

U.S. Municipal Bond Market

Georgia Run-Offs Begin New Year, Important to Watch for Credit Quality

Summary

- The COVID-19 daily cases, deaths and hospitalization numbers continue to worsen. December saw a record 77,000 deaths in the U.S. Dr. Anthony Fauci says the COVID-19 backdrop will likely get worse before it gets better, or at best the numbers will stay “terribly high.”
- Lockdown- and shutdown-related restrictions are tightening in Europe. President-elect Biden has said a national lockdown would be counterproductive. Fauci says targeted lockdowns would not be out of the question to contain the spread of the virus.
- The most important thing investors should be watching, which could impact municipal credit quality, to begin the new year are the results of the Jan. 5, 2021 Georgia Senate run-off elections.
- In November, the Georgia Republican candidates had a slight edge in the [average polling data per FiveThirtyEight](#). In recent weeks, the Democrats have pulled ahead slightly. Ossoff now holds a 1.4 point lead over Purdue and Warnock holds a 2.0 point lead over Loeffler. These leads are well within the margin of error, so right now it is best to describe these races as neck-and-neck.
- If the Republicans keep control of the Senate, it would likely mean that a sixth phase of COVID-19 relief (one that would include direct aid to states and cities) is unlikely in the near term. Movement on infrastructure-related legislation would be slightly possible, but many roadblocks would exist. If the Democrats win both Georgia Senate elections and take control of the Senate, more aid for states and cities would be possible and infrastructure legislation coming out of Washington, D.C. could not only be substantial, but it could move quickly.

Fauci Says COVID-19 Backdrop to Get Worse or Stay Terribly High

The near-term backdrop created by the COVID-19 virus will get worse or stay terribly high at best, despite the rollout of the vaccines. December was the worst month for deaths attributed to the COVID-19 virus as [the U.S. reported over 77,000](#). This is much higher than the next highest month, April, which saw 16,800.

[Dr. Anthony Fauci on Sunday morning's Meet the Press](#) noted, “The numbers are real...We have well over 300,000 deaths. We are averaging two- to three thousand deaths per day...All you need to do, Chuck [Todd of Meet the Press], is to go into the trenches, go into the hospitals, go into the intensive care units and see what is happening. Those are real numbers, real people and real deaths.”

Currently (as of Jan 3, 2021), the 7-day average of new daily cases is 212,965 (record high), the 7-day average of hospitalizations is 124,390 (record high), and the 7-day average of new deaths in the U.S. from COVID-19 is 2,634 (just short of the 2,710 high from Dec. 22), per New York Times COVID-19 Tracking Project data.

Fauci said he sees things getting worse most likely before they get better. “It likely will get worse in the next couple of weeks or at least maintain this terrible high level of

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infections and deaths we are seeing," Fauci said during Sunday morning's [Meet the Press interview \(see minute 4:30\)](#). This does not pose a positive back drop for January and February.

Despite reports and numbers showing that individuals traveled more at the end of November and December, we saw the [Dallas Fed's Mobility and Engagement Index \(MEI\)](#) fell at the end of November to (-51.72) and at the end of December to (-55.79) indicating that activity was slowing. It is important to note that we have not seen MEI numbers this low since the end of May 2020 (-58.21). There is a relationship with the MEI and economic activity.

Will Lockdowns or Shutdowns Begin Again in 2021?

Stricter lockdowns are occurring in Europe. British Prime Minister Boris Johnson is expected to announce tougher COVID-19 containment measures today according to reports. Today, [Scotland ordered new rules](#) to keep people at home until at least the end of January.

Biden Says No National Shutdown

President-elect Biden has said that he [does not envision a national shutdown](#). He noted that the COVID-19 situation is "different across various communities." Biden also noted a national shutdown would be "counterproductive."

When Dr. Fauci was asked during the [Meet the Press interview \(see minute 7:40\)](#) if another 15-30 day lockdown or partial lockdown is on the horizon, he said targeted lockdowns in certain areas of the country are not out of the question.

This leads us to believe that although a national shutdown might not occur, it is not out of the question to expect that large scale regional, state, or local shutdowns are not possible if not even likely in coming weeks. If so, these could worsen the budget situations some state and local governments and other public finance entities will need to navigate in coming months.

California's Lockdowns Extended

Some health care systems are being overrun in California. The state of [California](#) [extended its stay-at-home orders](#) in select areas at the end December.

Arizona Lockdown Recommendation Rejected by Governor

The Superintendent of Public Instruction, Kathy Hoffman, [called for a two-week quarantine period but the request was rejected by the governor](#), highlighting this was a local decision to be made by local leaders.

The Most Important Thing - Georgia Run-Off Election Results

The most important variable right now that could positively or negatively impact municipal credit quality is riding on the results of the [Senate run-off elections in Georgia](#).

According to state election rules, a winning candidate needs 50% of the vote to be named the winner. Neither candidate for Senate in Georgia reached that mark during the November 2020 elections, so there are two Jan. 5, 2021 run-offs scheduled. The first race is between Sen. David Purdue (R) and Jon Ossoff (D) and the second is between Sen. Kelly Loeffler (R) and Rev. Raphael Warnock (D).

In November, the Georgia Republican candidates had a slight edge in the [average polling data per FiveThirtyEight](#). In recent weeks, the Democrats have pulled ahead slightly. Ossoff holds a 1.4 point lead over Purdue and Warnock holds a 2.0 point lead over Loeffler. These leads, however, are well within the margin of error, so right now it is best to describe these races as neck-and-neck. The Georgia races are close and much is riding on the results as far as municipal credit and the potential for downgrades are concerned.

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Importance of Georgia Run-off Elections

Why are the results in Georgia so important? If Purdue and Loeffler hold on, or even if one of them wins, the Republicans will keep control of the Senate. If both Ossoff and Warnock unseat Purdue and Loeffler, the Democrats would take control of the Senate and complete the Blue Wave they sought in November.

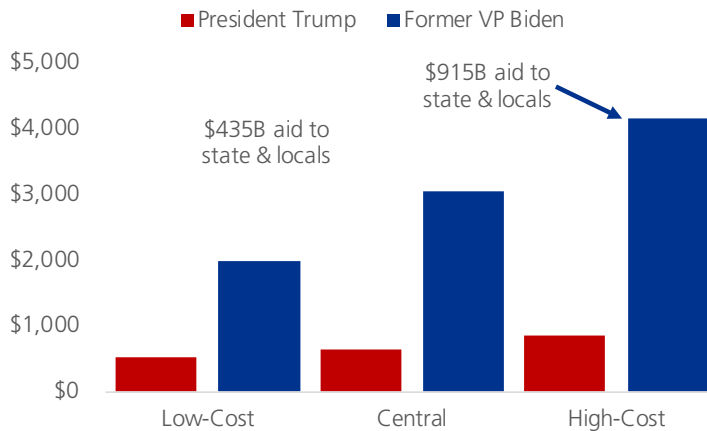
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Democrats in control of the White House and Congress could have a substantial positive impact on the outlook for municipal bond credit quality. The recent COVID-19 relief package secured only a very limited amount of funds that would boost municipal credit quality. We outline that package here in Late and Limited is Better Than Nothing, Lawmakers Finalize \$900 Billion Fifth Phase Relief, No Direct State and Local Aid and highlight that the Fifth Phase of Fiscal COVID-19 Relief is No State and Local Government Windfall in a follow-up report.

Again, the results in the Georgia run-off elections have the potential to be meaningful. If the Republicans keep control of the Senate, it could mean that a sixth phase of COVID-19 relief (one that would include direct aid to states and cities) is unlikely in the near term. Movement on infrastructure-related legislation could be slightly possible, but many roadblocks would exist. If the Democrats win both Georgia Senate elections and take control of the Senate more aid for states and cities could be possible and infrastructure legislation coming out of Washington, D.C. could not only be substantial, but it could move quickly.

What could the numbers look like? There could be close to \$1 trillion of state and city government aid that could follow-up the recent legislation if the Democrats oust incumbent Republican Senators. Please see the end of this report for our summary table by economic, market, and policy variable.

Primary Deficit Impact of Trump and Biden COVID-19 Plan (\$ billions, 2021-2030)



If the Republicans keep control of the Senate, it would likely mean that a sixth phase of COVID-19 relief (one that would include direct aid to states and cities) is unlikely in the near term.

Source: Committee for a Responsible Budget and HilltopSecurities.

Wins by the Democrats in Georgia would complete the Democrat “Blue Wave” scenario which can be described as our upside case for state and local government credit quality. While it might not return credit status fully to a pre-March 2020 neutral position, it is the closest we have seen presented by lawmakers that would come close. It is a scenario where an amount of state and local aid could total close to the \$915 billion passed by House Democrats over the summer. The Committee for a Responsible Federal Budget (CRFB) compared the prices of different low, medium and high cost COVID-19 relief plans. The \$915 billion would be considered in the high-cost scenario that could ultimately be included in a total COVID-19 response.

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Potential Relief for State and Local Government in HEROES Act

Type	Amount (\$ in billions)
State Governments	500
Local Governments	375
U.S. Territories	20
Tribal Governments	20
Total State & Local Relief	915

Source: Summary legislation and HilltopSecurities.

Without a Democrat “Blue Wave,” even though Biden was elected to the White House, meaningful federal aid will unlikely flow to state and city governments. We already saw this eventuality play out recently as Washington was unable to secure direct aid for state and city governments during the CARES Act and during the negotiations leading up to the fifth phase of relief.

This downside scenario continues to put state and city governments and municipal credit overall at risk. There has not been any unencumbered aid for state and city governments to be able to use for budget shortfall purposes yet. This comes as a surprise to some especially considering lawmakers have already spent over \$4.5 trillion of COVID-19 related relief. We reviewed the lack of unencumbered federal aid for state and locals here.

The “Blue Wave” election outcome scenario is the upside scenario for not only state and local government credit quality, but also the only way that there are not damaging results to government service delivery and employment levels in select states and areas hardest hit by shutdowns and decreases in activity. Projected state and city budget shortfalls in those areas hardest hit could be meaningful.

Moody’s Analytics forecast state and local government budget shortfalls at \$171 billion in their base case and \$308 billion in their severe case netting out federal aid and state reserves, as of December 2020. We lowered those numbers slightly after accounting for some of the funds from the fifth phase of COVID-19 relief, but the shortfalls still amount to \$107 billion in the base case and \$244 billion in the severe case.

State and Local Government Shortfall Update, Net of Federal Support, Reserves, & \$910B Relief (July 2020 - June 2020, \$ billions)

	Base Case	Severe Case
Gross combined shortfall:	331.5	468.2
Enhanced FMAP (FFCRA):	71.0	71.0
Education Grants (CARES):	17.0	17.0
Shortfall net of existing fed help	243.5	380.2
State Reserve Funds (FY19) End	72.0	72.0
Total Net Shortfall (prior to \$910B)	171.5	308.2
Education, from \$910B relief (\$82)	64.0	64.0
Adjusted Shortfall (after \$910B)	107.5	244.2

Source: Moody’s Analytics (Dec. 17, 2020) and HilltopSecurities.

Without aid, specifically targeted to state and city governments, these entities will be forced to cut (in some case severely cut) services and employment levels. Looking at current state and local government employment levels can give readers a sense of what is likely to happen without aid.

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In the wake of the Great Recession, state and local government employment finally bottomed out in July 2013 at 19.054 million. State and local government passed that mark in April 2020. While some jobs have come back, total state and local government employment remains well below the 2008 Financial Crisis lows we saw in 2013. Worse yet is that governments could be, in the downside scenario, be put into a position that will force them to severely cut employment without a clear indication that meaningful direct federal relief is likely to be on its way. We wrote that November employment results saw a third straight month of job losses for state and local governments.

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Outlook for Municipal Bond Downgrades and Upgrade Ratio

It is likely that municipal bond downgrades will outpace upgrades for years. The results of the Georgia elections will help determine how long, and how severe the downgrade activity lasts. From a municipal bond market credit rating perspective the rating downgrade activity would be much more severe in the downside scenario compared to the upside. The rating downgrade activity would cover practically all sectors but there would be a regional differential because there are some states, cities, and regions that are being hit harder by COVID-19 and related shutdowns and lower economic activity than others.

Issuance Forecast to be Revised

At the middle of November we forecast 2021 municipal bond issuance would come in at \$375 billion. This is well below the record amount of issuance we saw in 2020. However, this \$375 billion forecast assumed there was not going to be a fifth phase of COVID-19 relief and it assumed the Republicans held onto the Senate.

We will be revising our issuance forecast slightly higher because of the fifth phase of COVID-19 relief. We will also revise our forecast higher if the Republicans do not keep control of the Senate. We are going to wait until after the January 5th run-off election results are clear before we publish a revised estimate.

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Potential Economic, Market & Policy Impact from Georgia Run-off Elections

Policy Topic	Dems in White House (Biden, Rep, Dem)	Blue "Democrat" Wave (Biden, Dem, Dem)
A sixth phase COVID-19 relief (fifth phase already approved)	Another phase unlikely in the near term	Very likely to materialize, something close to HEROES Act-like numbers
Infrastructure	Slightly possible, likelihood uncertain	Very likely to be substantial (details very early in 2021)
Potential for fiscal stimulus (different than relief)	Slightly possible, but likelihood uncertain	Very likely- type, amount, timing to be determined
Economic recovery (near term pace)	Slower	Relatively faster, not without impact to deficit
Economic growth (near term, assuming the above policies)	Weakening consumer sentiment, less disposable income, weaker consumption, lower GDP growth	Stronger consumer sentiment, artificially supported disposable income, stronger consumption, faster GDP growth
Impact on U.S. Deficit	Unchanged to slightly negative	Negative to very negative
U.S. policy uncertainty	Well above average to just above average	Average to just above average
Climate change, energy/ environmental policy	Unlikely to change	Pressure to build into 2H21 proposal, could drag on economic performance
U.S. Trade	Tensions likely to decline	Tensions likely to decline
Regulation (bank, energy & environment)	Slight increase	Heavy increase, could also create a drag on economic performance

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National health care	Slight to moderate changes	Increased national support
Tax policy (reform)	Unchanged	Moderate to significant tax increases
Municipal credit conditions	Weaker to slightly weaker	Expect relief, still slightly weaker
Municipal bond issuance	Refundings up, new money down slightly to moderately	Refundings up, new money up potentially substantially if there is infrastructure and other relief/stimulus

Source: HilltopSecurities.

Recent HilltopSecurities Municipal Commentary

- [Fifth Phase of Fiscal COVID-19 Relief is No State and Local Government Windfall](#), December 23, 2020
- [Late and Limited is Better Than Nothing](#), December 21, 2020
- [D.C. Nears an Almost \\$1 Trillion Fifth Phase COVID-19 Relief Compromise](#), December 16, 2020
- [Leadership Working on Support for \\$908 Billion Bipartisan COVID-19 Relief Proposals](#), December 15, 2020
- [Gone to Texas, Land of Opportunity](#), December 14, 2020
- [Final Municipal Liquidity Facility Transactions, Most Likely](#), December 11, 2020
- [Optimistic Scenarios Related to Vaccines and COVID-19 Relief](#), December 10, 2020
- [Funding Deadline Pushed, Hope for COVID-19 Relief Remains](#), December 7, 2020
- [November Sees Third Straight Month of State and Local Government Job Losses](#), December 4, 2020

Readers may view all of the HilltopSecurities Municipal Commentary [here](#).

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