U.S. Municipal Bond Market

The Municipal Market in 2024, Hilltop's Municipal Sector Credit Outlooks

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- There was a temporary upswing in municipal bond credit quality that began in 2021. Now, just three years later, municipal credit is normalizing.
- The details and path of individual credit is important again and we are closely watching across all sectors to see if expenditure demand generally and spending specifically aligns with revenues.
- There is a reluctant optimism amongst market observers as it relates to the macro-economic backdrop taking hold to begin the new year. Calls for a U.S. recession in 2024 have declined. Challenges exist in 2024 even still as global disorder takes shape.
- The credit normalization process is surely occurring in the **State Government** sector as officials across the nation are seeking a refreshed level of fiscal balance.
- We lowered our **Local Government** sector outlook to "Stable" from "Positive." Upgrades will likely still outpace downgrades in 2024, just at a lower pace this year.
- We also lowered our **School District** sector outlook to "Stable" from "Positive." We are not expecting credit stress to develop, but factors such as enrollment declines are building.
- Our "Stable" outlook for the **Community Facilities District** sector is still appropriate as California property values remain relatively even, yet below national trends.

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HilltopSecurities Municipal Sector Credit Outlooks

Sector	HilltopSecurities Sector Outlook	Jan. 2024 HTS Action(s)
State Government	Stable	None
Local Government	Stable	Lowered to Stable
School Districts	Stable	Lowered to Stable
Community Facilities Districts	Stable	None
Airports	Stable	None
Charter Schools	Stable	None
Health Care	Negative	None
Higher Education	Private: Cautious Public: Cautious	Raised Private to Cautious
Housing	Stable	None
Public Power (Elec.)	Stable	None
Senior Living	Cautious	Raised to Cautious
Tobacco	Negative	None
Toll Facilities	Stable	None
Water & Sewer	Stable	None

Source: HilltopSecurities.

- The **Airport** sector has returned to a steadier circumstance because passenger enplanements recovered and in some individual cases even surpassed 2019 levels.
- **Charter Schools** could face medium term capital and operational pressures especially if lower stated aid revenues materialize.
- Obstacles in the **Health Care** sector remain. Entities in the sector continue to grapple with fiscal and workforce pressures. Merger activity could remain active in 2024
- Our outlook on Private **Higher Education** was raised to "Cautious" from "Negative." In both sub-categories, we are distinguishing between the "haves" and "have-nots."
- **Housing** sector activity should remain active and finances strong to stable for single and multifamily housing bond issuers.
- Rising energy needs and the search for a middle ground among affordability, reliability and decreasing the sector's carbon intensity creates pluses and minuses in the **Public Power** sector.
- We raised our **Senior Living** outlook to "Cautious" from "Negative" due to occupancy improvements, subdued labor expense increases, and moderating new supply.
- Consumption declines persisted, and regulatory and event risk remains in the **Tobacco** securitization sector.
- Traffic growth has evened out and financial metrics continue to be strong and should provide credit stability in the **Toll Facilities** sector.
- There are dauting regulatory headwinds for the **Water & Sewer** sector, but financial capacity remains very strong.

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There Was a Temporary Upswing, Now Path of Individual Credits is Important Again

The federal government's fiscal policies helped to supercharge a temporary upswing in municipal bond credit quality. This began in 2021, and while all the federal government money still has not been spent and or allocated, we are seeing, and expecting to continue to see municipal credit quality come back to earth. We indicated back in March of 2021 that we were expecting a Multi-Year, but Potentially Temporary, Upswing of U.S. Municipal Credit. We are seeing credit conditions normalize. The "Upswing" is close to being over across all sectors and reality is setting in for financial planning. The path of individual credit is important again and we are closely watching across all sectors to see if expenditure demand generally and spending specifically aligns with revenues.

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Big Picture – Lower U.S. Recession Risk, Yet A State of Global Disorder

This is the time of the year when we all read about global, macro-economic and industry-specific outlooks, risk checklists and market opportunities. Some examples we have found meaningful and thought provoking:

- These Four Questions Are Top of Mind for Investors in 2024, Wall Street Journal, Jan. 16, 2024
- A Pessimist's Guide to Global Economic Risks in 2024, Bloomberg Jan. 15, 2024
- Global Risks Report, World Economic Forum, Jan. 10, 2024
- The Top 10 Global Risks for 2024, Time Magazine, Jan. 8, 2024
- Three Economic Risks Facing America, Economist, Nov. 13, 2023

There are common themes among them. Chiefly, that the end of the COVID-19 Crisis did not mark a return to normalcy. Global disorder in differing forms has spread across the world and could continue in 2024. Geo-political conflict worsened in Eastern Europe and rose in the Middle East. Western nations are closely observing China, Russia, North Korea, and Iran. Technological change is advancing at speeds faster than the 1990s. Information (sometimes artificially generated) is spreading at a quicker pace, but the risk of misinformation spreading at quicker speeds is also a leading risk (see the WEF Global Risks Report.) Growing concerns over changes in the world weather patterns and humankind's lack of response remains at issue as well.

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United States Political Uncertainty

Ian Bremmer, President of Eurasia Group in Time Magazine indicated the greatest global risk in 2024 is "the United States versus itself." We have been watching the difficulty Washington D.C. lawmakers have had in recent years. Now, lawmakers are continuing to grapple with the annual budget process. The rise of internal conflict, the lack of compromise and factions facing off against one another could come to a head in the wake of the November 2024 elections in the U.S.

One of the most highly anticipated set of national elections in the U.S. in recent memory is now only about nine months away. There will be near-term noise surrounding the funding bills lawmakers are trying to get support for. We are anticipating the message voters send to lawmakers in November of 2024. Plenty remains at issue. Federal spending is enormously high for peacetime. Support of spending line items such as the desire for an increased state and local tax deduction cap is confusing at best. This uncertainty could spill-over to the U.S. public finance and the municipal bond market.

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What we are facing to begin 2024 from a macro-economic perspective in the U.S. is less uncertain than a year ago. U.S. macro-economic risk assessments were wrought with pessimism to begin 2023. Let's compare how we are beginning 2024. Spoiler alert- the macro-economic landscape is much more favorable to begin 2024 compared to 12 months ago. Market observers began 2023 on pins and needles. A Bloomberg model forecast that recession was a "100% certainty" before the end of 2023. Many other economists anticipated an economic downturn in 2023. It turns out a recession never materialized before 2023 ended, and growth has surprised to the upside.

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There is a reluctant optimism amongst market observers as it relates to the macro-economic backdrop taking hold to begin the new year. These are the numbers we have been seeing recently. Third quarter 2023 U.S. economic growth grew at a solid pace, or the strongest in two or so years. The Federal Reserve Bank of Atlanta's GDP Now indicator of economic activity is forecasting real GDP for the fourth quarter of 2023 at 2.2%, as of Jan. 10th. Macro-economic forecasts have strengthened to begin 2024. These numbers could cause uncertainty about the path of the U.S. Federal Reserve in the near-term. These numbers could also add to the non-action of investors, especially amongst investors waiting on the sideline and who are ready to begin to allocate or reallocate investment dollars.

Growth expectations for 2024 are building momentum. A Wall Street Journal survey reported a decreasing number – 39% from 48% – of economists expect a recession, per this Jan 14, 2023 article. At the end of 2023 a National Association for Business Economics (NABE) Outlook Survey for December 2023 reported three out of four panelists put recession risk at 50% or lower in the next twelve months. And another survey, this one of economists conducted by Bloomberg News reported that a little less than a third of economists surveyed expect a recession in the next 12 months.

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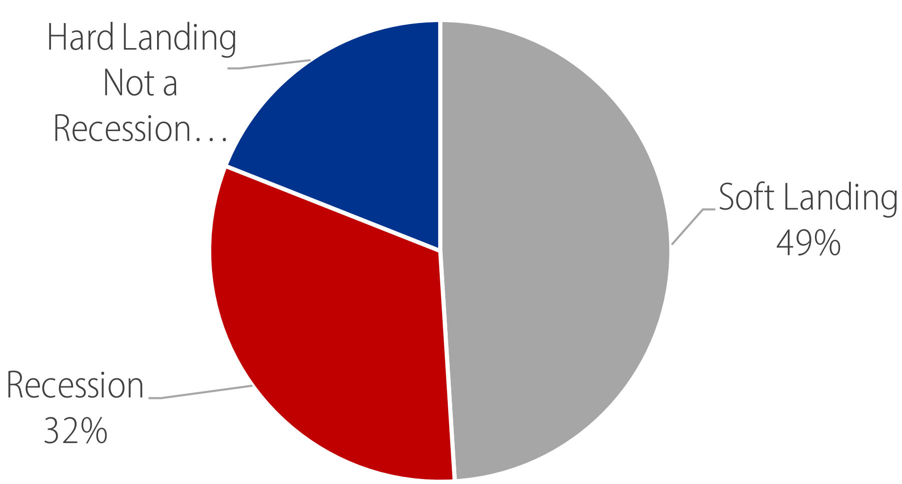
Most Economists Don't Expect Recession Within 12 Months



Source: Bloomberg News and HilltopSecurities.

Macro-economic forecasts have strengthened to begin 2024. These numbers could cause uncertainty about the path of the U.S. Federal Reserve in the near-term.

At the beginning of 2024 Hilltop's Scott McIntyre and Greg Warner indicated, "Recession fears evaporated as the economy accelerated, but the case for softer growth in the coming months remained intact," according to their January 5, 2024 Economic Summary – Q4 2023 commentary. Scott and Greg have also highlighted the mixed economic results we have seen to begin 2024, which will likely make the Fed's job in 2024 even more unpredictable. We saw a warmer Consumer Price Index (CPI) report in December reducing the odds of a March rate cut and the next day the December Producer Price Index (PPI) was much cooler than expected. The market expects as many as six rate cuts in 2024 and dropping (see Yields Climb on Surprisingly Brisk Consumer Spending [Jan. 17, 2024]), and feedback from interviews at Davos are not convinced the market is accurate in that expectation. What is clear is market sentiment is much different to begin 2024 compared to last year from a macro-economic perspective.

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Normalization of Municipal Credit Continues in 2024

We wrote about the "normalization" of the trajectory of municipal credit last year and we expect that process to continue in 2024. Normalization will be a multi-year process, it will not occur quickly. This is a positive for investors because they will be able to see if the boost in credit quality many, especially tax-backed credit profiles experienced, will be sustained. In some cases the 2021 federal fiscal relief may play a positive role but we are on the look-out for credits that could potentially have a problem maintaining multi-year structurally balanced budgets. We have always expected that the Golden Age of Municipal Bonds would be temporary. It is not over. Now, our enthusiasm is dropping and our skepticism rising. And we are probably closer to the end of this "Age" than the beginning. We maintain that this is an opportune time to review portfolios for credits that may have peaked. The federal government's fiscal policies continue to contribute to public finance upgrades. But, we are again going to be watching closely in 2024 to see how public finance entities in all sectors adjust to the revenue and expenditure pressures.

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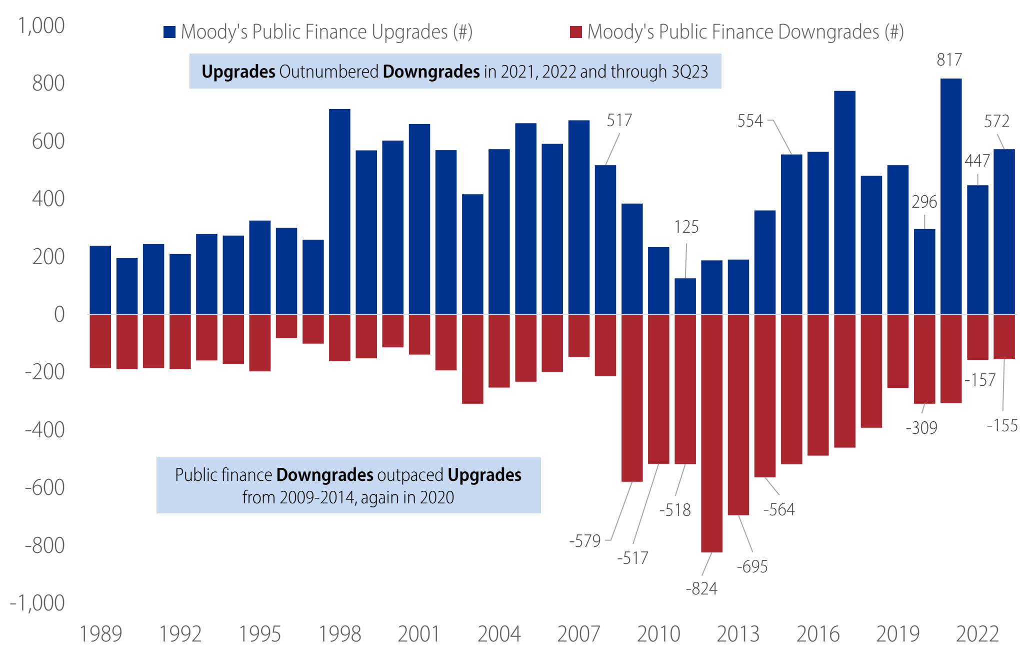
Public Finance Rating Upgrades Outpaced Downgrades Again in 2023



Source: Moody's and HilltopSecurities. 2023 #s through third quarter.

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U.S. State Government Sector

HilltopSecurities Credit Outlook: "Stable"
Recent Change: Unchanged in this analysis
Author: Tom Kozlik

The current strength of state government credit contrasts with the pressures we saw in several states just before the COVID-19 crisis.

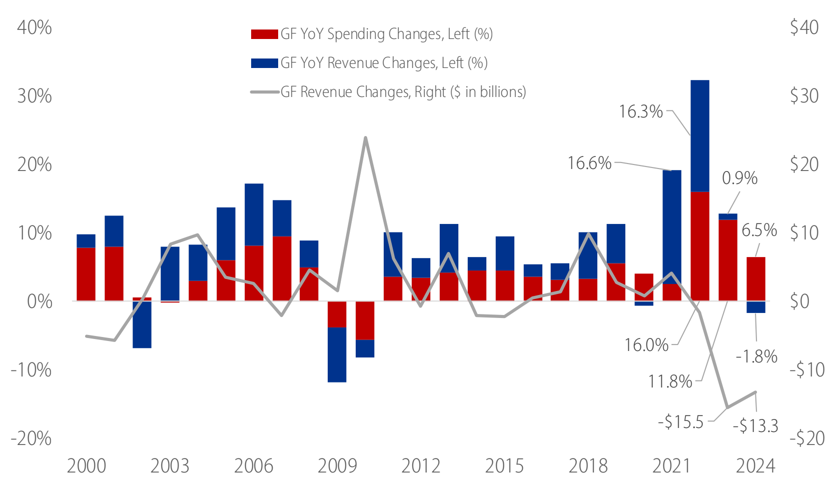
The fiscal story for U.S. state governments in 2024 will likely be similar as 2023. U.S. state credit quality remains strong. The current strength of state government credit contrasts with the pressures we saw in several states just before the COVID-19 crisis. The current strength is also largely because total balances remain healthy, forecast at $289 billion, or 23% of expenditures for fiscal year 2024 according to NASBO data. As a result, state government finances remain mostly well positioned to withstand a recession should one develop despite the decreased likelihood one materializes in 2024. The multi-year question is whether the willingness exists to plan for structural balance two to four years from now. Evolving imbalances this year (please see State Budget Problems Spread by Pew) illustrate why this could be more problematic than some expect. This question is related to the normalization of municipal credit we addressed in the opening summary.

General fund spending is projected to grow in fiscal year 2024 (also according to NASBO data) by 6.5% year-over-year.

The post-COVID year-to-year dynamic is worth examining. General fund spending is projected to grow in fiscal year 2024 (also according to NASBO data) by 6.5% year-over-year. There was also a hefty increased level of spending in fiscal year 2023, 11.8% and in fiscal year 2022 at 16%. The driving or supporting revenue foundation came from the 16.6% increase in fiscal year 2021 and the 16.3% increase in fiscal year 2022. General fund revenues are forecast to decline 1.8% in fiscal year 2024, but it is important to recognize the highs we saw two and a three years ago. We expect the spending and revenue picture to normalize in coming budget cycles. Pension payments will resurface as a rising expenditure demand. State governments enacted tax cuts and tax relief in the wake of the supportive 2021 federal fiscal policy. The form and amount of tax policy differs state to state, but overall NASBO reports that 37 states instituted tax cuts in fiscal year 2024 for an estimated total general fund revenue impact of -$13.3 billion (or about 1.1% of forecast fiscal year 2024 revenue). Forty percent of this amount is being attributed to one-time or temporary tax relief, also according to NASBO. It is possible state tax cuts are repealed, if needed. In 2017 Kansas reversed tax cuts that were enacted in 2012 and 2013, for example.

We expect the spending and revenue picture to normalize in coming budget cycles.

The Spending and Revenue Picture for U.S. State Governments



Source: National Association of State Budget Officers and HilltopSecurities

U.S. Local Government Sector

HilltopSecurities Credit Outlook: "Stable"
Recent Change: Lowered to "Stable" from "Positive" in this analysis
Author: Tom Kozlik

We are not anticipating credit quality in the sector to weaken, but we are expecting the local government credit landscape to smooth out in the near-term and normalize in coming budget cycles.

Local governments are moving into 2024 in a solid yet stabilizing financial position. We are not anticipating credit quality in the sector to weaken, but we are expecting the local government credit landscape to smooth out in the near-term and normalize in coming budget cycles. This stabilization is why we are lowering our sector outlook to "Stable" from "Positive." We are no-where near the opinion to think downgrades will outpace upgrades. However, we are expecting the pace of upgrades, while they will likely continue to outpace downgrades in 2024, will do so at a reduced rate than in recent years.

Housing values, which are a key driving force of public finance and local government credit quality rose in most places in the U.S. compared with 2019. Higher interest rates have increased home values in some places while also tempering housing activity largely nationwide. We are watching the housing market dynamic closely but are not expecting housing market uncertainty to negatively impact local government credit quality in the near term. Overall, home values remain as a stabilizing force for local government. Rising technological change, and the integration of artificial intelligence related technology will add to, not detract from the growth of certain regions. We expect the way that governments react to the normalization of municipal credit will be an important indicator of near-term credit quality.

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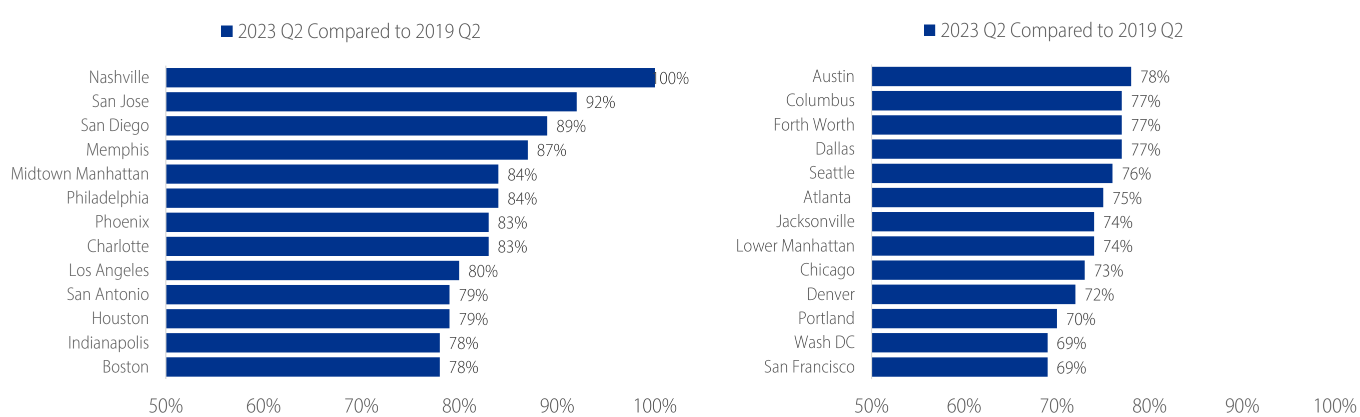
Demographic, migration patterns, the migrant crisis, and technology related trends remain local government hot topics. The New Great Migration from northern to southern states has continued. Immigration is supporting the U.S. population growth for now. Chicago's mayor says the financial stress from the migrant crisis in his city is not sustainable. New York's mayor does not expect that federal help is on the way, although the state is proposing to help. Denver has hit a "breaking point." Overall, State and Local Credit is Incredibly Resilient, and We Expect Only a Very Limited Credit Impact from Commercial Real Estate (Nov. 2, 2023) and trends related to the sustained practice of remote work.

A Slow Comeback. Residents, Workers, and Visitors in Core Downtown in 2023 Q2 Compared to 2019 Q2



Source: Placer.ai, PCCD and HilltopSecurities

U.S. School Districts

HilltopSecurities Credit Outlook: "Stable"
Recent Change: Lowered to "Stable" from "Positive" in this analysis
Author: Ted Chapman

Our credit outlook revision to "Stable" from "Positive" for the U.S. School District sector is based on a combination of financial and operational headwinds.

Our credit outlook revision to "Stable" from "Positive" for the U.S. School District sector is based on a combination of financial and operational headwinds. School district finances are largely creatures of their state. While our U.S. State Government Sector is "Stable" and while state governments largely maintain strong reserves, key revenue streams such as personal income taxes are softening or and in some cases are declining. We don't believe that tighter future state budgets will immediately lead to K-12 funding cuts. The more likely case is flat per pupil funding or – in less common but more dire situations – deferred state aid payments. The $121.9 billion from the third and final tranche of Elementary and Secondary School Emergency Relief (ESSER) funding has to be obligated by September 2024 and spent by January 2025, creating a looming fiscal cliff, especially for districts that are using any funding to supplement their operating budget.

Moreover, by decade's end K-12 enrollment is projected to decline in 35 states and remain flat in six others as the U.S. demographic shifts, the population grows older and charter schools continue to increase market share. The U.S. average is a projected 5% enrollment decline. While it is possible that districts could offset decreases in their formulaic state aid through natural attrition such as teacher and staff retirements, even high-growth states such as Texas are already seeing some local school districts consolidating campuses to cut costs.

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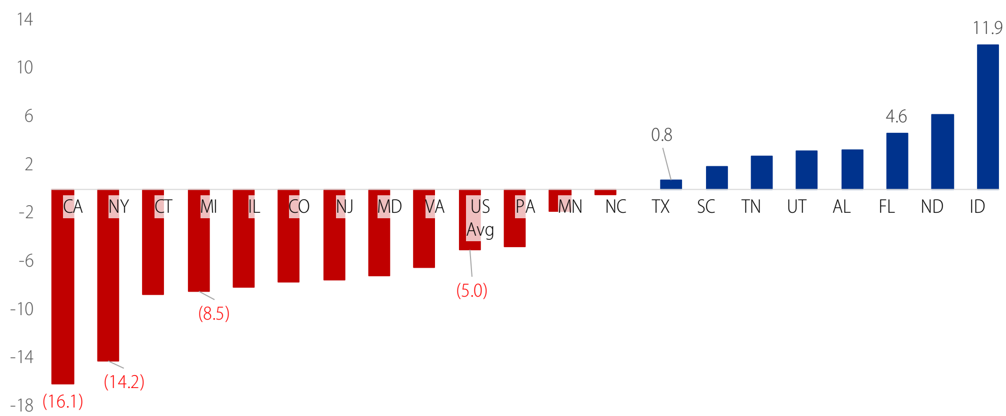
Projected K-12 School District Enrollment in Select U.S. States (% Change 2021 to 2031)



Source: U.S. Department of Education and HilltopSecurities.

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Community Facilities Districts

HilltopSecurities Credit Outlook: "Stable"
Recent Change: Unchanged in this analysis
Author: Doug Nelson

A community facilities district (CFD) is a special taxing district created within a municipality for infrastructure financing of new and existing development within a city or county. CFDs are unique to California, but there are other states that have similar mechanisms to fund infrastructure. The security for CFDs are special taxes levied based on parcel size. Most CFD bond issues that come to market are non-rated. Some of the larger CFDs attain an investment grade rating.

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Most CFDs are for residential development, so the weakness in commercial real estate markets has not impacted the general creditworthiness of CFDs. One of the main credit metrics of CFDs is the value-to-lien ratio which is calculated by dividing the appraised and/or assessed valuation of the property within the CFD by the debt outstanding. Overall, value-to-lien ratios have improved as property values have increased and debt is being paid down.

Higher mortgage rates have not substantially dampened demand for housing however, supply has been thin as homeowners that are carrying mortgages with a low rate have been unwilling to sell. The Federal Housing Finance Agency Price Index chart below shows that housing prices across California have been relatively stable but mostly have lagged the U.S. average. This is due to lack of affordability and the relatively higher cost of housing in California. We are maintaining our stable outlook for CFDs.

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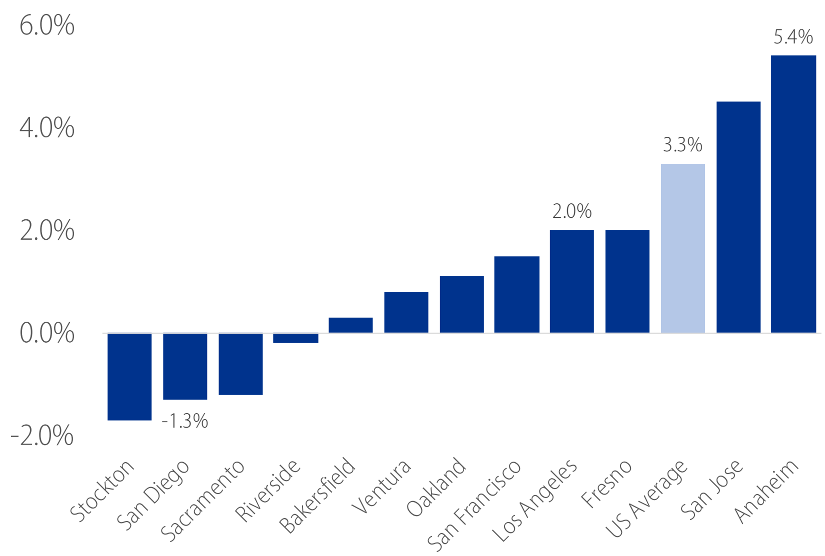
FHFA Home Price Index (% Change between Sept. 2022 and Sept. 2023)



Source: Federal Housing Finance Agency and HilltopSecurities.

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Airports

HilltopSecurities Credit Outlook: "Stable"
Recent Change: Unchanged in this analysis
Author: Phil Villaluz

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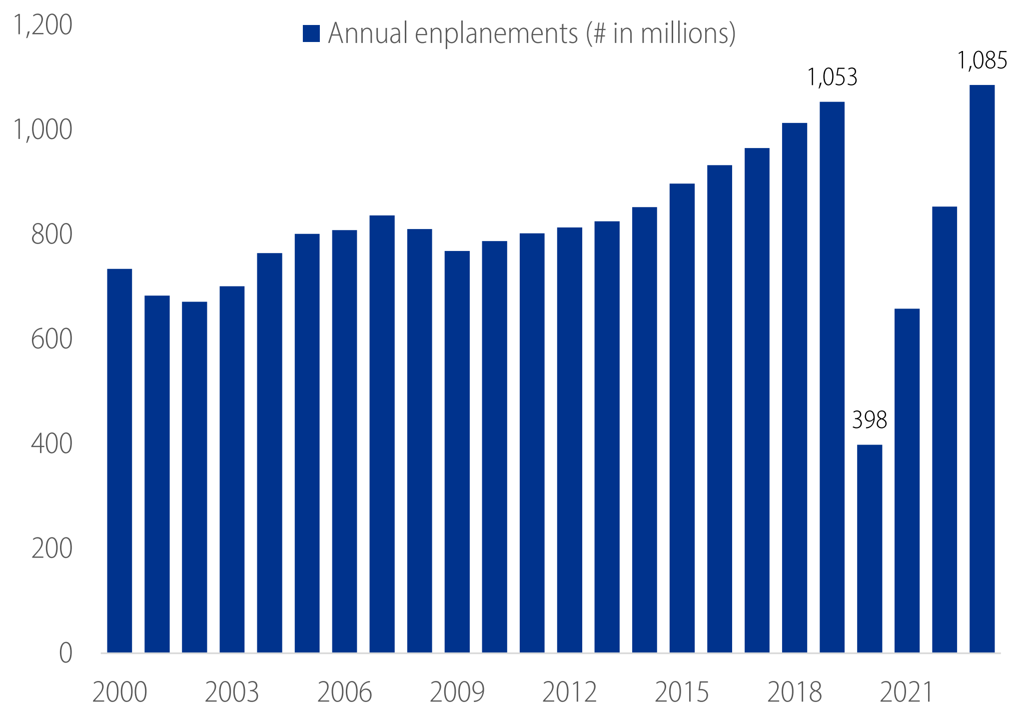
By September 2023, passenger enplanements had fully recovered and in some individual cases, airports had even surpassed 2019 levels. As a result, airports have returned to more normalized rate-setting flexibility and revenue metrics; we think this supports rating stability for the sector. Adjustments will be made to support any structural changes (potential changes to rate agreements for example), and we expect airlines and airports will be able to make the necessary adjustments over the near term.

Airport finances and liquidity levels have recently benefitted from significant federal aid, however, many large airport operators have begun using those cash reserves, rather than more costly debt issuance, to help fund capital spending. Furthermore, continued airport and airline labor and capacity constraints, combined with an anticipated softening U.S. economy in 2024 could moderate the demand for air travel as both leisure and business travelers cut back on spending.

The Airport Sector Activity Recovery Was Fast



Source: Bureau of Transportation Statistics and HilltopSecurities. 2023 enplanements are estimated assuming a recovery to 103% of 2019 levels.

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Charter Schools

HilltopSecurities Credit Outlook: "Stable"
Recent Change: Unchanged in this analysis
Author: Yaffa Rattner

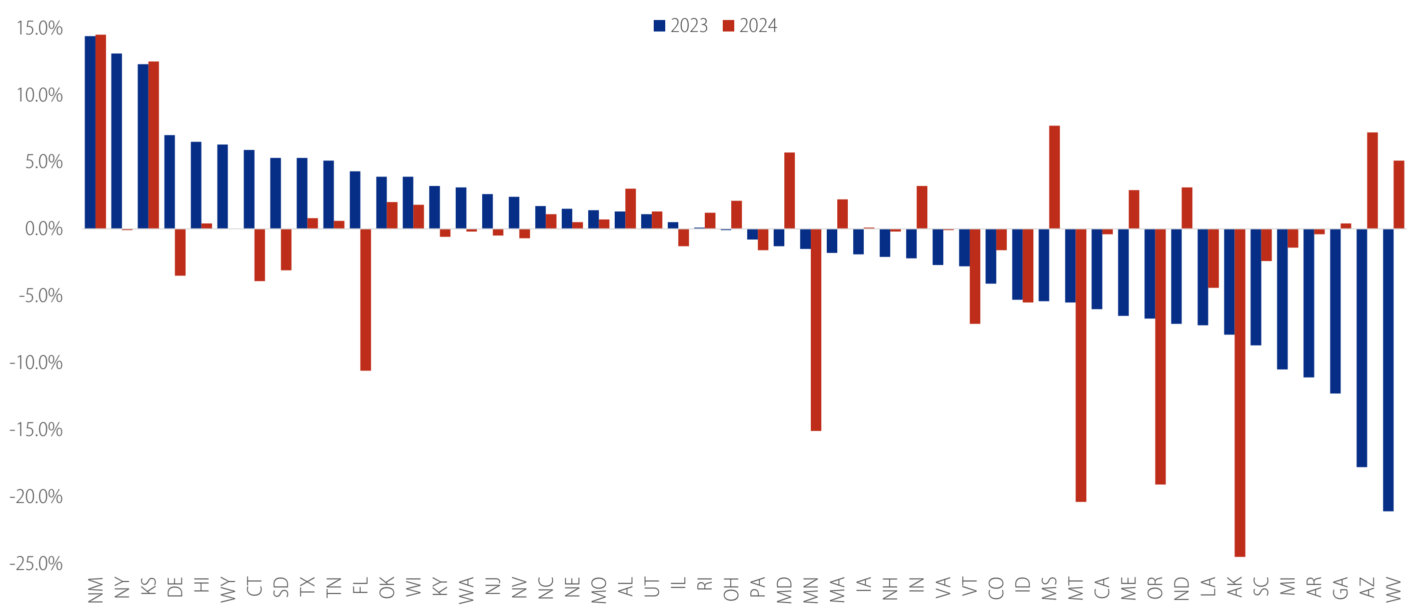
Despite our "Stable" outlook, we recognize that there are some headwinds reflecting capital and operational pressures that the schools will face over the medium term.

HilltopSecurities has a "Stable" outlook for charter schools as we look forward to 2024. This outlook reflects the relative maturation of the sector that now educates more than 3.7 million students in almost 8,000 campuses across the United States. Despite our "Stable" outlook, we recognize that there are some headwinds reflecting capital and operational pressures that the schools will face over the medium term. One key area of focus is on stated aid revenues as state aid per pupil funding is the largest source of charter school revenues. State credit ratings are high, however some states are beginning to experience flatter or even declining revenues as we describe in more detail in our State Sector Outlook. According to Moody's Investor Service, median tax revenues are likely to slow to low single digits. As a result, HilltopSecurities points to a potential charter school vulnerability as states with slowing growth in primary revenues may choose to slow incremental per-pupil revenue growth to charter schools as they seek to balance their own budgets. The potential impact of this observation will vary by state, and it is important to stay aware of individual state trends.

Given the probable likelihood that annual per-pupil revenue growth may not keep pace with operational and capital needs, charter school management teams will be forced to prioritize spending.

Fiscal health remains critical for long term charter school sustainability and reauthorization of charter school contracts. Given the probable likelihood that annual per-pupil revenue growth may not keep pace with operational and capital needs, charter school management teams will be forced to prioritize spending. Academic success is the other most significant ingredient to charter school growth and management will need to continue prioritization to its central mission. Never has management been more important to the continued success of each charter school and the continued attractiveness of a charter school investment.

Annual Change in U.S. State Government General Fund Revenue by Year



Source: NASBO and HilltopSecurities.

Health Care (Investment Grade)

HilltopSecurities Credit Outlook: "Negative"
Recent Change: Unchanged in this analysis
Author: Doug Nelson

The labor market has improved and a handful of states are in the process of raising the minimum wage, however this could put downward pressure on margins in the non-profit health care sector. There is still union activity, which brings with it the possibility of strikes going forward. Hospitals are still challenged by insurance payors providing reimbursements sufficient to cover increasing expenses.

It is expected that merger and acquisition activity will remain active this year. Surprisingly, Moody's Investor Service changed its outlook on the healthcare sector to "Stable," however S&P Global has a "Negative" outlook while Fitch Ratings has a "Deteriorating" outlook on the sector. We continue to have a "Negative" outlook on Health Care (Investment Grade) sector.

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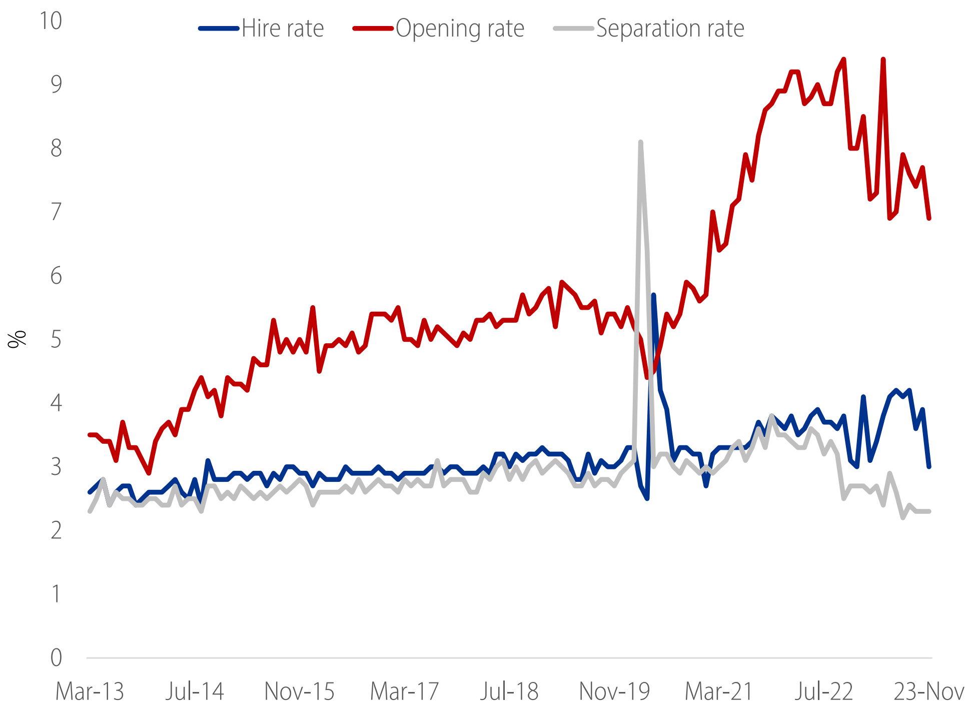
U.S. Health Care and Social Assistance Job Opening, Hire, and Quit Rates



Source: U.S. Bureau of Labor Statistics and HilltopSecurities.

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Higher Education

HilltopSecurities Credit Outlook: Public "Cautious" and Private "Cautious"
Recent Change: Raised Private Higher Education to "Cautious" from "Negative"
Author: Phil Villaluz

We are raising our Sector Outlook for Private Higher Education to "Cautious" from "Negative." While our sector outlooks for both Public and Private Higher Education are "Cautious," we want to reinforce to investors that credit selection is key to navigating both of these sub-sectors which are differentiated by "the haves" and "the have-nots".

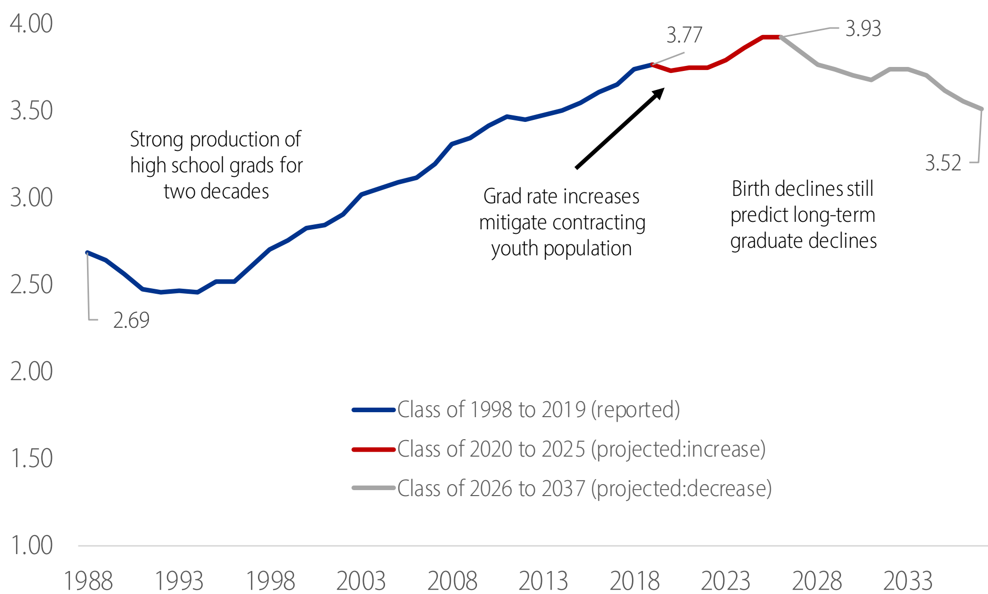
While our sector outlooks for both Public and Private Higher Education are "Cautious," we want to reinforce to investors that credit selection is key to navigating both of these sub-sectors which are differentiated by "the haves" and "the have-nots".

Enrollment and demand measures will continue to be leading factors to consider, as the level of competition from colleges and universities for a shrinking pool of students continues to intensify, due to a combination of overcapacity and the impending demographic cliff.

On the financial side, balancing rising operating costs and capital spending needs will continue to pressure school budgets in 2024. This pressure poses greater challenges for those schools with less financial resources. As pandemic funds are exhausted and states face the possibility of slower economic growth, public universities could experience deeper, more meaningful cuts to state aid revenues. Favorable investment gains during fiscal 2023, may however, allow certain private schools with deeper endowments or reserves to maintain balance-sheet flexibility despite weaker cash flows. Nonetheless, we think larger or wealthier institutions with diverse revenue streams, strong brand recognition and student demand, will fare better and maintain credit quality, compared to smaller, less-selective schools struggling with weak finances and declining enrollment.

On the financial side, balancing rising operating costs and capital spending needs will continue to pressure school budgets in 2024.

Number of High School Graduates Projected to Decline After 2025 (#s in millions)



Source: Western Interstate Commission for Higher Education, Knocking at the College Door: Projections of High School Graduates, 2020, www.knocking.wiche.edu and HilltopSecurities.

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Housing

HilltopSecurities Credit Outlook: "Stable"
Recent Change: Unchanged in this analysis
Author: Phil Villaluz

Despite borrowing rates remaining higher-for-longer, we believe single-family loan originations should stay active given HFAs' strong competitive position as an attractive option to homebuyers.

Our sector outlook for state housing finance agencies (HFAs) remains "Stable" for 2024. Despite borrowing rates remaining higher-for-longer, we believe single-family loan originations should stay active given HFAs' strong competitive position as an attractive option to homebuyers. Furthermore, steady HFA margins (16-17% range according to Moody's Investor Service expectations) should continue to be supported by stronger investment earnings, higher mortgage interest income and steady revenue from sales on the secondary, or to-be-announced (TBA) market – although significantly lower than the record years of 2020 and 2021 when rates were low.

HFA multifamily portfolios are expected to remain healthy due to robust occupancy rates and low delinquency rates. Although, multifamily originations will likely decelerate due to increased gap funding needs. By definition, funding gaps exist when investors are forced to refinance at a loan-to-value (LTV) ratio lower than the one at which they first borrowed, or when the value has fallen since the loan was originated. What's worth watching – given that this problem in the office real estate sector is already well known – a similar funding gap appears to be growing in the multifamily sector.

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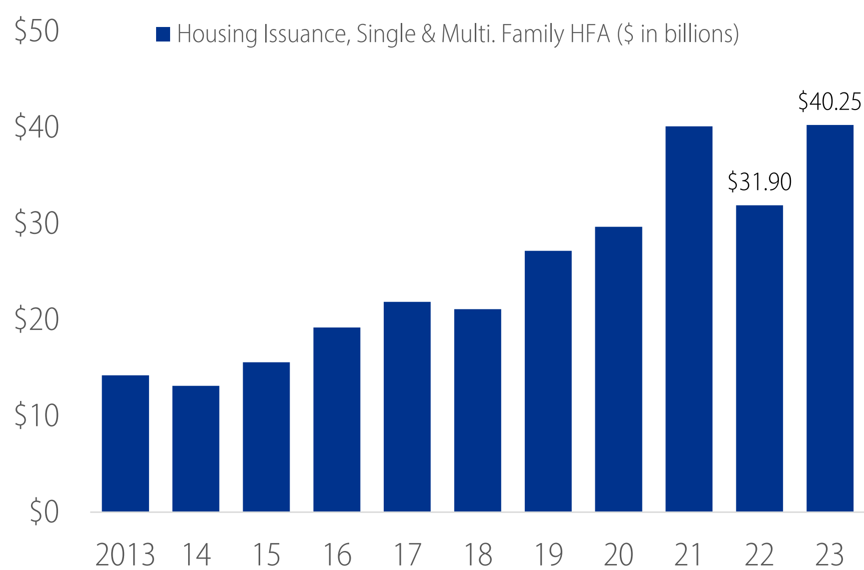
While we still do not expect credit or rating deterioration in the near term in the sector, a number factors including: erosion of margins to less than 12%; a multi-notch cut to US credit ratings; a surge in delinquency rates; and HFA balance sheet weakness resulting from a continued decline in issuance, could negatively impact HFAs. It should be noted that bond issuance fell in 2022 to about $30 billion but recovered in 2023 to about $40 billion. The trajectory of issuance in 2024 will depend upon interest rates, loan activity, and economic growth.

Housing Issuance Rebounded in 2023, Outlook Depends Upon Several Factors



The trajectory of issuance in 2024 will depend upon interest rates, loan activity, and economic growth.

Source: Refinitiv and HilltopSecurities.

Public Power (Electric)

HilltopSecurities Credit Outlook: "Stable"
Recent Change: Unchanged in this analysis
Author: Ted Chapman

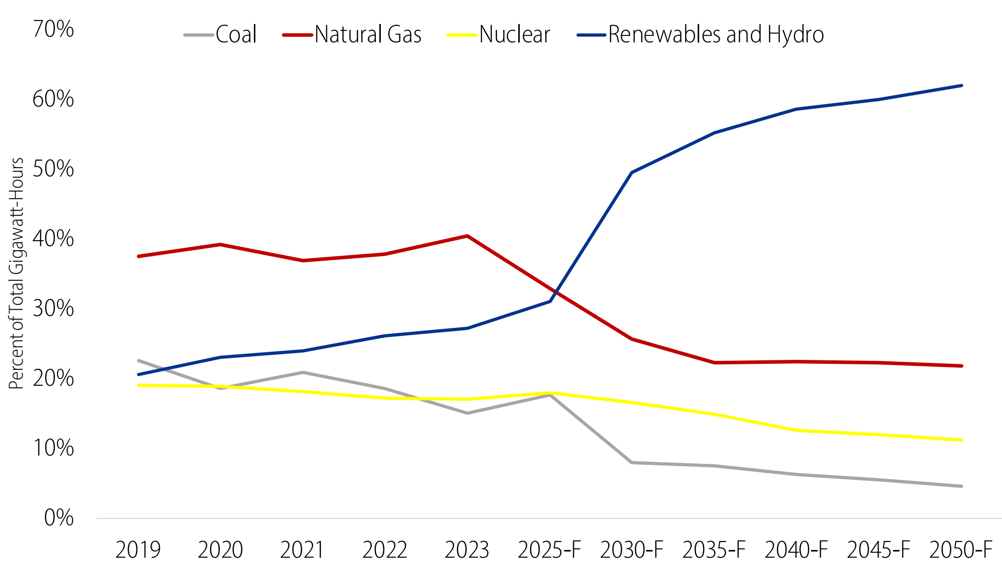
We expect the key drivers of the sector to remain concentrated in investment in new transmission, and integrated resource planning for future new generation.

2023 was a busy year in the Public Power sector. Deal issuance volume was over $17 billion, up more than 40% year-over- year. We expect the key drivers of the sector to remain concentrated in investment in new transmission, and integrated resource planning for future new generation. The latter is especially tricky because of plant retirements (due to age, because they burn coal, or both), explosion of renewables and changing load profiles. Rising energy needs for artificial intelligence, data centers, electric vehicles and cryptocurrency mining continue to grow rapidly. Right now, almost half of the energy used across all customer classes is for either heating and cooling people, water or food; computers and gadgets; and keeping the lights on; only lighting is likely to remain flat given the proliferation of energy-conserving bulbs and fixtures. How then to find a middle ground among affordability, reliability and decreasing the sector's carbon intensity? These three concepts tend to move in opposite directions: push one in a favorable direction and the other two push back.

Fortunately, natural gas prices are half of what they were a year ago, construction sector hyperinflation may have plateaued, and borrowing costs could moderate in 2024. Unfortunately installing more gas-fired capacity invites extreme weather risk and event-driven price spikes. Nuclear continues to enjoy a post-Fukushima renaissance – at least on the drawing board – but even small modular reactors remain too expensive and slow-to-complete for municipal systems to go it alone. Setting aside finalizing environmental and tax code rulemaking for clean hydrogen, how and from where the hydrogen is extracted - currently 95% comes as an expensive byproduct of fossil fuels that requires more energy than it delivers - will likely relegate it to niche fuel status not for use by electric utilities.

Rising energy needs for artificial intelligence, data centers, electric vehicles and cryptocurrency mining continue to grow rapidly.

U.S. Energy Sources



Fortunately, natural gas prices are half of what they were a year ago, construction sector hyperinflation may have plateaued, and borrowing costs could moderate in 2024.

Source: Source: US Energy Information Administration and HilltopSecurities.

Senior Living

HilltopSecurities Credit Outlook: "Cautious"
Recent Change: Raised to "Cautious" from "Negative" in this analysis
Author: Yaffa Rattner

We raised the Senior Living Credit Outlook to "Cautious" from the "Negative" outlook we assigned in 2023, and improvement reflects an uptick in senior housing occupancy, a moderation of labor expense increases, and a relatively modest supply of new available units.

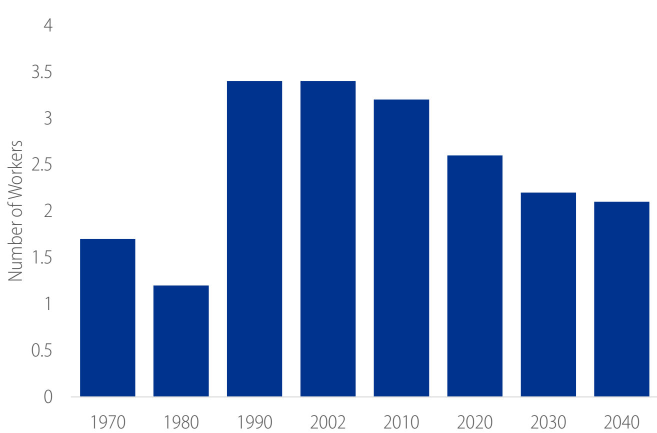
HilltopSecurities' outlook for the Senior Living sector remains cautionary as we head into 2024. We raised the Senior Living Credit Outlook to "Cautious" from the "Negative" outlook we assigned in 2023, and improvement reflects an uptick in senior housing occupancy, a moderation of labor expense increases, and a relatively modest supply of new available units. However, there is a significant difference of analytic opinion on the credit quality of transactions, and care should be taken to carefully assess fundamental credit expectations. Finally, the sector remains challenged as it continues to recover in a post-pandemic environment, reflected by 20 impairments and defaults in 2023, according to Bloomberg affecting $661 million of debt, which we forecast will moderate in 2024.

According to NIC Analytics, senior housing occupancy increased to 84.4% in the third quarter of 2023 which is a significant recovery from the 77.8% occupancy reported in 2021 driven by the pandemic. However, occupancy is still below 87.1% which was reported in the first quarter of 2020 before the pandemic set in. According to the Bureau of Labor Statics, labor costs increased 4.3% over the year through September 2023 compared to a 5% increase in September 2022; as well, the costs of benefits have similarly declined to 4.1% from 4.9% the prior year.

According to NIC Analytics, senior housing occupancy increased to 84.4% in the third quarter of 2023 which is a significant recovery from the 77.8% occupancy reported in 2021 driven by the pandemic.

Underlying the investment thesis in the senior living sector are the fundamental demographics of the American population that point to the continued need for congregate housing. According to data provided by Urban Institute, Social Security Administration, and The Alzheimer's Association, the number of adults ages 85 and older, will nearly quadruple between 2000 and 2040; and this is the group that most often needs help with basic personal care. Furthermore, an estimated 6.5 million Americans aged 65 and older are living with Alzheimer's dementia today. Finally, according to the Social Security Administration, the number of workers per social security beneficiary will decrease affecting availability of workers to care for the elderly. Taken together, fewer available employees and a growing population that will require care will result in the need for additional senior living communities.

Workers By Decade for Each Social Security Beneficiary



Source: Social Security Administration and HilltopSecurities.

Taken together, fewer available employees and a growing population that will require care will result in the need for additional senior living communities.

Tobacco

HilltopSecurities Credit Outlook: "Negative"
Recent Change: Unchanged in this analysis
Author: Doug Nelson

This ongoing trend is largely responsible for the declines in the Master Settlement Agreement (MSA) payments that secure the bonds.

Domestic consumption declines are continuing in the tobacco sector. This ongoing trend is largely responsible for the declines in the Master Settlement Agreement (MSA) payments that secure the bonds. The tobacco settlement revenue securitization bond issues are secured by the tobacco settlement revenues tobacco companies agreed to pay to state and other governments under that Master Settlement Agreement (MSA) in 1998.

The level of regulatory risk is also high, this could negatively impact consumption as well. The U.S. Food and Drug Administration (FDA) formally proposed a ban on menthol cigarettes in April 2022 and then missed a self-imposed deadline to finalize the ban by August of 2023.

California and Massachusetts have already banned menthol cigarettes along with dozens of counties across the U.S. A ban of menthol cigarettes by the FDA could accelerate declines in consumption. The tobacco industry has responded with new non-menthol versions of traditional menthol brands that contain WS-3, a menthol analogue. The FDA is also working to develop a proposed product standard that would establish a maximum nicotine level to reduce the addictiveness of cigarettes. This regulatory risk along with the continuing trend of the general reduction of smoking by the U.S. population has us maintaining our "Negative" outlook on the tobacco sector.

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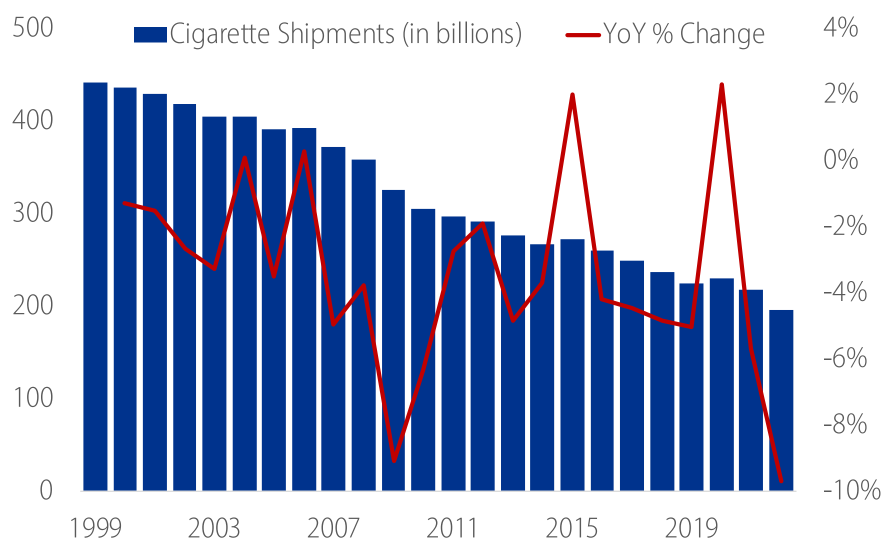
Decreasing U.S. Cigarette Shipments Continue



Source: National Association of Attorneys General and HilltopSecurities.

This regulatory risk along with the continuing trend of the general reduction of smoking by the U.S. population has us maintaining our "Negative" outlook on the tobacco sector.

Toll Facilities

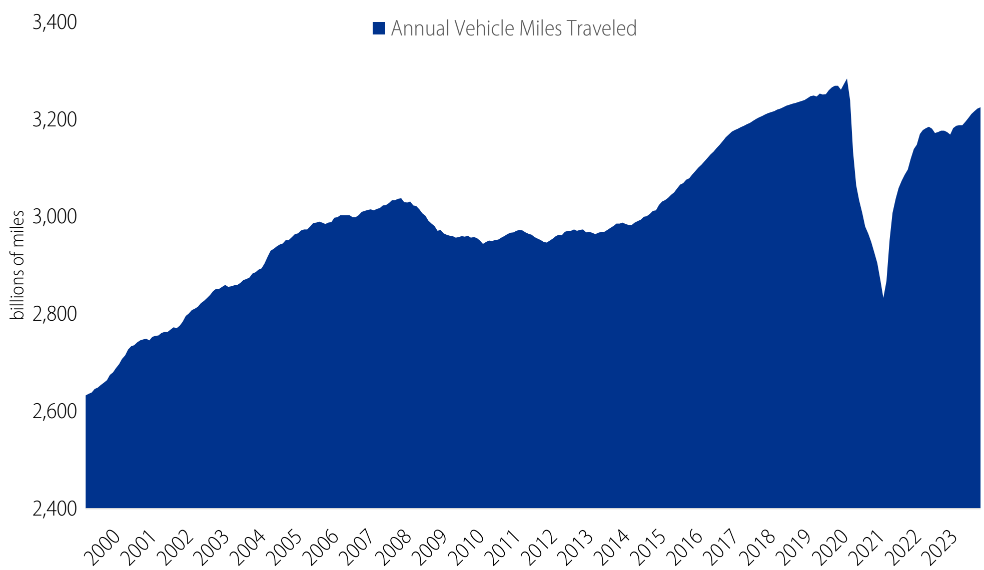
HilltopSecurities Credit Outlook: "Stable"
Recent Change: Unchanged in this analysis
Author: Phil Villaluz

Having quickly recovered from pandemic lows, traffic growth trends appear to have normalized, as measured by vehicle miles traveled.

Having quickly recovered from pandemic lows, traffic growth trends appear to have normalized, as measured by vehicle miles traveled. Nevertheless, we continue to observe that financial metrics continue to be strong and should provide credit stability in the U.S. toll road sector. Also, facilities with toll rate-setting policies linked to inflation have benefitted from recent revenue growth and likely to maintain healthy operating metrics and credit quality in 2024.

Tempering our outlook are expectations for slowing commercial traffic growth on softer economic conditions. Entities planning to ramp-up capital spending for maintenance and expansion projects in the near future may result in either a reduction of cash holdings, rising debt-financing costs or a combination of both.

The Pace of Vehicle Miles Traveled is Normalizing, Supporting Our "Stable" Outlook



Source: U.S. Dept. of Transportation and Hilltop Securities. This is a 12-month moving average and #s are in billions of vehicle miles traveled.

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Tempering our outlook are expectations for slowing commercial traffic growth on softer economic conditions.

Water and Sewer

HilltopSecurities Credit Outlook: "Stable"
Recent Change: None
Author: Ted Chapman

Water utilities are officially on the clock for lead service line replacements, starting with a full inventory by third quarter of 2024.

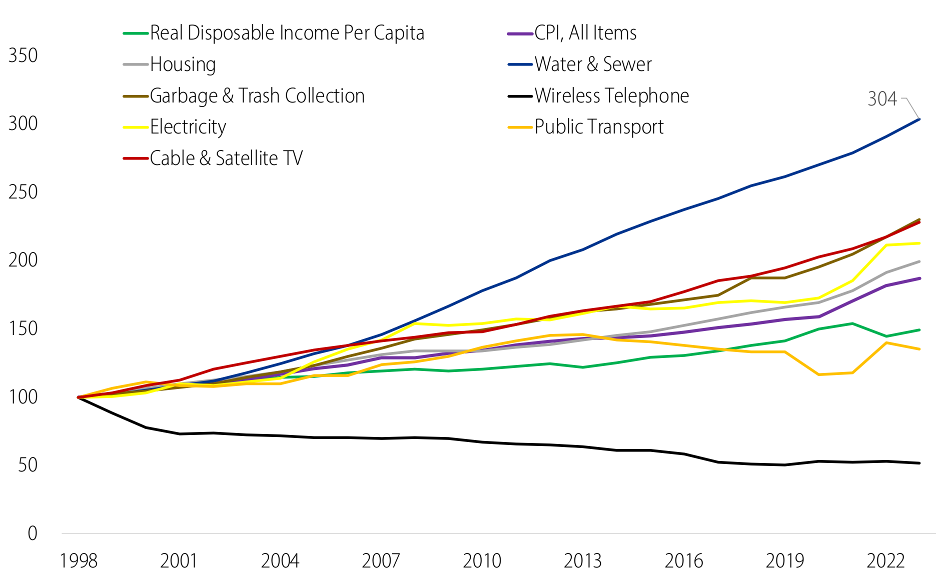
Get used to two acronyms. The first is related to an estimated 9 million lead service lines (LSL) across the country that help deliver clean water. The second is polyfluoroalkyl substances or (PFAS) which are chemicals that break down slowly. Water utilities are officially on the clock for lead service line replacements, starting with a full inventory by third quarter of 2024. Although the Bi-Partisan Infrastructure law of 2021 provided $15 billion to address lead, the American Water Works Association (AWWA) estimates it will take over $90 billion, with the heaviest concentration of need being in Florida, Illinois, and Ohio. One complication: no more than 10% of tax-exempt bond proceeds can be used to remediate the customer's side of the meter. Unless federal legislation such as the proposed Financing Lead Out of Water (FLOW) Act amends the tax code, lead removal will proceed slowly so as to not violate private purpose limitations.

As for PFAS, the limit the U.S. Environmental Protection Agency (EPA) proposed of four parts per trillion, analogous to four drops into 20 Olympic-sized swimming pools, is the smallest level labs can realistically measure. Once finalized, which we expect in the first quarter of 2024, the rule will trigger immediate lawsuits. AWWA estimates 7,500 utilities, serving most of the population, would see operating costs increase $3.8 billion per year. That by itself could drive a 4% rate increase. Complainants will argue that the regulation violates the 'arbitrary and capricious' standard. Opponents will also argue if it's technologically and economically feasible.

Unless federal legislation such as the proposed Financing Lead Out of Water (FLOW) Act amends the tax code, lead removal will proceed slowly so as to not violate private purpose limitations.

Even with such daunting regulatory headwinds, financial capacity is very strong. The modal ratings are Aa3/AA-, with median liquidity of 500 to 600 days cash on hand in the sector. Despite affordability worries at a fever pitch, we expect further incremental rate increases and impairments to remain uncommon.

Selected Inflation Rates, Last 25 Years



Source: Source: Bureau of Labor Statistics and HilltopSecurities.

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Recent HilltopSecurities Municipal Sector Outlooks

- The Municipal Market in 2023, Hilltop's Municipal Sector Credit Outlooks, Jan. 17, 2023
- REVISED: The Municipal Market in 2022, Due to the COVID-19 Paradigm Shift, Feb. 7, 2022
- We Expect a Multi-Year, But Potentially Temporary, Upswing of U.S. Municipal Credit, March 30, 2021

Definitions of HilltopSecurities Municipal Sector Credit Outlooks

Positive: HilltopSecurities believes there are factors which point towards improving issuer or sector credit quality. This may result in a higher level of credit ratings upgrades versus downgrades if issues are rated.

Stable: HilltopSecurities believes there are factors which point towards stable issuer or sector credit quality. This is likely to result in an even level of credit ratings upgrades versus downgrades if issues are rated.

Cautious: HilltopSecurities believes there are factors which introduce the potential for declines in issuer or sector credit quality. This may result in credit ratings downgrades only slightly outnumbering upgrades if issues are rated.

Negative: HilltopSecurities believes there are factors which point towards weakening issuer or credit quality. This will likely result in a higher number of credit ratings downgrades versus upgrades if the issues in the sector are rated.

Readers may view all of the HilltopSecurities Municipal Commentary here.