeline'; The Hill; March 26, 2020.
[7] Higgins-Dunn; Noah; White House health advisor Fauci says we may never get back to 'normal' after coronavirus pandemic; CNBC; April 6, 2020.
[8] Martz, Michael; Governor to call 'timeout' on budget, suspend all new spending, use cash for essential services; Richmond-Times Dispatch; April 6, 2020.
[9] Zheng, Lili; Fort Worth Leaders Expect 30% Drop in Sales Tax Revenue This Year Due to COVID-19; NBCCFW; April 7, 2020.
[10] Please see: Ciccarone, Richard; Chronically Late Municipal Bond Audits Further Dealyed in FY18, MuniNetGuide; Jan. 13, 2020.
[11] Fitch Ratings Updates 2020 Sector Outlooks to Reflect Coronavirus Impact; Fitch Ratings; March 27, 2020.

Recent HilltopSecurities COVID-19 Municipal Commentary

- Non-Profit U.S. Healthcare - Rising Costs of Care from the COVID-19 Pandemic, April 7, 2020
- Three Key Atypical Credit Risks & Market Update, April 3, 2020
- Mass Transit - From Here to There, April 2, 2020
- Public Higher Education - A Closer Look, April 1, 2020
- Private Higher Education - Impact from Social Distancing, March 31, 2020
- U.S. Airport Sector View - A Month into COVID-19, March 30, 2020
- Four Weeks in March, March 27, 2020
- House Speaker Pelosi Wants More for State and Local Governments in Potential Fourth Phase, March 26, 2020
- Agreement on the $2+ Trillion CARES Act, Not Nearly Enough for State and Local Governments, March 25, 2020
- Still Waiting on Congress, Looking for State and Local Government Stimulus, March 24, 2020
- Congress Working on $2+ Trillion of Stimulus; Fed Provides More Targeted Support for Municipals, March 23, 2020
- Tax Deferrals Could Create a Cashflow Crunch; Market Needs Help With Liquidity; Federal Government Provided Some, Working on More Targeted Support, March 20, 2020
- $12 Billion Flows Out of Municipal Funds,Recent Monetary & Fiscal Policy, March 19, 2020
- March 18 Market Activity – A Focus on the Significant Pressure in the VRDO Market, March 18, 2020
- March 17 Market Activity, March 17, 2020
- March 16 Market Activity: HilltopSecurities Lowers Credit Outlooks Due to Unprecedented Steps Taken to Contain COVID-19, March 16, 2020
- Municipal Market Update: Week of March 16 Playbook, March 16, 2020
- Municipal Market Update: COVID-19 Impact Worsens, March 12, 2020
- Lowered Airport Sector Outlook: Recent COVID-19 Impact, March 11, 2020
- Falling Confidence and No Federal Stimulus Increase to Start the Week, March 9, 2020
- Uncertainty – What the Municipal Market Knows and Doesn't Know About COVID-19, March 4, 2020
- Bracing for the Worst; the Coronavirus Market Effect – Status of the Coronavirus Impact on the US Municipal Bond Market (page 2), Feb 26, 2020

Recent HilltopSecurities COVID-19 Economic Commentary

- March Payrolls Plunge, April 3, 2020
- Sifting Through Irrelevant Data, April 1, 2020
- Help is on the Way as Massive Relief Bill Passes the Senate, March 26, 2020
- Staying Afloat Until the Storm Passes, March 23, 2020
- Government Goes Big on Latest Rescue Plan, March 19, 2020
- Serious Support on the Horizon, March 16, 2020
- Waiting on Fiscal Policy as Aggressive Fed Move Falls Flat, March 16, 2020
- Stocks Rebound as Central Banks Respond, March 13, 2020
- On the Edge of Recession, March 12, 2020
- Central Banks Rush to Mitigate Pandemic Fallout, March 11, 2020
- Untying the Knot, March 10, 2020
- Runaway Markets Ignore Massive Payroll Number, March 6, 2020
- Bracing for Zero, March 5, 2020