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U.S. Municipal Bond Market

Public Finance Downgrades to Outpace Upgrades, Probably for Years

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Summary

- For the first time in 21 weeks, new unemployment claims fell below 1 million, coming in at 963,000 according to data released today by the U.S. Labor Department.
- Today, the National League of Cities published a report forecasting tax revenues could fall by as much as 13% in FY2021.
- S&P Global public finance "Negative" outlooks and "CreditWatch Negative" assignments are concentrated in revenue sectors like transportation and higher-ed, for now.
- We believe public finance downgrades will outpace upgrades in 2020 and could for several years. The number of downgrades is more likely to peak faster this time compared to the wake of the Great Recession, perhaps in 2021 or 2022.
- Moody's second quarter of 2020 data already shows downgrades are beginning to outpace upgrades.

Jobless Claims Remain Very High, Still Nothing About More Relief

For the first time in 21 weeks, new unemployment claims fell below 1 million, coming in at 963,000 according to data released today by the U.S. Labor Department. This can be considered a better-than-expected result, as the consensus expectation was 1.1 million.

In the wake of the Great Recession jobless claims topped 665,000 in March 2009, which should help to give today's better-than-expected number some additional perspective. A total of 28.3 million individuals received unemployment benefits at the end of last month.

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The economic backdrop stabilized since March, relatively speaking that is, through a significant amount of Federal Reserve intervention and over $3 trillion of U.S. fiscal policy relief. The fiscal policy stabilizing factor will be rolling off, or has already, in some cases without additional congressional action. Talks for a fifth phase of COVID-19 relief have not been revamped. Currently, it seems as though both sides have drawn a line in the sand. Each party may be comfortable with the political ramifications of the stalemate, and this argument may be even stronger on the Republican side because of the bump received from Saturday's presidential actions.

We think the economy will have a difficult time staying close to the level considering it has been even in just recent weeks without additional federal relief. The possibility of actual growth without more federal aid will be elusive.

Municipal Credit Landscape, All Signs Point to Further Credit Deterioration

We assigned "Negative" outlooks to eight out of 11 municipal sectors back in May.[1] The three sectors with "Stable" outlooks remain housing, public power, and water and sewer. We continue to believe going forward the municipal entities that are more fiscally conservative are those that are going to have an easier time navigating the current and near-term landscapes. As a little more time has passed, we are getting a better idea of the health- and fiscal-related near-term challenges facing municipal

Please see disclosure starting on page 4.

entities. We have written numerous times about the $555 billion projected budget shortfall for state governments, for example.[2] The impact from these shortfalls will flow downstream and most likely impact other entities like schools and local governments in the form of lower state aid. Today, the National League of Cities released a report forecasting tax revenues (including property, sales, and income taxes) could fall by as much as 13% in FY2021.[3]

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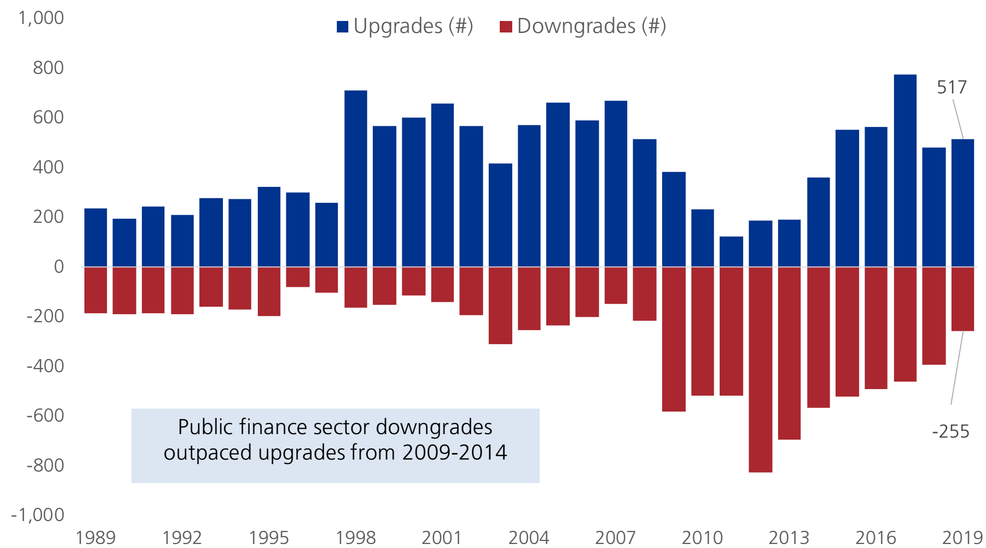
Credit Deterioration Will Impact Municipal Ratings

Some have commented to us that it seems there have not been as many municipal rating actions as one might have expected, considering the significant consequences from the steps taken to contain the COVID-19 virus. Our response is that usually municipal rating downgrades lag behind those on the corporate side and even lag behind the economic cycle to a degree, as well. That being said, you can be sure the downgrades are coming.

In the wake of the Great Recession, public finance downgrades first outpaced upgrades in 2009, which was fairly quickly. However, the number of downgrades did not peak until 2012, several years after the recession ended. This lagged effect is because of the nature of the revenues involved and budget cycles. Additionally, in the last recession housing prices (and property tax revs) were significantly impacted because of the mortgage crisis, and the lag also occurred because the influence from the federal 2009 Recovery Act wore off.

Public Finance Downgrades (Annual) Peaked in 2012, Moody's Public Finance Portfolio



Source: Moody's Investor Service and HilltopSecurities.

We think the pace of downgrades could, or most likely will, occur faster this time around as a result. The severity of the downgrades very much depends upon federal aid, but even with additional federal relief downgrades will follow.

That being said, this time is different because of the severe impact state, regional, and local economies are, and will continue, experiencing until the health crisis can be better contained. We think the pace of downgrades could, or most likely will, occur faster this time around as a result. The severity of the downgrades very much depends upon federal aid, but even with additional federal relief downgrades will follow. Without federal aid, there will be more and they will most likely occur sooner.

Near-Term Outlook for Rating Downgrades

The stage is set for an increase in near-term public finance rating downgrades. The pace of downgrade action is going to depend upon the security pledge, sector, and perhaps region of the country. We can get a better grasp of the general credit situation of different sectors by looking at the percentage of the S&P Global Public Finance portfolio S&P has assigned "Negative" outlooks and "CreditWatch Negative" by sector. Revenue bond sectors, transportation, and higher education have more "Negative"

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outlooks and "CreditWatch Negative" assignments than the others, especially the tax-backed sectors. At the end of last week, S&P notably placed the municipal airport sector on "CreditWatch Negative." We should note that a "CreditWatch Negative" assignment does not mean a downgrade is inevitable, but it does mean there are events that could potentially lead to a change. A "CreditWatch Negative" assignment is normally assessed within 90 days.

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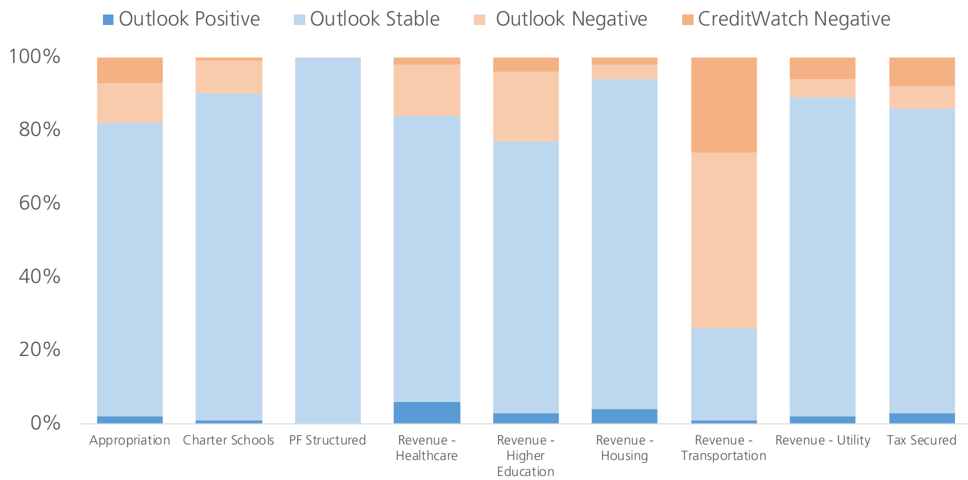
S&P Focused on Revenue Sectors So Far, Outlooks on Percentage of Public Finance Portfolio



Source: S&P Global and HilltopSecurities.

Downgrades to Outpace Upgrades

We noted that downgrades outpaced upgrades in 2009, very soon after the official end of the Great Recession. However, downgrades continued to outpace upgrades until 2014 on an annual basis. We believe that public finance downgrades will outpace upgrades this year. It is more probable that downgrades peak sooner this time around, potentially in 2021 or 2022, only a year or two into this economic slump as opposed to the four years it took after the last economic fall.

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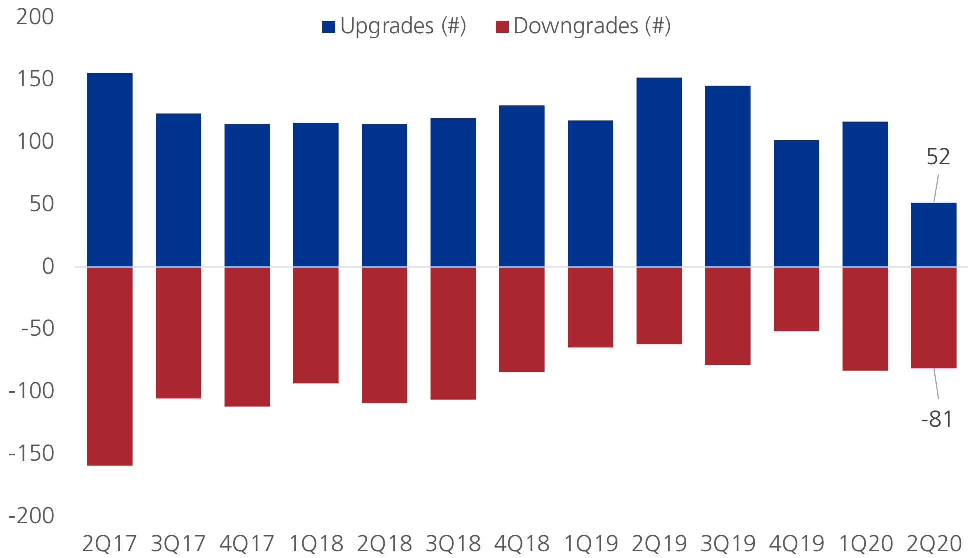
Moody's Public Finance Downgrades Outpaced Upgrades Already in 2Q20



Source: Moody's Investor Service and HilltopSecurities.

Next, we would like to consider the duration that downgrades will likely outpace upgrades. Downgrades are likely to outpace upgrades beginning this year, and this relationship could continue for several years. We noted this relationship lasted from

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2009 to 2014, after the most recent economic decline. Downgrades will almost certainly outpace upgrades in the coming years, and we would not be surprised if this trend lasts even longer than it did after the Financial Crisis downturn. Moody's just released their second quarter 2020 upgrade and downgrade data and it shows downgrades outpaced upgrades on a quarterly basis in the second quarter of 2020 for the first time since 2017. It was not by a significant margin, but it is likely that this is a relationship that is likely to continue for years to come.

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[1] *Kozlik, Thomas; Municipal Sector Credit Outlooks, Municipal Credit Two Months Into the New COVID-19 Normal; HilltopSecurities; May 20, 2020.*
[2] *McNichol, Elizabeth and Michael Leachman; States Continue to Face Large Shortfalls Due to COVID-19 Effects; Center on Budget and Policy Priorities; July 7, 2020.*
[3] *City Fiscal Conditions, 2020; National League of Cities; August 13, 2020.*

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