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U.S. Municipal Bond Market

Credit Deteriorating, Moody's Lowers State Outlook to "Negative"

Tom Kozlik
Head of Municipal Strategy & Credit
214.859.9439
tom.kozlik@hilltopsecurities.com

Summary

- The Fed announced adjustments to its $500 billion Municipal Liquidity Facility (MLF), highlighted by city and county eligibility expansions. Some additional elements about the process and requirements were also provided.
- Today, Moody's lowered their U.S. State sector outlook to "Negative" from "Stable."
- The Center on Budget and Policy Priorities (CBPP) increased their forecast of U.S. state budget shortfalls to $650 billion from $500 billion.
- House Speaker Nancy Pelosi made clear this week that the Democrats are pushing for $1 trillion of aid for state and local governments. There is resistance from Republicans, but we need to wait to see how negotiations play out before we can identify the level of political risk that exists.
- S&P Global assigned a "Negative" outlook to most of their public and private U.S. higher-ed institutions this week because of the COVID-19 impact.
- We are seeing evidence of weakening demand for narrow security pledges in the higher-ed sector. We saw only very limited interest in a public higher-ed institution that brought competitive issues this week.
- We believe there is legislation that is being considered that would broaden the reach of the Federal Home Loan Banks, potentially allowing them to back non-housing bonds.
- A bipartisan State and Municipal Aid for Recovery Transition (SMART) proposal is being championed by Senators Menendez (D-N.J.) and Cassidy, M.D. (R-La.). We expect advocacy to continue related to this effort, and perhaps in the near term (even next week), we may begin to hear more specifics.
- $1.255 billion of investment dollars flowed out of municipal funds this week, according to Lipper data.

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The Federal Reserve Expanded its Municipal Liquidity Facility this Week

On Monday, April 27, the Federal Reserve announced adjustments to its $500 billion MLF, highlighted by city and county eligibility expansions. Some additional elements about the process and requirements were also provided. Other basics are still missing and are going to be provided at a later time, according to the Federal Reserve and Federal Reserve Bank of New York.

We covered this important happening with a five-page summary report and included six pages of tables that identify the eligible states, cities and counties in our April 29 report: Fed Expands Municipal Liquidity Facility, Provides Details.

Moody's Lowered State Government Sector to "Negative" from "Stable"

Today, Moody's lowered their U.S. State sector outlook to "Negative" from "Stable." The rating agency wrote, "States themselves have strong powers to make budgetary adjustments through cuts, revenue increases and shifting costs to lower levels of government, but the historic crisis will substantially test the options." And Moody's identified the following factors as key contributors:

- The coronavirus-driven economic downturn will extend beyond widespread businesses reopening across the country;
- Some state actions to counter the downturn will increase the sector's leverage and diminish its record reserves;
- High fixed costs will reduce flexibility for some states;
- Emergency federal aid is not yet earmarked to replace lost revenue;
- The innate strengths of state credit will buttress the sector's ability to manage through the cycle;
- What could change the outlook (also from Moody's): The outlook could shift to stable if efforts to contain and treat the virus and develop a vaccine proceed more rapidly and improve the speed and strength of an economic recovery. Substantial federal aid directed to offset state revenue declines could also lead to a return to a stable outlook.[1]

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Larger State Budget Shortfalls Forecasted by the CBPP

The CBPP increased their forecast of U.S. state budget shortfalls to $650 billion from $500 billion. Further, the CBPP noted, "Federal aid provided to date will help cover some of these shortfalls but it is not nearly enough. Only about $65 billion of the aid provided in earlier COVID-19 packages is readily available to narrow these shortfalls. Using that aid and the $75 billion that states have in rainy day funds would leave states with about $510 billion in unaddressed shortfalls."[2]

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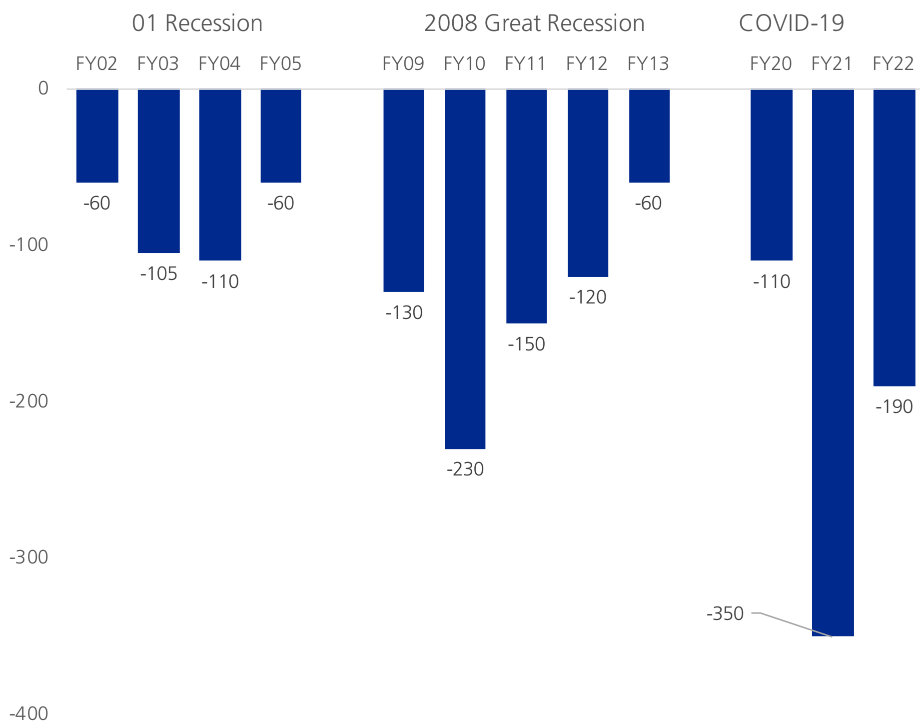
The CBPP Revised State Budget Shortfall Forecast to $650 Billion



Source: Center on Budget and Policy Priorities and HilltopSecurities.

Speaker Pelosi Suggests $1 Trillion for State and Local Government Aid

Mostly ideas are being circulated about what could be included in the next CARES 2 emergency package. Detailed negotiations are currently not occurring on the topic.

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House Speaker Nancy Pelosi made clear this week that Democrats are pushing for $1 trillion of aid for state and local governments.3 There is resistance from Republicans, but we need to wait to see how negotiations play out before we can identify the level of political risk that exists.

but we need to wait to see how negotiations play out before we can identify the level of political risk that exists. It seems, "Senate Republicans haven't yet said they would be willing to do another stimulus bill any time soon. [Senator Majority Leader Mitch] McConnell said this week he is open to helping state and local governments with coronavirus expenses. But he's said that any new bill must contain liability protections for businesses that reopen during the pandemic."[4]

S&P Global tried to give investors, issuers, and observers an idea of what they can expect as far as potential for change is concerned related to the outlook moves and potential downgrades

S&P Revised Individual Outlooks on Most Higher Ed Institutions to "Negative"

S&P Global lowered the outlooks on most of its U.S. public and private higher-ed institutions to "Negative" from "Stable" this week. Some were lowered to "Stable" from "Positive" as well. The current and potential impact from COVID-19 was cited as the leading cause for the outlook actions. The rating agency wrote:

> Although liquidity, as measured by available resources compared to debt and operating expenses, was the primary metric assessed, an institution's overall credit profile, including draw, selectivity, matriculation rates, operating margins, and revenue diversity, was also considered. For public institutions, reliance on state operating appropriations and expectations around future funding levels was also an important part of our assessment.[5]

And S&P Global tried to give investors, issuers, and observers an idea of what they can expect as far as potential for change is concerned related to the outlook moves and potential downgrades.

> A negative outlook reflects our view that there is at least a one-in-three chance that operating and economic conditions will worsen to a degree that affects the ability of the college or university to maintain credit characteristics in line with the current rating level.[6]

Toward the middle to end of April, the negotiated and competitive markets seemed to be on a course back to normalcy. But, this week a glimpse of what may be to come for municipals if or when credit becomes a larger concern appeared in the competitive market.

Uncertainty Remains in the U.S. Higher Education Sector

For weeks, questions about access to the municipal bond market have existed. There were weeks in March when, mostly because of liquidity pressures, state and local governments and other tax-exempt issuers were not able to sell debt. Toward the middle to end of April, the negotiated and competitive markets seemed to be on a course back to normalcy. But, this week a glimpse of what may be to come for municipals if or when credit becomes a larger concern appeared in the competitive market.

Competitive Market

There does not seem to be anything structurally wrong with the competitive municipal market now. This week's competitive calendar was relatively light at just over $1 billion. And next week's calendar is now expected to be just under $1 billion. Interest and follow-through was mostly strong for the competitive issues in the market this week. Spreads widened in the front-end of the yield curve, but this is a relationship that we are seeing in the negotiated market as well.

Iowa State University

What was unique in this week's competitive market is that there was no to limited interest in three different security pledges offered by Iowa State University (Board of Regents). Under normal circumstances we may have expected a half-dozen to a dozen bids for each of the issues. Instead, we saw one bid for two and no bids for one of the issue offered.

- $17.665 million State University of Iowa Telecommunications Facility Revenue (Aa1) took bids at 11 a.m. EST. This issue received only one bid.
- $14.695 million State University of Iowa Athletic Facility Revenue (Aa3) took bids at 11 a.m. EST. This issue did not receive any bids.
- $17.650 million Iowa State Univ (Univ. of Science and Tech) Dormitory Revenue (Aa2/A+) took bids at 11:30 a.m. EST and only received one bid. This issue was insured by Build America Mutual, a distinguishing feature for sure.

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Different Security Pledges

Iowa State University, located in Ames, has historically had a strong credit profile. It is the state's land grant university and its athletic teams compete in the Big 12 Conference. Student demand (32,000 FTE) had been consistent (although it has fallen very slightly in recent years). The university itself has a strong liquidity position as measured by 201 days cash on hand (169 is the Moody's Aa median.) The university has an Academic Building Revenue structure secured by a broad university pledge. It also has a complicated debt structure with several other more narrow revenue streams including: Dormitory Revenue Bonds; Athletic Facilities Revenue Bonds; Utility System Revenue Bonds; Revenue Bonds (Biosciences Building Projects); Parking System Revenue Bonds; and the Memorial Union Revenue Bonds.

The competitive issue that did not receive any bids was the State University of Iowa Athletic Facility Revenue Bonds (Aa3), which are secured by the net revenues of the Athletic Facilities System. The Athletic Facilities System pledge includes the university football facilities and Jack Trice Stadium, used primarily for Big 12 football games. This type of security would be considered a much more narrow security pledge compared to a broad university pledge of revenues.

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FHLB System Proposed Legislation

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As part of the 2008 financial crisis era programs, The Housing and Economic Recovery Act of 2008 (HERA) amended Section 149(b) of the Internal Revenue Code allowing Federal Home Loan Banks to credit enhance non-housing tax-exempt bonds. This expanded authority sunset 2010. Between 2008 and 2010 there were 130 tax-exempt of bond transactions totally about $4 billion.

There is a proposal being considered that could potentially allow the Federal Home Loan Banks to issue LOCs for all tax-exempt municipal bonds. We still do not know the potential breadth and depth of this proposal, or its chances of passage. This proposal is still in the very early stages, and we will continue to monitor its progress and identify the implications to the market.

Bipartisan State and Municipal Aid for Recovery Transition Proposal

A bipartisan State and Municipal Aid for Recovery Transition (SMART) proposal is being championed by Senators Bob Menendez (D-N.J.) and Bill Cassidy, M.D. (R-La.); you can see the announcement here.[7] The initial announcement noted the need for a $500 billion stabilization fund in line with the request made a few weeks ago by governors nationwide. Please note above that the $500 billion shortfall is now a $650 billion shortfall. We expect advocacy to continue related to this effort and perhaps in the near term (even next week), we may begin to hear more specifics.

Municipal Fund Flows Turned Negative This Week

An important identifier of municipal bond demand turned negative this week. $1.255 billion of investment dollars flowed out of municipal funds this week, according to Lipper data. This is after demand was just positive for two straight weeks, as about $900 million flowed into municipal funds in the previous two weeks.

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[1] State outlook revised to negative as coronavirus impact deepens; Moody's Investor Service; May 1, 2020.
[2] Leachman, Michael; New CBO Projections Suggest Even Bigger State Shortfalls; Center on Budget and Policy Priorities; April 29, 2020.
[3] Lillis, Mike; Pelosi floats almost $1T for states in next relief package; The Hill; April 30, 2020.
[4] Wasson, Erik; Billy House, and Laura Litvan; Pelosi Says State and Cities Seek $1 Trillion in Next Stimulus; Bloomberg Politics; April 30, 2020.
[5] Outlooks Revised On Certain US Not-For-Profit Higher Education Institutions Due to COVID-19 Impact; S&P Global; April 30, 2020.
[6] Ibid.
[7] Menendez, Cassidy Announce Bipartisan Breakthrough to Deliver Much-Needed Federal Resources to States, Communities on Frontline of COVID-19 Fight; Sen Menendez website; April 19, 2020.

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- No Relief, April 20, 2020
- Health Crisis Abates, Markets Normalizing & Watching Credit Quality, April 17, 2020
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