

U.S. Municipal Bond Market

Municipal Yields are Historically Attractive- Our View on How to Finish Out the Second Quarter of 2023

- Municipal yields are historically attractive. This is an opportunity for investors.
- The Golden Age of Public Finance is still alive. Upgrades outpaced downgrades in the first quarter of 2023 and we expect that relationship to continue for the rest of the year.
- Now is a perfect time for fixed income investors to review their portfolios and replace weaker holdings.
- U.S. municipal primary market issuance is 26% lower through May compared to the first five months in 2022. May issuance was only \$26 billion, or 29% lower than May issuance in 2022. We have not revised our \$350 billion issuance forecast for 2023.

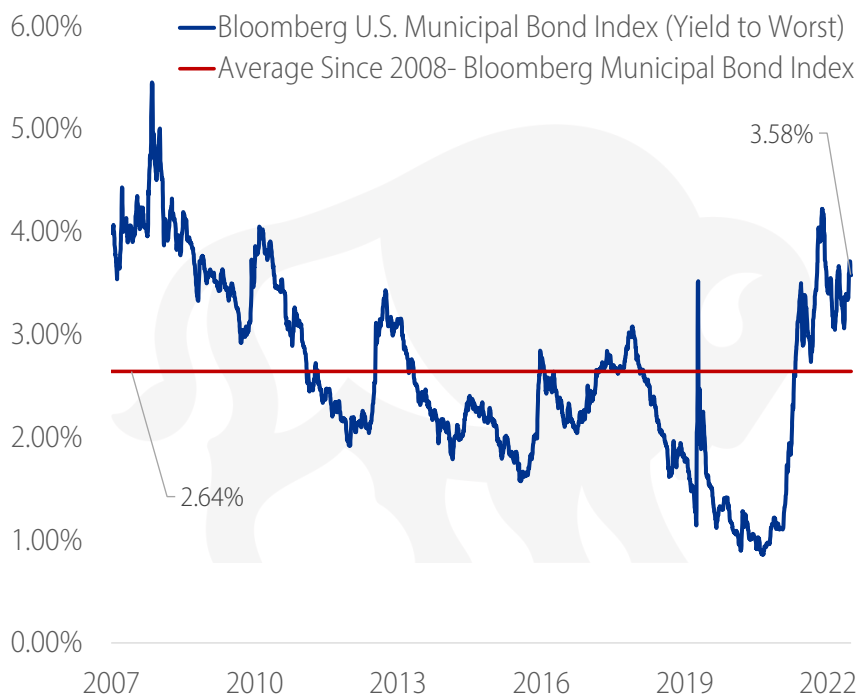
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How to Approach Municipals to Begin the Summer of 2023

Questions about the U.S. debt ceiling, and the partisan divide were both answered Saturday June 2 after President Joe Biden signed the bi-partisan Fiscal Responsibility Act of 2023 into law. Now that the risk of a potential U.S. sovereign default is behind us, investors can return to consider more traditional analysis and comparisons when choosing to allocate investment dollars over the summer of 2023. Please see our, "Debt Ceiling Deal Likely to Avert Default, Not Expected to Claw Back State & Local Govt. Fiscal Aid," May 31 report here for more details as well.

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Municipal Yields are Historically Attractive Now



Source: Bloomberg and HilltopSecurities.

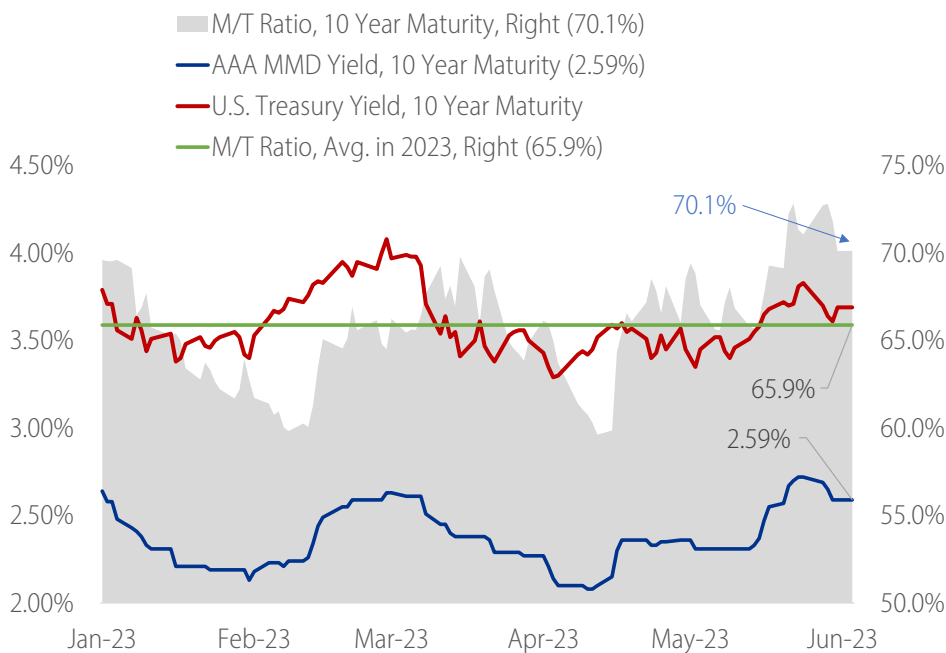
Please see disclosure starting on page 5.

Last week's [labor market data](#) reinforced the idea that the Federal Reserve may continue to tighten monetary policy after potentially pausing on June 14. But, the inverted U.S. Treasury yield curve and implied Fed. Funds futures data support, at least the potential for a recession, and lower rates by the end of 2023. This is a key reason why it is that it is important for investors to zero in on the historically attractive tax-exempt municipal yields that exist right now, because the elevated yield environment may not continue.

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The Bloomberg U.S. Municipal Bond Index is at a 3.58%, a level that is well above its average going back to the beginning of 2008 of 2.64%. Also, the yield in one of the sectors we have been watching closely since the beginning of 2022 is the "A" rated Hospital yield at the 30-year maturity. In mid-April it fell to a 4.30%, but it has since risen back to a 4.57% (June 6, 2023). Municipal to Treasury Ratios are not as attractive as they have been at select times in recent years past, but they have risen in recent weeks. In the below line-chart we feature the 10 year M/T Ratio which is at a 70%, just above its average for 2023 of 66%. We are continuing to talk to investors about allocating funds to the municipal asset class regularly in order to take advantage of opportunities such as the current landscape. The backdrop that has developed in recent weeks, as described above, is one of the opportunities investors should not miss.

Municipal to Treasury Ratios Slightly Improved in Recent Weeks



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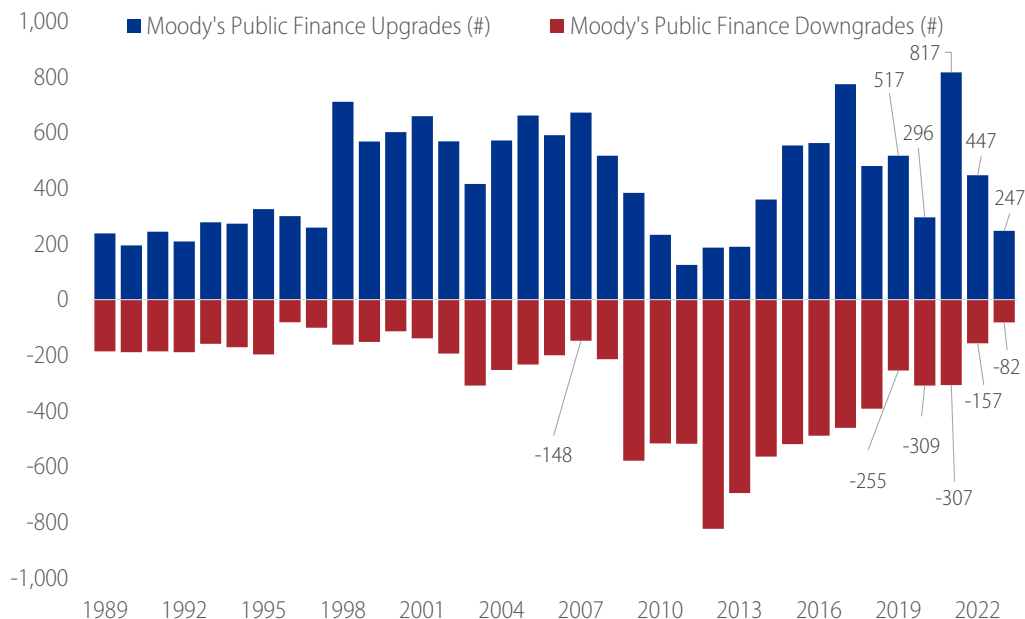
Source: Refinitiv and HilltopSecurities.

The Golden Age of Public Finance Going Strong in 2023

The Golden Age is still alive. Very strong credit fundamentals for many if not most tax backed public finance entities still exist. This has again resulted in another quarter when Moody's Public Finance upgrades outpaced downgrades. We saw 247 public finance upgrades in the first quarter of 2023 and only 82 downgrades per Moody's data for the first three months of the year. We still expect upgrade activity will outpace downgrades for the rest of the year. We also still believe that investors should take this opportunity to review portfolios and trade out of issues that will experience budget strains or regain structural imbalances.

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More Public Finance Upgrades than Downgrades in First Quarter 2023



Source: Moody's and HilltopSecurities.

U.S. state governments ("Stable" credit outlook) are still well-positioned to withstand economic deterioration, and even a mild recession. We lowered our U.S. State sector Credit Outlook to "Stable" from "Positive" back in January but this was not because we are expecting credit deterioration in the sector. We took this action because we just do not think there are likely to be many more if any state sector credit rating upgrades on the horizon. They are mostly done for now. Total balances remain near record highs and most credit metrics are strong or very strong. For now, we are looking to see if there are states that return to fiscally unsound habits, like we saw before the COVID-19 crisis in small but important situations.

Where the local government ("Positive" credit outlook) and school district ("Positive" credit outlook) sectors are concerned we still think there could be some rating action upside. Over the last two years most of the public finance upgrades we have seen have been taxed backed and many of them occurred in these sectors. Upgrades will continue for the rest of 2023 we think. While there are also healthy reserves and credit metrics in these sectors as well, we are also going to be watching to see how individual entities shift their spending and revenues to align with the post-COVID-19 crisis era. This will be important because these entities will not have federal relief to fall back on, and there could be some select credit deterioration as a result if shifts do not occur. A focus on the need to accurately fund pensions will also return in coming budget cycles and this is going to get expensive for some entities. Our Credit Outlooks for the Local Government and School District sectors remain "Positive," for now.

We do see opportunities in many of the revenue sectors but believe investors should be on the look-out for developing weaknesses. In select cases weaknesses may be structural, and turn-around may be difficult. There is still a good story in the Airport sector ("Stable" outlook) sector. Recovery is ongoing and oftentimes is only limited by capacity. There is a good story with Toll Facilities, too. What investors are going to find in

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the Health Care and Higher Education sectors is much different. These are sectors where there is more weakness and some of it is unavoidable. Investors should be more careful here and this is why we have a “Negative” outlook for both investment-grade and non-investment-grade Health Care and a “Cautious” outlook for those entities that would be considered in the Public area of Higher-Education and a “Negative” outlook for Private Higher Education.

HilltopSecurities Municipal Sector Credit Outlooks

Sector	Hilltop Credit Outlook	Key Sector Trends
State Government	Stable	Total balances remain near record levels, most states can withstand a recession
Local Government	Positive	Healthy reserves, concerned some credits are not preparing for financial reality
School Districts	Positive	Reserves are healthy here too, fiscal balance also needed
Airports	Stable	Enplanements bouncing back with a “permanent structural change”
Charter Schools	Stable	Charters maintained COVID-19 enrollment gains
Community Facilities Districts	Stable	California property values will support the state’s CFDs market
Health Care (inv. grade)	Negative	Fiscal strain, consolidations, partnerships & affiliations still occurring
Health Care (sub-inv. grd, NR)	Negative	Same backdrop as above, less resources
Higher Education	Public: Cautious Private: Negative	Forecast expects the number of high school grads to drop off starting in 2025, healthy state coffers provide a near-term boost to public entities
Housing	Stable	Fiscal momentum is slowing and issuance is expected to drop
Public Power (Elec.)	Stable	Good cash position and coverage ratios are under pressure
Senior Living	Negative	We expect more and greater operating headwinds in the medium-term
Tobacco	Negative	More downside risk b/c of government policy and declining tobacco usage
Toll Facilities	Stable	Vehicle miles traveled are recovering, watching economic growth
Water & Sewer	Stable	Essentiality remains a factor but fiscal pressures are building

Source: HilltopSecurities.

Primary Market Municipal Bond Issuance

Public finance entities only sold \$26 billion of municipal bonds in the primary market in May 2023. This was 29% lower compared to the \$37 billion sold in May of 2022. So, another month of low issuance occurred and there is probably no end in sight for this reluctance to bring new bonds to market because really the only factor that could jumpstart this activity (besides a tax policy scare) would be falling interest rates. Issuance through the first five months of the year has been about \$134 billion compared to \$180 billion at the same time last year. Remembering that we began 2023 with an issuance forecast of \$350 billion, we think it is very possible still.

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Only \$26 Billion of Public Finance Issuance in May 2023, 29% Lower Than Last Year

Ten Year Average '13 - '22	Month	2020 Actual	2021 Actual	2022 Actual	2023 Actual	% Change from 2022	Iss. Required for \$350B in 2023	Iss. Required for \$400B in 2023	HTS Initial 2023 Forecast (Nov. 22)
\$27	January	\$33	\$28	\$26	\$23	-12%	\$29	\$33	\$25
28	February	42	37	32	21	-33%	29	33	25
35	March	20	48	46	33	-28%	29	33	30
34	April	32	37	40	31	-24%	29	33	30
34	May	31	35	37	26	-29%	29	33	25
40	June	52	50	38	-	-	29	33	40
32	July	48	38	28	-	-	29	33	30
37	August	43	45	42	-	-	29	33	30
33	September	54	45	27	-	-	29	33	30
43	October	73	42	29	-	-	29	33	35
32	November	21	37	26	-	-	29	33	25
34	December	35	41	20	-	-	31	37	25
\$409	Total	\$485	\$483	\$391	\$134	-26%	\$350	\$400	\$350

Source: Refinitiv, The Bond Buyer and HilltopSecurities.

Recent HilltopSecurities Municipal Commentary

- [Debt Ceiling Deal Likely to Avert Default, Not Expected to Claw Back State & Local Govt. Fiscal Aid, May 31, 2023](#)
- [First Quarter 2023 Public Finance Infrastructure Financings Lower, as Expected – Our Update on Issuance, Fund Flows, & Benchmark Yields, April 12, 2023](#)
- [Municipals Seen as Quality Amid Bank Stress, Economic Uncertainty, April 6, 2023](#)
- [The Fed is Not Changing Course, Reaffirms Our 2023 Municipal Outlook, Feb. 3, 2023](#)

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

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