U.S. Municipal Bond Market

We Expect a Multi-Year, But Potentially Temporary, Upswing of U.S. Municipal Credit

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- We raised credit outlooks on seven of our 11 municipal sectors, mostly as a result of recent meaningful U.S. fiscal policy relief and the path of the U.S. vaccination effort.
- A multi-year, yet potentially temporary, upswing of U.S. municipal credit is expected.
- We are cautioning observers that this upswing could only be temporary for some entities, especially those entities that do not balance revenues and expenditures.
- It may be necessary to reevaluate our outlook assignments if a significant fourth wave of new COVID-19 cases, hospitalizations, and deaths develops.

Upswing from U.S. Fiscal Policy, Concerns Remain Even as Vaccinations Increase

Municipal credit fundamentals continue to be a central consideration, but overall credit quality across public finance will get a boost in the form of significant direct, and almost completely unencumbered, U.S. fiscal policy support from the American Rescue Plan Act of 2021. All told, the federal government has unveiled about $6.4 trillion of fiscal policy support for the U.S. in the wake of COVID-19 and much of it has supported the U.S. economy in near-unprecedented fashion.

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The most recent $1.9 trillion Rescue Plan included about $650 billion (see page 5 of our March 19 report) of funds that will flow to public finance-related sectors. $350 billion will be allocated to state and local governments alone (see pages 8-9 of the same report). This week, President Biden is set to unveil his legislative plans that will include a push for infrastructure spending. We expect that infrastructure-focused spending on top of all that listed above, which has already come out of Washington, will only solidify what we are referring to as a potential "Golden Age" for U.S. public finance.

Balancing Revenues with Spending in the Near-Term, Credit Issue to Watch

However, it is key to remember that this one-time federal funding is not going to recur year-after-year, and ongoing expenditures are going to need to be balanced with revenues. For these reasons, we are expecting a multi-year upswing of U.S. municipal credit but cautioning observers that this upswing could only be temporary for some entities, especially those entities that do not balance revenues and expenditures. Therefore, it is important investors keep in mind how sustainable spending habits of public finance entities become in near-term budget cycles. While this federal enhancement is substantial at this point, an important transition needs to occur in the next budget cycle or two. First, public finance entities need to transition

HilltopSecurities Municipal Sector Credit Outlooks (as of March 30, 2021)

Sector	Hilltop Credit Outlook	Recent Action (March 2021)	Key Sector Trends
State Government	Stable	Raised two notches	Revenues did not plumment as some forecast, income tax receipts were more reslient than expected, $200 billion plus will flow directly to states, pension liabilities remain a near term stress, structural imbalances could/will reappear
Local Government	Stable	Raised two notches	AV growth has been surprisingly strong through COVID, $150 billion plus will flow directly to local govts, pension liabilities remain a near term stress, structural imbalances could/will reappear
School Districts	Stable	Raised two notches	AV growth has been surprisingly strong through COVID, $129 billion plus will flow directly to schools, pension liabilities remain a near term stress, structural imbalances could/will reappear
Airports	Stable	Raised two notches	Enplanements not yet to pre-COVID levels but they are ramping up, we expect activity to steadily rise as vaccinations continue and the economic recovery strengthens, we may see more modernization and upgrades if infrastructure legislation is approved by DC lawmakers
Health Care	Negative	None	Profits fell, labor costs increased and many elective procedures were put on hold as a result of COVID-19, Rescue Act and CARES Act funds have provided support to the sector, but pre-COVID and COVID-era stresses could continue to offer roadblocks
Higher Education	Private: Negative Public: Cautious	Raised Pub Sect Outlook	We had a "Negative" outlook on entire sector even before COVID-19, the $40 billion of Rescue Act money will help bridge the COVID-19 gap, but pre-COVID pressures could set in again in another year or two, state sytem enrollments could continue to strengthen, endowments have grown
Housing	Positive	Raised	State Housing Finance Agencies (HFAs) were less impacted than other sectors, we expect housing demand to continue & credit of HFA programs to remain strong
Public Power (Elec.)	Stable	None	Recovery to 2019 usage levels could take years but federal support has provided a base, we expect infrastructure focused stimulus could provide a boost to the sector
Tobacco	Negative	None	MSA numbers were slightly higher in 2020 YOY, we continue to expect more downside risk in this sector going forward, near term federal funds could offer some positive retail sales numbers
Toll Facilities	Stable	Raised two notches	Commerical related revenue has helped to compensate for commuter decreases in some cases, vehicle miles traveled fell to 2004 level, already seeing usage increase, Rescue Act money could flow through offering support, a sector-specific boost could come from potential infrastructure stimulus
Water and Sewer	Stable	None	Essentiality remains important driver, one of the approved uses of the Rescue Act funds is for water and sewer infrastructure, additional relief could come from potential infrastructure stimulus

Source: HilltopSecurities.

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from COVID-19 shutdowns to recovery, and then to some level of growth. This process could be more difficult for entities that were faced with structural imbalances even before the COVID-19 pandemic.

Much has gone right on the COVID-19 front since the beginning of January. The numbers for cases, deaths, and hospitalizations have fallen significantly, according to almost all data sources. Although concerns in some states are developing (see below). We typically refer to the New York Times for the latest. Economic considerations are also trending in the right direction. The Dallas Federal Reserve's National Mobility and Engagement Index rose to new post-March 2020 record levels

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Public Finance Sector-by-Sector Impact From the American Rescue Plan Act of 2021

Provision	Amount ($ billions)	Sector(s) to Benefit Most	Credit Relevance
State and Local Govt. Aid	$350.00	U.S. state, local, and tribal governments	Direct fiscal assistance to governments, in some cases totaling as much as 30% of operating revenue (not completely unencumbered, however)
K-12 School Aid	126.00	U.S. state and local govts.	Focused on primary and secondary education funding
Affordable Care Act (ACA) Tax Credits & COBRA Coverage	63.00	Healthcare	More generous tax credits will allow more people to obtain or maintain health insurance and reduce hospitals' uncompensated healthcare costs
Higher Education Relief Fund	39.60	Higher Education	Additional direct aid to universities and colleges; must use a percentage for emergency student financial aid
Additional Aid to Mass Transit Operators	30.50	Mass Transit	Provides financial assistance to sector hard hit by ridership and operating revenue declines
Incentives for non-expansion states under ACA to expand Medicaid	16.40	State govt., Healthcare	If all 12 non-expansion states accept the incentives, each will net an estimated $10 billion (nearly), after their new Medicaid costs
Coronavirus Capital Projects Fund	10.00	U.S. state, local, and tribal governments	Cricital capital projects in response to the public health emergency (Sec 604)
Homeowner Assistance Fund	10.00	Housing	Assistance to homeowners for mortgage payments, utilities and insurance
Emergency housing vouchers	5.00	Housing	Incremental emergency housing vouchers that provide tenant-based rental assistance under Section-8
	$650.50		

Source: Moody's Investor Service, House Oversight Committee, Joint Committee on Taxation, Committee for a Responsible Federal Budget, and HilltopSecurities.

COVID Concerns Remain

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Health officials have been concerned about another wave of infection developing. U.S. Centers for Disease Control and Prevention (CDC) Director, Dr. Rochelle Walensky said during a recent announcement, "I am going to pause here. I'm going to lose the script." She then indicated she had a "recurring feeling of impending doom." She said, "Right now, I am scared," as her voice cracked. Additionally, yesterday after President Biden made prepared comments, he was asked if he believes some states should pause their reopening efforts as he was walking out of the press room. The president, after he heard the question, stopped, paused and looked back at the press, removed his mask, answered "Yes," and walked away. See the brief video of the Q&A via CSPAN here.

When asked if some states should pause reopening efforts, President Biden responded, "Yes."

State Government

New and Current Outlook: "Stable"
Recent Action: We raised the outlook two notches to "Stable" from "Negative"

We believe the impact from COVID-19 on state budgets has not been as bad as feared.

State Government Summary: Even though we had a "Cautious" outlook on the state sector before COVID-19, we believe the expected impact from COVID-19 on state budgets has not been as bad as feared. Moody's Analytics revised February 2021 estimate shows a net $57 billion budget shortfall for state governments compared to their April 2020 estimate of $113 billion. In addition, federal aid has been substantial and will help states manage through at least the next few budget cycles. $200 billion of relief is going to flow directly to state governments via President Biden's Rescue Plan. Perhaps we will need to reassign a "Cautious" outlook if structural imbalances appear in the meaningful states we saw them in before the COVID-19 pandemic. For now, we believe a "Stable" outlook is appropriate for the sector. Rising pension liabilities will continue to be an important contributing factor in this sector.

Local Government and School Districts

New and Current Outlook: "Stable"
Recent Action: We raised the outlook(s) two notches to "Stable" from "Negative."

$150 billion of federal relief is going to help shore-up what local leaders are able to do while helping citizens and workers react to changes after COVID-19.

Local and School District Government Summary: Local governments are going to receive $150 billion or more in federal relief to help them recover from COVID-19. It is going to help shore-up what local leaders are able to do while helping citizens and workers react to changes after COVID-19. The mayors of Dallas, Texas and Fort Worth, Texas wrote, "Take it From us Mayors: Here's How the COVID-19 Relief Law Helps Fort Worth; Dallas." School districts have not only been hit hard since COVID-19 began, but many experienced funding declines since the wake of the Financial Crisis of 2008. The $126 billion ($123 billion for public schools) of K-12 funding is a significant infusion of resources for schools to utilize over the next three years. Schools face high price tags as they seek to open for in-person learning, close the digital divide, and help keep students across the country from losing too much ground as a result of the time spent outside of the classroom during COVID-19. Please see American Rescue Plan Act Includes Much-Needed K-12 Funding by the Center on Budget and Policy Priorities for more. Assessed valuations (AV) have been surprisingly strong at the local government level over the past year.

Remote work has been a success, according to employers and employees who responded to this January 2021 PWC poll. It is not yet determined how successful local governments will adapt their revenue streams as a result of changes in workforce dispersion. This is a factor that could drive credit quality in the coming years, and we will be watching and considering it closely. Rising pension liabilities will continue to be an important contributing factor in these sectors as well.

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Airports

New and Current Outlook: "Stable"
Recent Action: We raised the outlook two notches to "Stable" from "Negative"

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Airports Summary: The travel rebound is underway. Seniors were among the first to receive vaccinations and they are leading the 2021 travel boom almost country wide. Enplanement and TSA checkpoint travel numbers are continuing to increase as travelers feel safer. March 28, 2021 TSA Traveler Throughput was 1,574,228 (and rising) according to TSA data, compared to only 180,002 for 2020 and 2,510,294 in 2019. American Airlines reported that net bookings are at 90% of the 2019 pre-pandemic average, with 80% of seats filled. Direct federal relief will also help this sector as will in-direct relief that will help support leisure travel. Business travel is not expected to return as quickly. We will be watching closely to see how the sector is able to adjust post-pandemic. It could take some time to play out. One study reported that up to 36% of airline business won't return after the COVID-19 pandemic ends.

Healthcare

Current Outlook: "Negative"
Recent Action: Our sector outlook has been "Negative" since our outlooks were created Aug. 26, 2019, and our outlook continues to be "Negative."

Healthcare Summary: Meaningful aid for the healthcare sector did flow from the federal government's massive fiscal response to COVID-19. This was a plus, but COVID-19 also stressed providers and systems as many were forced to cut down, or at times virtually eliminate, elective services in order to help combat COVID-19. Profits fell, labor costs increased, and liquidity improved in 2020 year-over-year, according to a March 24, 2021 Moody's Investor Service sector report. Hospitals are reporting lower revenues and are seeking the remaining payout of 2020 CARES Act money in some cases to bolster their standing. It will likely take more time to see how entities in this sector will recover in the post-COVID world than other sectors. For example, even though the sector was beginning to manage operating revenue and expense growth better in 2019, this weakened in 2020 according to Moody's median data.

It will likely take more time to see how entities in heathcare will recover in the post-COVID world than other sectors.

Higher Education

New and Current Outlook(s): "Negative" for Private Higher Education, and "Cautious" for Public Higher Education (Higher-Ed)
Recent Action: We divided our outlook in two and raised our outlook for Public Higher-Ed to "Cautious" from "Negative." We kept our outlook "Negative" for Private Higher-Ed.

Higher Education Summary: We divided our outlooks because we believe it was even more important now to acknowledge the growing divide between public and private higher education. We originally assigned a "Negative" outlook to the higher education sector back in August 2019 as a result of several factors, such as falling enrollment, demographic influences, and we noted that the stress at the end of that summer we saw after Alaska cut its higher-ed budget could be a sign of things to come for soon-to-be stress for public higher-ed. At that time, no one could

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have guessed a virus would clear out classrooms and campuses. Higher education funding for public entities had been down in nearly every state in the years just after the Great Recession. The Center on Budget and Policy Priorities had called it a "Lost Decade in Higher Education Funding." That being said, almost $40 billion from the recent Rescue Plan package is going to flow to universities and colleges from the federal government. State budgets will generally get a boost, and this may flow through to public universities in a positive way. We could readjust our outlook on public higher-ed after a few years because of lower state funding.

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Housing

New and Current Outlook: "Positive"
Recent Action: Our sector outlook was "Positive" when they were created Aug. 26, 2019. We lowered it to "Stable" in March 2020, and we are raising it back to "Positive."

Housing Summary: It is important we reinforce that the details of this sector outlook refer to single and multi-family housing revenue bonds sold by state housing finance agencies (HFAs). There are several other housing subsectors (student, military, public housing cap funds), but those generally include a different type of security, different levels of risk, and should be considered individually. The main reason we have assigned a "Positive" outlook to the Housing (again with a concentration on State HFAs) sector is the very high credit quality that exists generally in the sector. HFA portfolios will benefit from several of the spending line-items included in the $1.9 trillion Rescue Plan. Therefore, credit quality is likely to experience an enhancement. This recent support includes a $10 billion Homeowner Assistance Fund and $5 billion of emergency housing vouchers. Funds from other line-items will indirectly (and directly) impact housing credit to the upside as well. State HFA credit quality remained resilient, even in the depths of the last recession, which significantly pressured housing markets across the country. This is a very nuanced sector. Please see our recent Jan. 14 report, Housing Fundamentals Remain Solid and Our Housing (HFA) Sector Outlook Remains "Stable" to Begin 2021 and May 6, 2020 report, Single Family Housing, Durability Will Help Endure the New COVID-19 Normal, for a more detailed look at single family HFA housing.

The main reason we have assigned a "Positive" outlook to the Housing sector is the very high credit quality that exists generally in the sector.

Public Power

Current Outlook: "Stable"
Recent Action: We did not revise after COVID-19 began and, we are continuing to keep it "Stable."

Public Power Summary: There is a relationship between economic growth, and/or a decline in economic activity and energy use. This exposure exists in other sectors but is very apparent in public power. A record drop was forecast as a result of COVID-19. Demand for electricity fell in 2020 and a return to 2019 levels of energy consumption will likely take years, according to the U.S. Energy Information Administration Annual Energy Outlook 2021. However, the essential nature of this product for commercial, industrial, and residential usage underscores its importance and strengthens the argument for the sector's "Stable" outlook despite the fact that usage has fallen and could take time to recover. We expect operating and financial metrics in the sector

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to weaken, but federal government relief and especially infrastructure-focused funds targeted to the sector will provide assistance. Legislation in Texas is being considered that could require weatherization for power systems. Texas Senate Bill 3 was approved by the State Senate and is going to be considered by the Texas House.

Trends do not point to a world void of tobacco products, but expectations by some is that consumption in select countries could become extinct by 2050.

Tobacco

Current Outlook: "Negative"
Recent Action: Our sector outlook was "Negative" when they were created Aug. 26, 2019, and we are keeping it at "Negative."

Tobacco Summary: Trends do not point to a world void of tobacco products, but expectations by some is that consumption in select countries could become extinct by 2050. The tobacco settlement revenue securitizations are bond issues secured by the tobacco settlement revenues tobacco companies agreed to pay to state and other governments under the Master Settlement Agreement (MSA) in 1998. Falling domestic cigarette sales are largely responsible for the declining trend in the actual MSA payments that secure the bonds. The National Association of Attorneys General released its annual U.S. MSA domestic cigarette shipment data and results showed numbers year-over-year were slightly higher in 2020 compared to 2019. However, we do not expect a sustained trend to continue higher in the coming years.

In toll facilities, we expect activity to trend upward as vaccine distribution continues and believe the numbers could rise significantly beginning in the second half of 2021.

Toll Facilities

Current Outlook: "Stable"
Recent Action: Our sector outlook was "Stable" when they were created Aug. 26, 2019. We lowered it to "Cautious" in March 2020 and lowered again to "Negative" in May 2020, but we are now raising it back to "Stable."

Toll Facilities Summary: This is one of the sectors that was hardest hit by the new COVID-19 normal. Traffic volumes collapsed across the U.S. Overall, they fell to a level not seen since 2004. There was a regional difference as well. Vehicle miles traveled fell most in the northeast U.S. (-16.2%) and it fell least in the south and gulf states (-7.9%) according to U.S. Dept. of Transportation data. We expect activity to trend upward as vaccine distribution continues and believe the numbers could rise significantly beginning in the second half of 2021. The potential for this to occur and the federal relief targeted to the sector supports sector credit quality. A structural change in mass transit ridership could present a funding problem that was already developing before COVID-19. This is something we will watch closely in the coming months and years. Mass transit did receive another $30 billion in the Rescue Plan Act of 2021.

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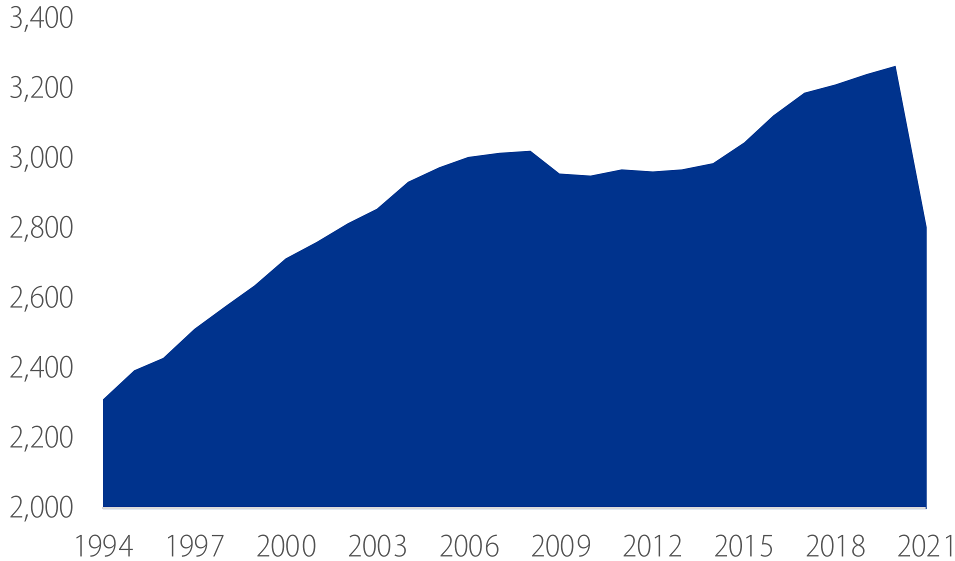
Vehicle miles traveled fell most in the northeast U.S. (-16.2%) and it fell least in the south and gulf states (-7.9%).

Vehicle Miles Traveled (Moving 12-Month Average) Fell to 2004 Level



Source: U.S. Dept. of Transportation and HilltopSecurities.

Water and Sewer

Current Outlook: "Stable"
Recent Action: No change

Water and Sewer Summary: The essentiality factor of water and sewer service remains a significant driver of the strong financial and credit conditions of most of the entities in this sector. One of the approved uses of the $350 billion of direct relief to state and local governments from the Rescue Plan is for water and sewer infrastructure, so this could provide a boost to aging asset conditions. We do not expect a significant change in debt service coverage levels for 2020 and going forward they should improve in areas where there was weakness. Environmental risks are here to stay and some entities are tackling them. This will be an important item to watch going forward as it relates to this sector.

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Definition of Outlooks

- Positive: HilltopSecurities Strategy and Credit believes there are factors which point towards improving issuer or sector credit quality which may result in a higher level of credit ratings upgrades versus downgrades.
- Stable: HilltopSecurities Strategy and Credit believes there are factors which point towards stable issuer or sector credit quality which are likely to result in an even level of credit ratings upgrades versus downgrades.
- Cautious: HilltopSecurities Strategy and Credit believes there are factors which introduce the potential for declines in issuer or sector credit quality that may result in potential credit ratings downgrades only slightly outnumbering upgrades.
- Negative: HilltopSecurities Strategy and Credit believes there are factors which point towards weakening issuer or credit quality that will likely result in a higher number of credit ratings downgrades versus upgrades.

Recent HilltopSecurities Municipal Commentary

- Infrastructure Could Strengthen Golden Age of U.S. Public Finance, Prelim Talks to Begin, March 23, 2021
- American Rescue Plan Provides Massive Economic Boost, U.S. Public Finance Could Be on Brink of a Golden Age, Especially if Infrastructure Stimulus Follows, March 19, 2021
- America's Infrastructure GPA: C-, up from D+, March 3, 2021
- Continuing to Assess Cost and Liquidity Pressures for Texas Power Utilities, March 2, 2021
- Brazos Electric Power Files Ch. 11 Petition, S&P Places Six Texas Utilities on CreditWatch with Negative Implications, March 1, 2021
- Winter Storm Uri Costs Slowly Reported by Texas Local Governments, February 26, 2021
- Texas' ERCOT-Area Public Power Utilities on 'Rating Watch Negative,' per a Fitch Rating Action, February 24, 2021
- Pension Funding Not Improving From Stabilizing Fiscal Conditions, NJ Proposing Full Payment to Avoid Asset Depletion, February 24, 2021

Readers may view all of the HilltopSecurities Municipal Commentary here.