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U.S. Municipal Bond Market

No Municipal Debt Binge, and There Won't Be One

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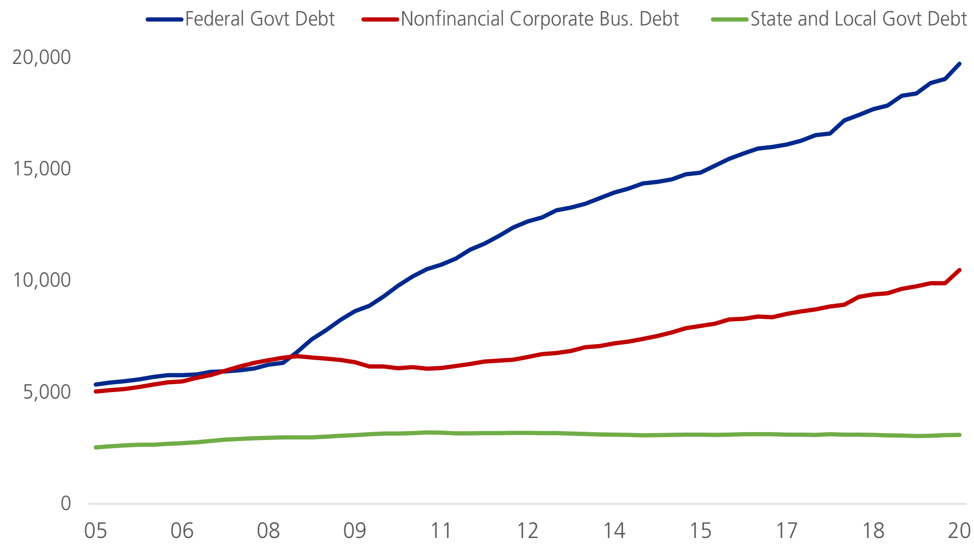
Summary

- There is a misconception about the quantity of municipal bonds issued in recent years. Municipal bond issuance flatlined relative to the growth we saw in federal and corporate debt over the last ten years.
- The new fiscal reality after the Great Recession contributed to the lack of municipal bond issuance.
- Many observers were surprised in the early part of the last decade when new money municipal bond issuance did not return close to pre-Great Recession levels. Those with an intimate understanding of what public finance entities had gone through and were experiencing even up to the Pandemic Recession were not surprised at all.
- Deficit financings will remain uncommon. Some may occur selectively, but we do not think they will occur in an amount that will be meaningful enough to influence overall issuance levels.
- Balanced budget requirements and state and federal limitations on the use of proceeds municipal entities are allowed to sell debt for have been, and will continue to be, major influencing factors that will keep municipal issuance from rising substantially, if at all.

There is a misconception about the quantity of municipal bonds that have been issued in recent years. Municipal bond issuance flatlined relative to the growth we saw in federal and corporate debt over the last ten years.

Comparison of Outstanding Federal Govt., Nonfin Corp., State/Local Govt. Debt, Securities



Source: FRED data via Federal Reserve Bank of St. Louis and HilltopSecurities. $ in billions

The Misconception - There Has Not Been a Municipal Bond Issuance Binge

There is a misconception about the quantity of municipal bonds that have been issued in recent years. Municipal bond issuance flatlined relative to the growth we saw in federal and corporate debt over the last ten years. The new fiscal reality after the Great Recession contributed to the lack of municipal bond issuance. Balanced budget requirements and state and federal limitations on the use of proceeds municipal entities are allowed to sell debt for have been, and will continue to be, major influencing factors that will keep municipal issuance from rising substantially, if at all.

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New Money Municipal Issuance After the Great Recession Was Light

A new fiscal reality gripped state and local governments and other municipal bond market issuers after the 2008 World Financial Crisis and Great Recession. This new reality was characterized by revenues that could not keep up with rising expenditure demand. There was budget belt-tightening that occurred even after the recession ended, and a fiscally conservative view mostly continued as lagging indicators—such as falling housing prices and deteriorating property taxes—continued to work through budgets. A similar relationship existed across almost every municipal sector, not just among state and local governments.

Municipal bond issuers across almost all sectors limited the amount of new money debt they added to their balance sheets. The reason, or source, of the rising expenditure demand might have varied from sector to sector or issuer to issuer, but for the most part we did not see new money municipal bond issuance rise significantly over the last decade compared to the previous 10 year period.

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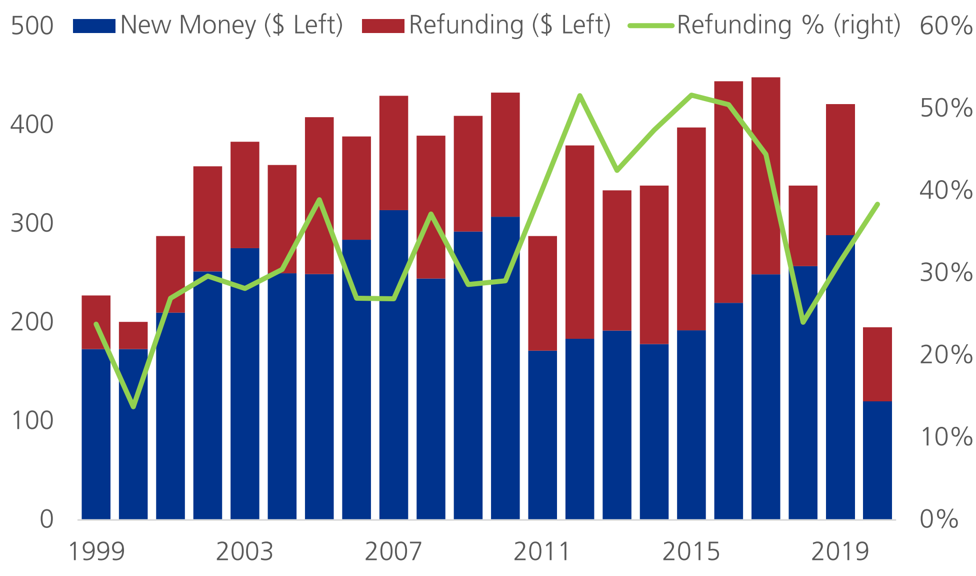
New Money and Refunding Municipal Issuance

There are two general municipal bond uses of funds. The first is referred to as new money bonds, which are exactly what their name indicates: new debt. Refundings are bonds sold at a lower interest rate and they replace previously issued bonds. This results in debt service savings that can be leveraged in other areas of the budget. It is helpful to think of a refunding as being similar to the refinancing of a home mortgage, for example.

New Money Steadily Grew, Remained Mostly Below Pre-Great Recession Levels



Source: Thomson Reuters data via The Bond Buyer, HilltopSecurities. 2020 data through June 30, 2020.

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amount of taxable Build American Bonds that issuers crammed into the end of 2010. Before issuance fell in 2011, the last time municipal bond market issuance was below $300 billion was ten years before in 2001. Overall issuance rebounded by almost $100 billion in 2012 to about $380 billion, but upon further analysis one can see that new money issuance only increased slightly. This is one of the most important points where municipal issuance trends are concerned. Much of the perceived increases in the middle of the decade were from refundings, not new debt. New money issuance only rose a little over ten billion to $183 billion in 2012. For the nine years between 2011 and 2019 new money peaked at $288 billion in 2019, but only averaged $214 billion. In contrast, new money issuance peaked at $314 billion in 2007 and averaged $268 billion in the prior decade. The last decade did not see a municipal bond issuance binge.

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Notable Municipal Debt Trends from Different Sectors

When observing debt trends across different municipal sectors there is a common theme. Debt levels rose prior to 2009/2010 but then changed very little, according to most measures between 2011 and today. Below is Moody's median data from different sectors to support this argument:

- **State government** median net tax supported debt as a % of personal income fell to 2.0% (2019) from 2.4% (2008);[1]
- **Local government** median net direct debt as a percentage of full value %:[2]
    - Cities: stayed constant at 1.1% between 2013-2018
    - Counties: stayed constant at 0.5% between 2013-2018
    - School districts: rose slightly to 1.6% from 1.5% between 2013-2018
- **Private higher-education** median debt service to operating expenses rose slightly to 5.2% (2019) from 5.1% (2015).[3]
- **Public higher-education** median debt service to operating expenses rose slightly to 4.4% (2018) from 4.2% (2014).[4]

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Municipal Issuance 2020 to Date

Total issuance forecasts for 2020 were relatively high before the Pandemic Recession. Most expected issuance over $400 billion, and our issuance forecast was for a market record of $450 billion.[5] We broke our forecast down accordingly: $297 billion of new money (66% of total) and $153 billion of refundings (34% of total).

Issuance for the first six months of 2020 have actually not been as low as some might have expected, seeing as how the municipal bond market was only running at a fraction of its typical capacity in March and April. Through the first six months of 2020, municipal bond issuers sold $120 billion of new money bonds (62%) and $75 billion of refundings (38%) for a total of $195 billion through the end of June. On an annualized basis this does not even break the $400 billion barrier, nor does it come close to the $450 billion record amount we expected pre-Pandemic Recession.

Key Misconception

A key misconception about issuers of municipal debt arises because some observers are keenly aware of federal and corporate debt trends. Federal and corporate debt trends have been significantly rising over the last ten years. That is not what has been happening with municipal issuance, as we have seen.

There has been a Federal Government and Corporate Debt Binge

Many current market observers cannot remember a time when the federal government was not accumulating an ongoing budget deficit. A growing economy and technology boom, along with federal budget policies, created almost a decade of federal surpluses in the mid and late 1990s.[6] Federal tax cuts in the early 2000s, a slowing economy, and military spending in the wake of September 11, 2001, put a quick end to surpluses.[7] The Great Recession was to blame for the highest debt-to-GDP levels since World War II. Efforts to stabilize the financial markets and the $831 billion 2009 Recovery Act piled on the liabilities.

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The U.S. gross domestic product (GDP) was $21.4 trillion last year and according to the Committee for a Responsible Federal Budget, the U.S. federal debt is likely to exceed GDP by as early as this year.[8] Falling U.S. GDP and the $2+ trillion Coronavirus Aid, Relief, and Economic Security Act (CARES Act) are the leading reasons why. With no end in sight for the current health crisis, it is possible—if not almost certain—there will be future rounds of federal government relief and stimulus driving U.S. debt-to-GDP levels even higher.

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Increase in Corporate Bond Issuance

There are less restrictions for the use of corporate bond proceeds, compared to those that exist for municipal bonds. "Companies use the proceeds from bond sales for a wide variety of purposes, including buying new equipment, investing in research and development, buying back their own stock, paying shareholder dividends, refinancing debt, and financing mergers and acquisitions."[9]

Unique circumstances over the last decade have contributed to an increase in corporate bond issuance. The low interest-rate environment made it more affordable for companies to add debt to their balance sheets, and the same low interest-rate environment made it more appealing for investors to move out on the credit spectrum and loan money to riskier corporate credits. Corporate issuers seemingly reacted to the demand. The riskiest corporate credits, or those rated BBB made up a little over 50% of the global investment grade market in 2019, up from 17% in 2001.[10]

The corporate debt binge is something that is often acknowledged and regularly reported. "A decade of historically low interest rates has allowed companies to sell record amounts of bonds to investors, sending total U.S. corporate debt to nearly $10 trillion, or a record 47 percent of the overall economy," wrote David Lynch.[11]

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There is No State and Local or Municipal Debt Binge

It is important to note that there are limitations for the use of funds that exist if municipal entities want to sell tax-exempt bonds. Limitations or restrictions are less onerous for taxable issuance. There are different rules and limitations issuers must follow when they sell tax-exempt public and private purpose bonds.

In general, tax-exempt municipal bonds fund much of the nation's infrastructure. States, state authorities, local governments, and other municipal entities sell bonds to finance mostly capital projects that extend over a number of years. Often this period of time is stretched to 10, 20, or even 30 years, depending on the sector and type of financing. The type of infrastructure financings include small-to-large and usually high-cost new projects or upgrades, such as:

- Schools
- Public buildings, courthouses
- Airports
- Roads
- Bridges
- Hospitals
- Water, sewer, and treatment facilities
- Power plants
- Housing

Although entities sometimes pay for capital investments with current revenues, the strategy of borrowing allows them to spread the costs across multiple, future generations. This way the future users bear some of the cost through future taxes or other charges that pay debt service.

In 2019, municipal issuers sold $421 billion of new money and refunding municipal debt: $110 billion of it was for primary, secondary, and higher education purposes; $65 billion was for general local government use; and $34 billion for general state government use.

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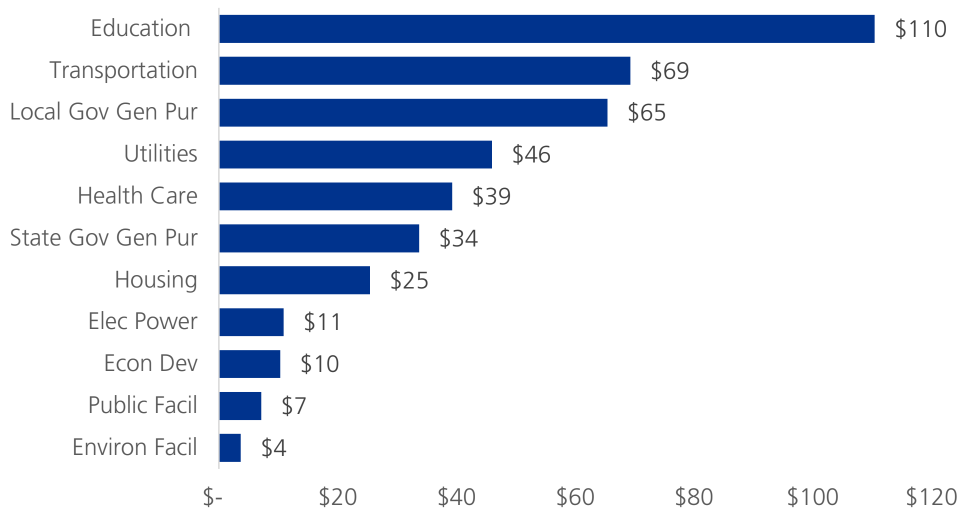
There is a New COVID-19 Financial Reality that state and local governments and other municipal entities are trying to adjust to currently.

Issuers Sold $421 Billion of Municipal Bonds in 2019, Summary by Sector



Source: Thomson Reuters, The Bond Buyer, and HilltopSecurities. $ in billions.

The issuance rules, and state and federal tax regulations, differ sector to sector. In the state of Texas, for example, school districts can issue bonds for these specific purposes:[12]

- Construct, acquire, and equip school buildings
- Purchase sites for school buildings
- Purchase new (or retrofit) school buses
- Purchase (or retrofit) emergency, safety, or security vehicles

State government budget shortfalls are estimated to be about $600 billion, according to analysis by the Center on Budget and Policy Priorities.

Tools in the Budget Toolbox

There is a New COVID-19 Financial Reality that state and local governments and other municipal entities are trying to adjust to currently. Revenues are coming in at levels that are lower than before March 2020. The traditional tools that state and local governments and other municipal entities have available in their toolboxes to deal with the New COVID-19 Reality are fairly limited, and many have already been used.

The need is clear and growing. State government budget shortfalls are estimated to be about $600 billion, according to analysis by the Center on Budget and Policy Priorities. The National League of Cities estimated local government revenue shortfalls at about $350 billion. Transit authorities and airports are running at a fraction of their pre-pandemic levels. The New York Metropolitan Transit Authority noted recently they will need another $4 billion at the end of July.

One option would be for entities to raise revenues. That would mean governments and others would be raising taxes and/or fees in an environment with record levels of unemployment. Not only is this going to be difficult politically but it will be hard practically, too. Entities have different levels of reserves and many have already used them or have plans to use them. Another lever is on the expenditure side. Four months into the Pandemic Recession, this lever has been used to a higher degree than we saw in the last decade. State and local governments shed more jobs through April than they did in the entire wake of the entire Great Recession. More jobs cuts are likely coming.

Will Municipal Issuance be Driven by Deficit Financings?

It is possible that state and local governments could resort to the use of deficit financings. There are a handful of large states and some cities that are candidates for potential deficit financings. Deficit financing may occur selectively, but we do not think they will occur in an amount that will be meaningful enough to influence overall

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issuance levels. Fitch Ratings notes that New York City and Illinois are considering deficit issues, but also overall believes deficit financings are likely to "remain uncommon."[13]

What we likely see is an increase in short-term issuance, such as tax and revenue anticipation notes. These short-term borrowings are usually performed when there is a mismatch between tax receipts or other revenues and disbursements. This is a financial tool that is likely to be utilized at an above-average level in the near term.

We Could Even See Less Debt, Not More in the Near-to-Medium Term

Of all of the options that are available in the budget toolbox, we think that—mostly as a result of falling revenues and balanced budget requirements—state and local governments and related municipal bond issuers will continue to choose expenditure cuts, not other budget levers. This, by definition, means there will be a crowding-out effect that will not allow issuers to sell additional debt.

We are already seeing anecdotal evidence building. A recent survey by the National League of Cities reported that 700 cities have paused plans to make important infrastructure investments.[14]

New York City Mayor Bill de Blasio is lowering his request for borrowing authority to $5 billion from $7 billion in order to close the city's budget shortfall. Mayor de Blasio has also warned that without federal relief NYC could lay off as many as 22,000 workers to balance the city's budget.[15]

Meaningful federal relief means overall issuance could stay close to neutral, but without relief, state and local governments will continue to cut budgets in order to adjust to the New COVID-19 Reality. This means more jobs will be lost and fixed costs, like debt service, will not have a place in spending plans.

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[2] U.S. Local Government Medians – Tax base expansion bolsters revenue, but pensions remain a hurdle; Moody's Investor Service; May 19, 2020.
[3] Medians – Private universities produced steady operating performance in fiscal 2019; Moody's Investor Service; June 25, 2020.
[4] Medians – Public University revenue growth declines again, driving cost containment; Moody's Investor Service; June 27, 2019.
[5] Kozlik, Tom; The U.S. Municipal Bond Market in 2020, in the Last Decade, and in the Next; HilltopSecurities; Dec. 18, 2020; page 12.
[6] Schick, Allen; A Surplus, If We Can Keep It: How the Federal Budget Surplus Happened; Brookings; Dec. 1, 2000.
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[9] What are Corporate Bonds? Investor Bulletin; Securities and Exchange Commission; June 2013.
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[11] Lynch, David; Corporate debt nears a record $10 trillion, and borrowing binge poses new risks; The Washington Post; Nov. 29, 2019.
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