



## U.S. Municipal Bond Market Credit and Market Update

### Summary

- Moody's lowered its outlook on the U.S. local government sector to "Negative" from "Stable" on Monday mostly because of COVID-19 related factors; lowered state outlook last week.
- The American Hospital Association estimates a four month impact totaling \$202 billion of financial losses for March 1, 2020 to June 30, 2020 for America's hospitals and health systems.
- SEC Chairman Jay Clayton and Director of its Office of Municipal Securities Rebecca Olsen released a public statement on May 4: [Importance of Disclosure for our Municipal Markets](#).
- The National Federation of Municipal Analysts sent a letter to the MSRB asking for the development of a better process and structure for issuers to arrange COVID-19 disclosure.
- At the beginning of this week, the [Coronavirus Relief Fund Frequently Asked Questions Updated as of May 4, 2020](#) was posted on the Treasury's website. It is related to the CARES Act Coronavirus Relief Fund.
- Commentary from Wharton School's Robert Inman and Penn Law's David Skeel: [Here's a fair approach to calculating COVID-19 specific aid to the states](#).
- S&P Global Ratings updated the market on how they see pensions evolving in the near- to medium-term. S&P noted, "If returns stagnate, we [S&P] estimate the funded ratio for the average state and local government pension plan could decrease to 60% from 73%."
- California Governor Gavin Newsom's office announced yesterday that they expect a \$53 billion state budget shortfall and that California unemployment could hit 18%.
- The Fifth U.S. Circuit Court of Appeals upheld changes the pension board made to the Dallas Police and Fire Pension Fund. This court decision is a constructive development for the City of Dallas' credit profile.
- Illinois \$1.2 billion short-term issue was pulled this week, now considered day-to-day.
- Lipper reported money flowed out of municipal funds again this week (ending May 6) of \$408 million.

### Moody's Lowered Local Government Outlook to "Negative"

Moody's lowered its outlook on the U.S. state government sector to "Negative" from "Stable" this week because of mostly COVID-19 related factors. The rating agency identified the following larger themes as being at issue:

- Weakened economic conditions will persist.
- Declines in property tax revenue will take longer to materialize compared with drops in other revenue sources.
- Other revenue declines will vary based on economic sensitivity and state action.
- Significant budget adjustments will be necessary for local governments with high fixed costs and healthcare facilities.
- Social challenges will persist because of differing coronavirus containment measures.<sup>1</sup>

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### Estimated Hospital Losses from COVID-19

The American Hospital Association (AHA) estimates a total four month impact of \$202 billion of financial losses from March 1, 2020 to June 30, 2020, or an average \$50 billion per month for America's hospitals and health systems. Here is a copy of the AHA's report: [Hospitals and Health systems Face Unprecedented Financial Pressures Due to COVID-19](#).

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### SEC Public Statement: Importance of Disclosure for U.S. Municipal Bond Market

U.S. Securities and Exchange Commission (SEC) Chairman Jay Clayton and Director of the SEC's Office of Municipal Securities Rebecca Olsen released a public statement on May 4, titled [Importance of Disclosure for our Municipal Markets](#).

The statement is directed to issuers and investors of municipal bonds. Its intention is to parallel the SEC's April 8 public statement [The Importance of Disclosure – For Investors, Markets and Our Fight Against COVID-19](#) from Chairman Clayton and Director of Division of Corporation Finance William Hinman. Some of the themes in the municipal related statement included the following:

- Market participants should recognize the size, importance, complexity and specialized nature of the municipal securities market.
- The importance of robust, timely and accurate municipal issuer disclosures has become even greater as a result of the effects of COVID-19.
- Important considerations that generally weigh in favor of providing updated investor-oriented disclosures that discuss the current and anticipated effects of COVID-19.
- Examples of information municipal issuers could provide to investors.

### Municipal Analysts Ask MSRB to Organize COVID-19 Disclosures

The National Federation of Municipal Analysts (NFMA) [sent a letter to the Municipal Securities Rulemaking Board \(MSRB\)](#) asking for the development of a better process and structure for issuers to arrange COVID-19 related disclosure. The letter notes:

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The NFMA respectfully requests that the Municipal Securities Rulemaking Board (MSRB) develop a process and structure to assist issuers and investors in filing and retrieving critical COVID-19 credit-related information. The MSRB's current laissez-faire approach to these filings is both a missed opportunity to provide leadership and order to disclosure filings during the most significant credit event in memory and risks that critical credit information provided by issuers is not readily accessible by investors.<sup>2</sup>

We expect the importance of disclosure will continue to be a meaningful topic by regulators going forward. We should also note from a market perspective [in our survey of 211 municipal bond credit analysts](#) we found only 11% of responding analysts were "Satisfied" with the timing and amount of municipal disclosure right now.

### The U.S. Treasury Posted Another Coronavirus Relief Fund Q&A

At the beginning of this week, the [Coronavirus Relief Fund Frequently Asked Questions Updated as of May 4, 2020](#) was posted on the Treasury's website related to the CARES Act Coronavirus Relief Fund. It included seven pages of Q&A and was comprised of questions such as:

- Are governments required to submit proposed expenditures to Treasury for approval?
- The Guidance says that funding can be used to meet payroll expenses for public safety, public health, health care, human services, and similar employees whose services are substantially dedicated to mitigating or responding to the COVID-19 public health emergency. How does a government determine whether payroll expenses for a given employee satisfy the "substantially dedicated" condition?

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- The Guidance says that a cost was not accounted for in the most recently approved budget if the cost is for a substantially different use from any expected use of funds in such a line item, allotment, or allocation. What would qualify as a “substantially different use” for purposes of the Fund eligibility?

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### **Relevant Commentary: “Here’s a fair approach to calculating COVID-19 specific aid to the states”**

Robert Inman, professor at the University of Pennsylvania’s Wharton School and David Skeel, professor at the University of Pennsylvania Carey Law School wrote they believe it is possible to achieve those political and policy goals Congress seeks related to potential relief for state and local governments. The end result is a recommendation for a total of almost \$500 billion for state and local governments. Inman and Skeel stress the “distribution of the funds is nearly as important as calculating the amount,” and recommend \$358 billion be made as a direct grant and \$130 billion be directly paid into state unemployment insurance trust funds. You can see the full commentary from the Washington Post here: [Here’s a fair approach to calculating COVID-19 specific aid to the states.](#)

### **The Future of Public Pensions, S&P**

The rising costs of public pensions has been an issue of contention for issuers, investors, and rating agencies in recent years. S&P Global Ratings updated the market on how they see pensions evolving in the near to medium term as it relates to public finance and state and local government credit. S&P noted:

- A Q2 2020 return of nearly 30% is needed for government-sponsored pension systems to maintain the 73% average funded ratio from a year ago.
- If returns stagnate, we estimate the funded ratio for the average state and local government pension plan could decrease to 60% from 73%.
- Pension plan sponsors and administrators are likely entering into a period of fiscal stress. To alleviate budgetary pressures, adjustments to reduce plan costs and contribution increases are likely to be considered.
- Though employer audits may not show the impact of the sudden-stop recession for months, experience from the Great Recession of 2008 gives a sense of what’s to come.<sup>3</sup>

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### **State of California Forecasting Budget Shortfall**

California Governor Gavin Newsom’s office announced yesterday that they expect a \$53 billion state budget shortfall and that California unemployment could hit 18%.<sup>4</sup> This financial forecast is a complete turnaround from the \$5 billion surplus the governor anticipated in his pre COVID-19 budget proposal.

### **Federal Appeals Decision Constructive for Dallas Credit, Police & Fire Pension**

The Fifth U.S. Circuit Court of Appeals upheld changes the pension board made to the Dallas Police and Fire Pension Fund.<sup>5</sup> A group of retired officers filed a lawsuit in 2017 against the board challenging those changes, but the Court of Appeals decision should give some comfort to those concerned about near-term insolvency of the pension plan. This court decision is a constructive development for the City of Dallas’ (A1/AA-/AA) credit profile. Moody’s wrote, “The risk of near-term insolvency is almost certainly eliminated.”<sup>6</sup>

Moody’s also pointed out that still, “Pensions are a significant credit challenge for Dallas.”<sup>7</sup> City of Dallas CFO Elizabeth Reich communicated the Moody’s analysis to the City Council on a May 1, 2020 memo and noted, “This article is not a rating change from Moody’s but reflects the positive impact of the federal appeals court ruling and prudent benefit changes that have helped stabilize the DPFP in an especially challenging time for municipal governments.”<sup>8</sup>

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### Illinois Deal Pulled, Now Day-to-Day Status

The state of Illinois was scheduled to sell \$1.2 billion of short-term debt this week but after spreads widened to unanticipated levels as feedback came back from the market, the issuer decided to pull the financing. Its status is now considered day-to-day. "Their spreads had already widened out dramatically on COVID impact...on forecasted budgetary deficits for the next few years, obvious revenue declines," John Miller, head of municipals at Nuveen, said in a telephone interview with Bloomberg on Tuesday. Coming to market now "would be more expensive than it has to be."<sup>9</sup>

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What happened with Illinois does not represent how the majority of the market is operating. We are still seeing the municipal bond market returning to normalcy, but there is some hesitancy with issues in the lower end of the credit spectrum.

### For Two Straight Weeks Money Flowed Out of Municipal Funds

Lipper reported money flowed out of municipal funds again this week (ending May 6) of \$408 million. Last week, we saw \$1.3 billion for the week ending 4/29 flow out of municipal funds. This now marks two straight weeks of outflows.

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<sup>1</sup> *Local Government: Outlook changes to negative as coronavirus intensifies severity and length of recession; Moody's Investor Service; May 4, 2020.*

<sup>2</sup> *COVID-19 Credit Related Material Event Notices, Letter to the MSRB; National Federation of Municipal Analysts; May 8, 2020.*

<sup>3</sup> *Pension Brief: the future of U.S. Public Pensions after the Sudden-Stop Recession; S&P Global; May 6, 2020.*

<sup>4</sup> *Bollag, Sophia and Adam Ashton; California faces \$53.3 billion deficit, 18 percent unemployment, Newsom's office projects; The Sacramento Bee; May 7, 2020.*

<sup>5</sup> *Comtois, James; Appeals court affirms dismissal of lawsuit over Dallas Police DROP changes; Pensions & Investments; April 29, 2020.*

<sup>6</sup> *Dallas (City of) TX; Federal appeals court hands City of Dallas another won on pension changes; Moody's Investor Service; May 1, 2020.*

<sup>7</sup> *Ibid.*

<sup>8</sup> *Moody's Investors Service Recognizes Dallas Police & Fire Pension System Federal Appeals Court Ruling as 'Credit Positive' – INFORMATION; Memo to City Council from Dallas CFO; May 1, 2020*

<sup>9</sup> *Singh, Shruti and Danielle Moran; Illinois Delays \$1.2 Billion Debt Sale After Penalty Soars; Bloomberg; May 5, 2020.*

### Recent HilltopSecurities COVID-19 Municipal Commentary

- [Single Family Housing Durability Will Help Endure the New COVID-19 Normal](#), May 6, 2020
- [Credit Deteriorating, Moody's Lowers State Outlook to "Negative,"](#) May 1, 2020
- [Fed Expands Municipal Liquidity Facility, Provides Details](#), April 29, 2020
- [2020 Municipal Bond Analyst Survey](#), April 28, 2020
- ["Push the Pause Button" Elevating the Level of Political Risk](#), April 23, 2020
- [No Relief](#), April 20, 2020
- [Health Crisis Abates, Markets Normalizing & Watching Credit Quality](#), April 17, 2020
- [Governments on Deadline for \\$150 Billion of Cares Act Relief](#), April 13

### Recent HilltopSecurities COVID-19 Economic Commentary

- [The Bright Side of Worst Employment Report Ever](#), May 8, 2020
- [Automakers Face a Rocky Road to Recovery](#), May 4, 2020
- [The Fed's Promise and Vaccine Progress Boost Stocks](#), April 29, 2020
- [News and Notes from a Troubled Week](#), April 24, 2020
- [The Problem With Oil](#), April 21, 2020

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