U.S. Municipal Bond Market

The Municipal Market in 2025, Hilltop's Sector Credit Outlooks

Ted Chapman
ted.chapman@hilltopsecurities.com
214.859.1067
Tom Kozlik
tom.kozlik@hilltopsecurities.com
214.859.9439
Doug Nelson
doug.nelson@hilltopsecurities.com
818.212.2048
Yaffa Rattner
yaffa.rattner@hilltopsecurities.com
214.859.9883

- The Golden Age of Public Finance is now over.
- A temporary upswing in municipal bond credit quality began in 2021 boosted by Federal fiscal policy. Four years later, municipal credit is now returning to normal levels.
- A more positive macro-economic backdrop exists to begin 2025 compared to last year.
- The potential impact of the new administration and 2025 fiscal policy remains a significant uncertainty as we begin the year.
- Specifically, we are concerned about the now imminent threat to the municipal bond tax-exemption.
- Our **State Government** sector outlook remains "Stable" with healthy total balances projected for fiscal year 2025, despite the ongoing normalization of municipal credit.
- Our **Local Government** sector outlook also remains "Stable" due the housing market's role as an economic stabilizer, and despite potential fiscal policy changes and immigration challenges.
- We lowered our **School District** sector outlook to "Cautious" from "Stable" due to factors like declining enrollment, expenditure pressures, and potential reductions in state aid.

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HilltopSecurities Municipal Sector Credit Outlooks (Jan. 2025)

Sector	Hilltop Sector Outlook	Recent HTS Action(s)
State Government	Stable	None
Local Government	Stable	None
School Districts	Cautious	Lowered to "Cautious" today
Community Facilities Districts	Stable	None
Airports	Stable	None
Charter Schools	Stable	None
Health Care	Cautious	Raised to "Cautious" today
Higher Education	Private: Negative Public: Negative	Both lowered to "Negative" on Sept. 25, 2024
Housing	Stable	None
Public Power (Elec.)	Stable	None
Senior Living	Stable	Raised to "Stable" on Dec. 17, 2024
Tobacco	Negative	None
Toll Facilities	Stable	None
Water & Sewer	Cautious	Lowered to "Cautious" today

Source: HilltopSecurities.

Please see disclosure starting on page 18.

- We kept our outlook for the **Community Facilities District** sector "Stable" due to robust housing demand, increasing residential property values, and stable commercial property values in California.
- U.S. airports are expected to see continued growth in passenger traffic and infrastructure improvements, supported by strong liquidity and solid balance sheets, leading to a "Stable" **Airport** sector outlook.
- Charter school enrollment continues to grow, creating opportunities and increasing issuance, leading to a "Stable" **Charter School** sector outlook for 2025.
- Entities in the **Health Care** sector are showing improved profit margins, robust patient volumes, and a more stable labor market, highlighting the sector's flexibility and adaptability causing us to raise our sector outlook to "Cautious" from "Negative."
- We lowered our sector outlooks for both the "Public" and the "Private" **Higher Education** sector to "Negative" due to severe systemic pressures, including declining enrollment, rising costs, and reduced government support, which are leading to significant credit stresses, especially for smaller private institutions.
- State Housing Finance Agencies are expected to maintain strong balance sheets and credit fundamentals in 2025 leading to a "Stable" **Housing** sector outlook.
- Rising energy and data center demand, and natural disaster risks and are key pressures for the **Public Power** sector, however we kept our "Stable" sector outlook.
- We raised our **Senior Living** sector outlook to "Stable" from "Cautious" due to increased occupancy, higher revenue, and stabilizing expenses, amid growing sector issuance and an aging population.
- The U.S. cigarette smoking rate hit an 80-year low in 2024, with regulatory risks and declining consumption helping to reinforce our "Negative" outlook on the **Tobacco** sector.
- Our **Toll Facilities** sector outlook remains "Stable" due to rebounded vehicle-miles, steady economic growth, minimal impact from federal actions, and the ability of toll road systems to adapt to post-pandemic patterns and inflationary pressures.
- We lowered our outlook on the **Water and Sewer** sector to "Cautious" from "Stable" due to ongoing budget pressures, regulatory compliance costs, and workforce challenges.

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We lowered our sector outlooks for both the "Public" and the "Private" Higher Education sector to "Negative" due to severe systemic pressures, including declining enrollment, rising costs, and reduced government support, which are leading to significant credit stresses, especially for smaller private institutions.

We lowered our outlook on the Water and Sewer sector to "Cautious" from "Stable" due to ongoing budget pressures, regulatory compliance costs, and workforce challenges.

U.S. State Government Sector

HilltopSecurities Credit Outlook: "Stable"
Recent Change: None
Author: Tom Kozlik

The normalization of municipal credit continued in 2024, and this process will proceed this year as well.

The Golden Age of Public Finance is over. The normalization of municipal credit continued in 2024, and this process will proceed this year as well. This does not mean state credit quality is strained to begin 2025. In fact, overall state credit quality is still generally stronger than it was prior to the COVID-19 era, but that also is not a high bar to clear. Most observers did not realize how exposed state government credit quality was before the COVID-19 era, as illustrated in this article, Your state is probably facing a new dawn of public finance problems.

State government total balances are projected to remain robust in fiscal year 2025, according to the National Association of State Budget Officers Fall 2024 Fiscal Survey of States. The preliminary estimate is $297 billion, or a still very healthy 24% of expenditures. By comparison, the average total balance between 2000 and 2019 was $64 billion and 8.7% of expenditures. Most state ratings remain very strong, and most state rating outlooks are "Stable" or "Positive," per the rating agencies. A few states continue to face larger than average credit challenges. Credit selection is important in the state sector.

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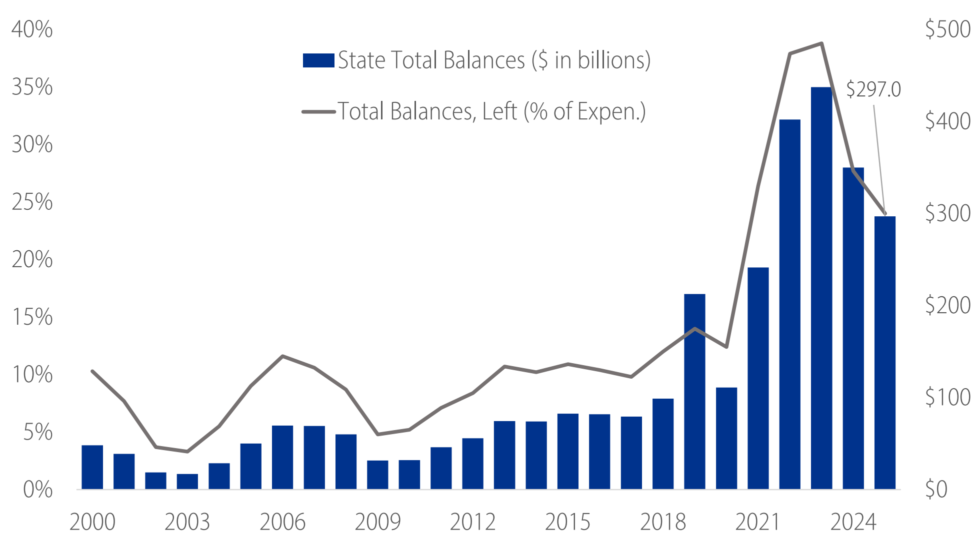
During his second week in office, President Trump ordered a pause in federal aid. The spending freeze order was soon thereafter rescinded but, such actions can undermine the resilience not only of the state government sector but also the entire municipal bond market. State priorities will also help determine the near-term credit path for state governments. We are closely monitoring the potential impact tax cuts and tax relief could have on the state-by-state budget picture. Additionally, we anticipate rising expenditure demands from local governments, K-12 schools, higher education, inflation, and rising pension payments will compete as overall expenditure pressures grow.

State Government Total Balances Remain Robust to Begin 2025



Source: National Association of State Budget Officers and HilltopSecurities.

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U.S. Local Government Sector

HilltopSecurities Credit Outlook: "Stable"
Recent Change: None
Author: Tom Kozlik

Public Finance sector rating upgrades continued to outpace downgrades through the first three quarters of 2024.

Public Finance sector rating upgrades continued to outpace downgrades through the first three quarters of 2024. We expect the ratio of upgrades to downgrades to slightly weaken in 2025. This serves as a significant quantitative indicator that the Golden Age of Public Finance has concluded. Credit selection is important in the sector. U.S. local governments are navigating a complex landscape of challenges and opportunities. Infrastructure remains a cornerstone of local government credit quality, with investments in roads, bridges, schools, and public utilities essential for economic resilience and community well-being. This cornerstone could be under attack by 2025 fiscal policy if lawmakers choose to use the municipal bond tax-exemption as a pay-for.

The elimination of the tax-exemption would increase the infrastructure gap in the U.S. Borrowing rates for infrastructure would rise an additional $824 billion, a cost that would be passed onto U.S. taxpayers and amount to a $6,555 tax and rate increase for every American household over the next decade, according to the GFOA. 2024 HilltopSecurities Public Entity Survey results show "Aging Infrastructure" was one of the top challenges facing public entities. Other challenges identified by public entities in the survey were infrastructure related including: affordable housing, traffic, schools, water, flooding, climate change, and energy reliability. We are watching closely to see how cities manage the financial aspects of the immigration crisis by reallocating resources, tap into emergency reserves, and seek state and federal assistance. The housing market and property tax revenues have continued to be an economic stabilizer for the local government sector even as interest rates have remained elevated.

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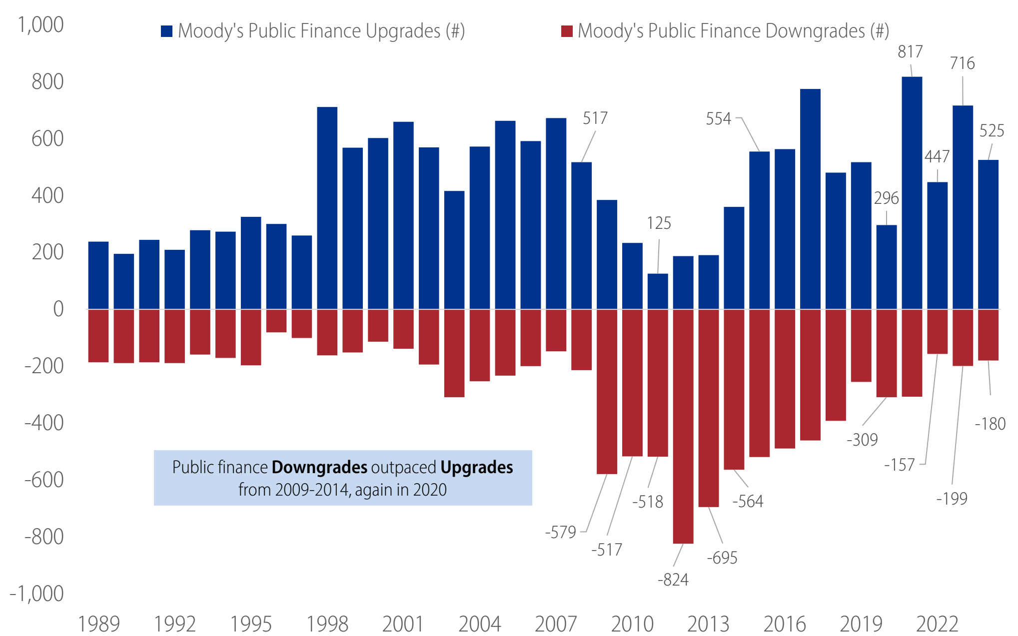
Public Rating Upgrades Outpaced Downgrades Through First Three Quarters of 2024



Source: Moody's Investor Service and HilltopSecurities.

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U.S. School Districts

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

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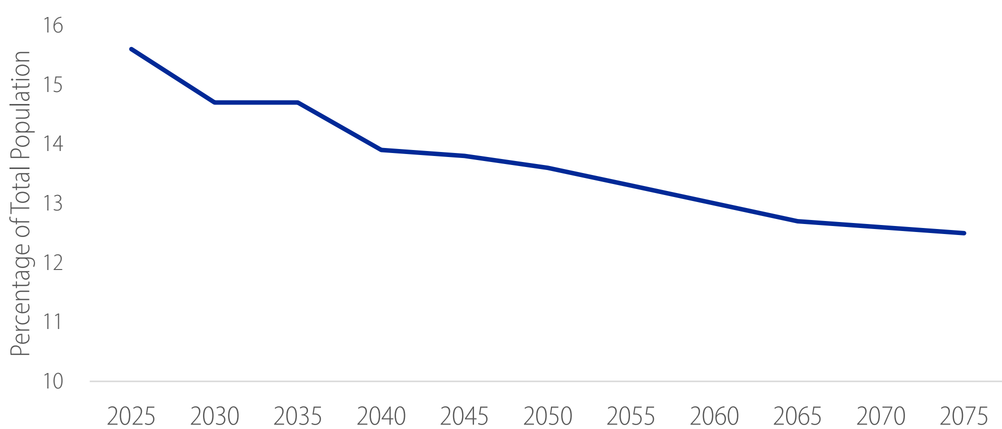
In many parts of the U.S., public sector K-12 school enrollment is flat at best, if not declining. U.S. public school enrollment increased every year between 1990 and 2019, increasing by about 8.4 million students. Experts are warning that the rising enrollment trend is coming to an end. Longer-term, lower birthrates are more problematic than competition from charter and private schools, but both will continue to strip away at total revenues for districts who rely on per pupil funding formulas for state aid.

State total balances (and rainy-day funds), while still generally at record highs (as noted in the State Government sector outlook), could be pressured on a variety of fronts including changing federal policies; slower – but still positive – growth in key state revenues such as personal income taxes; and expenditure pressures. The National Association of School Business Officials (NASBO) reported that for the current budget year, seven states reported no expected change to fund balance levels but 10 expected lower reserves by the end of fiscal 2025. Tighter budgets at the state level could lead to declining aid for local governments, including school districts, within a budget cycle or two.

The National Association of School Business Officials (NASBO) reported that for the current budget year, seven states reported no expected change to fund balance levels but 10 expected lower reserves by the end of fiscal 2025.

Expenditure pressures related to both current and retired personnel are driving school boards to consider difficult decisions including closing campuses. It's not just in mature urban areas like Chicago, San Francisco, and Philadelphia. School districts in growing states such as Texas, Arizona, and Colorado have closed or are considering closing campuses to cut costs.

School-Age Children as a Percentage of Total U.S. Population



Source: U.S. Census Bureau and HilltopSecurities.

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Community Facilities Districts

HilltopSecurities Credit Outlook: "Stable"
Recent Change: None
Author: Doug Nelson

Community Facilities Districts or CFDs provide infrastructure financing, mainly for residential developments in California.

Community Facilities Districts or CFDs provide infrastructure financing, mainly for residential developments in California. CFD debt is repaid with special taxes that are levied based on parcel size, as opposed to property taxes that are levied based on property value. Our outlook for CFDs remains "Stable".

Housing demand continues to be relatively robust in California due to housing shortages in various areas of the state. A scenario where mortgage rates fall could further increase housing market demand. Affordability and development restrictions (based on water availability and other factors) have dampened growth in some areas.

In general, residential property values have continued to increase and as CFD debt is paid down, value-to-lien ratios continue to improve. Commercial property values appeared to have bottomed out, so value-to-lien ratios for commercial CFDs are stable. The chart shows that gross domestic product (GDP) has been growing across the state which equates to a stable economy and thus stable property values.

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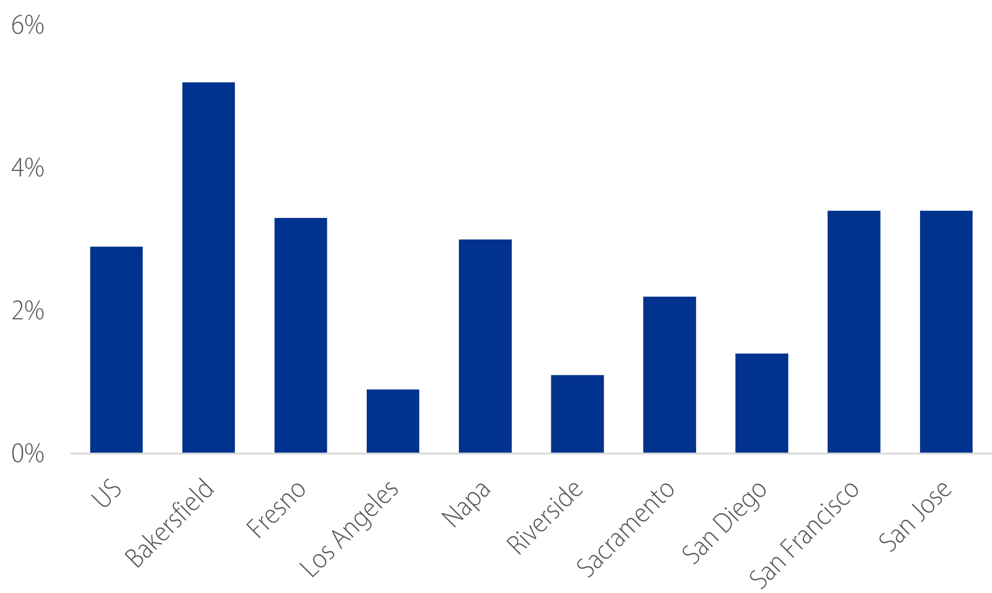
Gross Domestic Product Year-over-Year Change from 2023



Source: U.S. Bureau of Economic Analysis and HilltopSecurities.

Airports

HilltopSecurities Credit Outlook: "Stable"
Recent Change: None
Author: Doug Nelson

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Passenger traffic at U.S. airports should continue to grow, albeit at a reduced rate than in previous years. The change in Gross Domestic Product (GDP), which is an indicator of economic growth can be a gauge for the change in enplanements at airports. The growth in the U.S. GDP has slowed which should equate to a slowing of air travel. The bankruptcy of Spirit Airlines is not expected to reduce enplanements at the airports it services, due to its small market share at these locations.

Under the Airport Improvement Program, the Federal Aviation Administration awarded over $2 billion in grants to improve airport infrastructure across the U.S. in 2024. Many airports have capital needs due to growth and aging infrastructure, so it is expected that new debt will be issued in the next few years. The additional debt is not expected to deteriorate credit quality since most airports have good liquidity, strong balance sheets and the ability to pass on increased debt service through increases in airline rates and charges. The airline industry in general is in good shape with record revenues from increased traffic. Since the pandemic has ended, there has been a sustained demand for travel and many airports have exceeded pre-pandemic passenger traffic.

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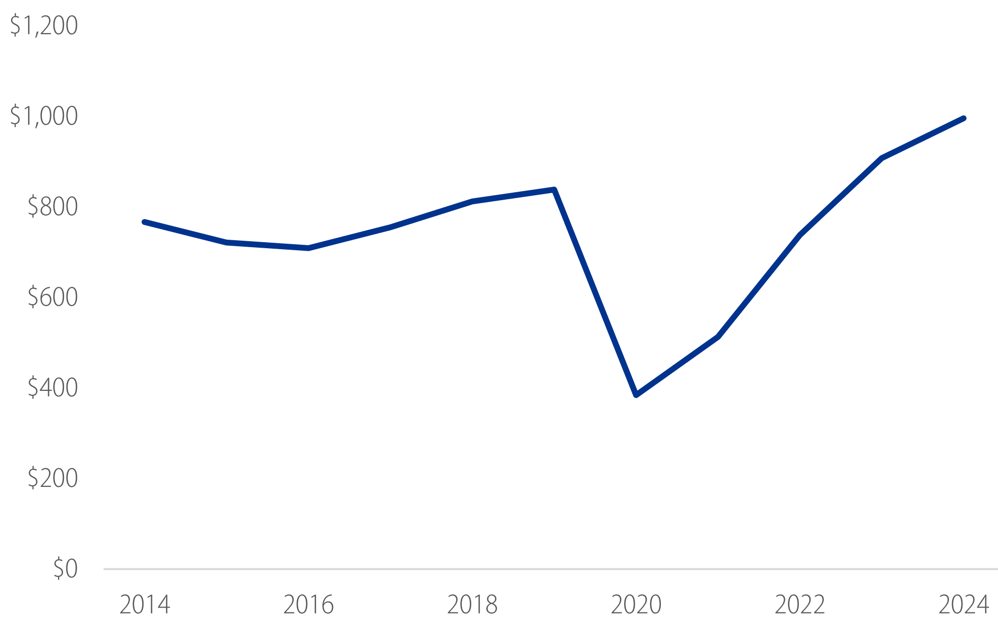
Revenue of Commercial Airlines ($ in billions)



Source: Statista and HilltopSecurities.

Charter Schools

HilltopSecurities Credit Outlook: "Stable"
Recent Change: None
Author: Yaffa Rattner

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Looking ahead to 2025, the continued need for charter schools to accommodate growing enrollment is evident as charter school enrollment increased by 3.7 million students and now accounts for the education of almost 8% of U.S. K-12 students. Of note, charter school enrollment grew by grew by 83,172 in 2023-24 and almost 400,000 since fiscal year 2020-2021.

At the same time, U.S. public schools saw a decline of 274,412 students this year, and a decline of 1.8 million since fiscal year 2021 according to the National Alliance for Public Charter Schools. This enrollment shift is creating additional opportunities in the charter school sector but may introduce fiscal challenges to traditional schools that have declining enrollment (as we highlight on page 5 in our School District outlook).

Charter school issuance in 2024 increased by more than 25%, reaching $4.3 billion from $3 billion in 2023. This growth reflects the rising enrollment at charter schools and the need for additional capital capacity. Texas, Arizona, California, Florida, and New York accounted for just over two-thirds of the 2024 issuance, with the Wisconsin Public Finance Authority (PFA) contributing another 10% of the total par value.

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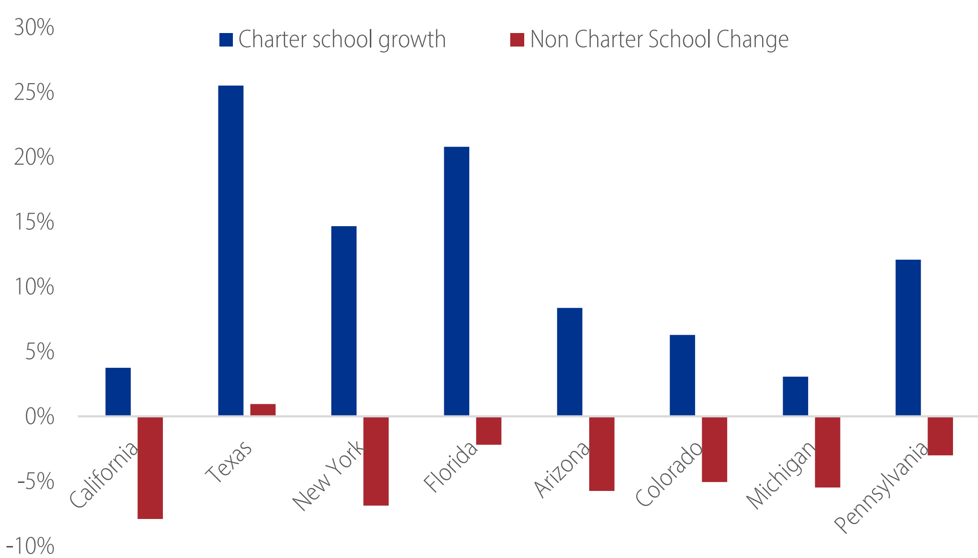
Charter School vs Non Charter School Enrollment Change FY 2020 vs 2024



Source: National Alliance for Public Charter Schools and HilltopSecurities.

Health Care (Investment Grade)

HilltopSecurities Credit Outlook: "Cautious"
Recent Change: Raised to "Cautious" from "Negative" in this analysis.
Author: Doug Nelson

Health care facilities are making notable strides, with improved profit margins, robust patient volumes, and a more stable labor market. This progress highlights the sector's flexibility and adaptability in the face of ongoing challenges.

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The change of administration at the White House and the turnover of Congress at the federal level could be a negative factor for this sector. A recent Gallup poll found that a 62% majority in the U.S. believe the government should ensure all Americans have healthcare coverage-the highest percentage in more than a decade, however, the poll also found that a majority of Republicans still believe ensuring health coverage is not the government's job.

Many health systems are demonstrating strong financial health, with good liquidity and robust balance sheets that can cushion potential reductions in government funding. Most health care providers have successfully controlled expenses by managing labor costs, while simultaneously achieving top-line growth through increased patient volumes. This combination of financial prudence and growth underscores the sector's fortitude and adaptability.

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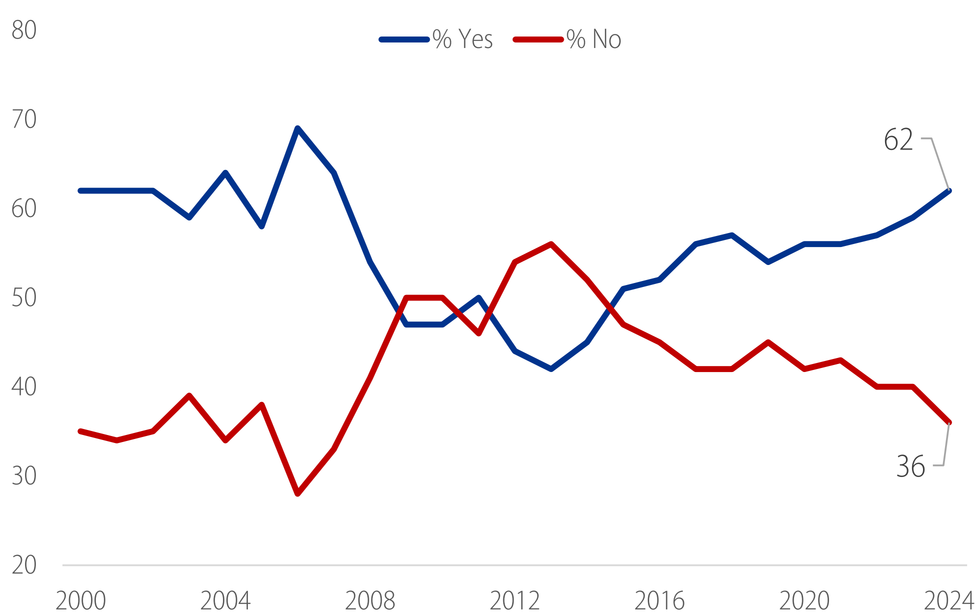
Moody's maintains a "Stable" outlook for the sector. S&P Global raised its outlook to "Stable" from "Negative" and Fitch Ratings revised its outlook on this sector from "Deteriorating" to "Neutral." We also changed our outlook on the health care sector to "Cautious" from "Negative."

Gallup Poll: Is it the responsibility of the Federal Government to ensure that all Americans have healthcare coverage?



Most health care providers have successfully controlled expenses by managing labor costs, while simultaneously achieving top-line growth through increased patient volumes

Source: Gallup and HilltopSecurities.

Higher Education

HilltopSecurities Credit Outlook: Public "Negative" and Private "Negative"
Recent Change: Both lowered to "Negative" in our Sept. 25, 2024 report.
Author: Tom Kozlik

The non-profit U.S. higher education sector is encountering severe systemic pressures.

The non-profit U.S. higher education sector is encountering severe systemic pressures. Both public and private institutions are affected, but mostly it is the smaller private institutions which are experiencing the most significant credit stresses, leading to what can be described as an existential crisis for some. Despite recent federal relief, higher than expected economic growth, positive investment returns, and the rising importance of future skills that universities are in a unique position to deliver, these institutions are under attack on multiple fronts.

The current crisis is characterized by declining enrollment; expensive tuition and rising debt loads; declining government support; inflation; falling confidence in higher education, and the increased chance that college doesn't pay off for individual students. These factors have resulted in a significant disparity of rating downgrades compared to upgrades, closures, mergers, and other strategic maneuvers. The entire higher education sector faces looming challenges, notably the impending enrollment cliff and demographic shifts expected to begin in 2027. These factors could present the most significant hurdles yet, potentially leading to the sector's toughest times ahead.

The current crisis is characterized by declining enrollment; expensive tuition and rising debt loads; declining government support; inflation; falling confidence in higher education, and the increased chance that college doesn't pay off for individual students.

Despite these challenges, many higher education institutions will continue to be vital for the future. The institutions best positioned to thrive will be those that are selective, larger, innovative, and flexible, with budget models that are not heavily dependent on fluctuating student enrollment. These institutions will be better equipped to adapt to evolving educational paradigms, ensuring they remain relevant and effective in preparing students for the future job market.

Systemic Pressures Causing Higher Education Crisis

Current Pressures:
• Declining enrollment
• Expensive tuition, rising debt loads
• Declining government support
• Inflation
• Falling confidence in higher education
• Increased chance college does not pay off
Upcoming Pressure:
• Enrollment cliff (2027 per forecast)

Source: HilltopSecurities.

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Housing

HilltopSecurities Credit Outlook: Stable
Recent Change: None
Author: Tom Kozlik

The municipal housing sector had a record year of issuance in 2024, and this year's housing activity could be similarly robust.

The general housing sector may face challenges due to the Federal Reserve pausing its pivot toward lower interest rates. However, the municipal housing sector had a record year of issuance in 2024, and this year's housing activity could be similarly robust. This expectation is driven by the anticipation that single-family loan originations will remain strong, thanks to State Housing Finance Agencies' (HFAs') competitive position as an attractive option for targeted, first-time, and low-income homebuyers. Down payment assistance further enhances HFAs' competitive edge.

State HFA balance sheets and credit fundamentals are expected to remain strong in 2025. With strong investment earnings and continued higher mortgage interest income, we anticipate stable HFA margins (19-20% range according to Moody's Ratings expectations). If interest rates remain elevated for an extended period, it could likely bolster HFA credit quality even further. While we do not anticipate sector-wide credit or rating deterioration in the near term, we are closely monitoring for the potential impacts of the new Presidential administration's and 119th Congress' fiscal policies. U.S. sovereign credit rating action is something we will be watching for in 2025 as well.

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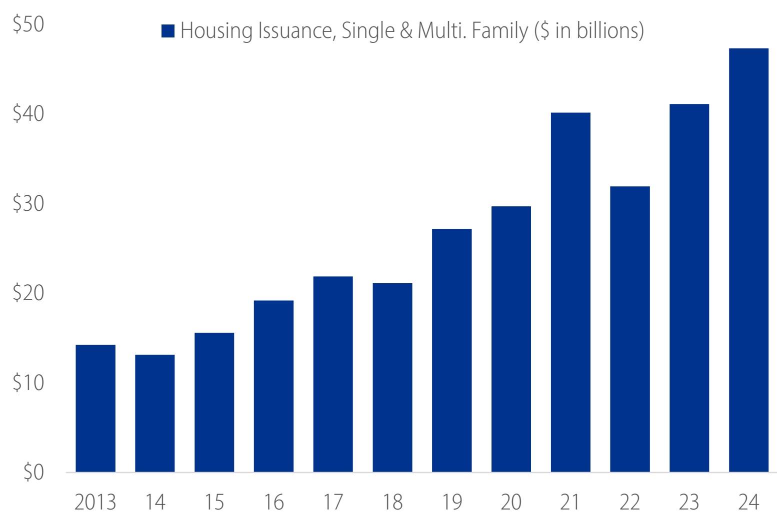
We still expect steady revenue from secondary, or to-be-announced (TBA) market activity. However, if interest rates elevated TBA activity is unlikely to reach the record levels seen in 2020 and 2021 when rates plummeted. Housing sector bond issuance fell to about $32 billion in 2022 but recovered in 2023 and surged to approximately $47 billion in 2024. The trajectory of issuance in 2025 will again depend on interest rates, loan activity, and economic growth. Fiscal policy and political developments in D.C. could be very unpredictable factors this year. Overall, we anticipate that 2025 could be another busy year for State HFAs and the housing sector.

Housing Activity Jumped Again in 2024



Source: Refinitiv and HilltopSecurities.

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Public Power (Electric)

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

The tragedies of the California wildfires serve to remind that natural disaster risks are ever-present. There are other states that have inverse condemnation laws, but they are generally not applicable to utilities. Therefore, it is our view that credit pressures will mainly be confined to California issuers, as reflected in the recent rating action activity. The biggest pressures, especially in low-cost power areas such as the Pacific Northwest, will come from integrated resource planning for data centers. In 2023, the most recent year available, data centers consumed about 4.4% of all electricity generated in the U.S. A 2024 report by the Berkeley National Laboratory predicted that could almost triple, to 12%, by 2028. An average-sized data center might have an electric load of 20 to 100 megawatts. Assuming the average home of 3 people uses 1,000 kilowatt-hours per month, then an average data center has about the same load profile (i.e. demand on the grid) as a city of 20,000.

The potential upside to an aggressive policy shift of oil and gas drilling is a slower pace of increase in natural gas prices, though maybe not enough to temper the resurgence of prepaid natural gas deals. In January 2025, the U.S. Department of Energy's Energy Information Administration's short-term energy outlook forecasted a rise in the spot market price from the average of $3.10 per million British thermal units (MMBtus) to $4.00 in 2026. That it is currently hovering just over $3 per mmBTU is itself nearly double that of early 2024's record lows, when a mild winter and high storage levels depressed prices. Electric utility prices were once highly correlated to natural gas prices. How much the new administration's policies will stabilize prices to electric utilities remains to be determined, as growth in liquefied natural gas exports continues to skyrocket: just in the last year the Gulf Coast has three new facilities will be at or near full operations by 2025-26. That means it is more and more likely that surplus natural gas won't meaningfully bring down gas nor electric prices because there won't be surpluses. Rather, more gas could be made available for export and electricity prices could continue to rise.

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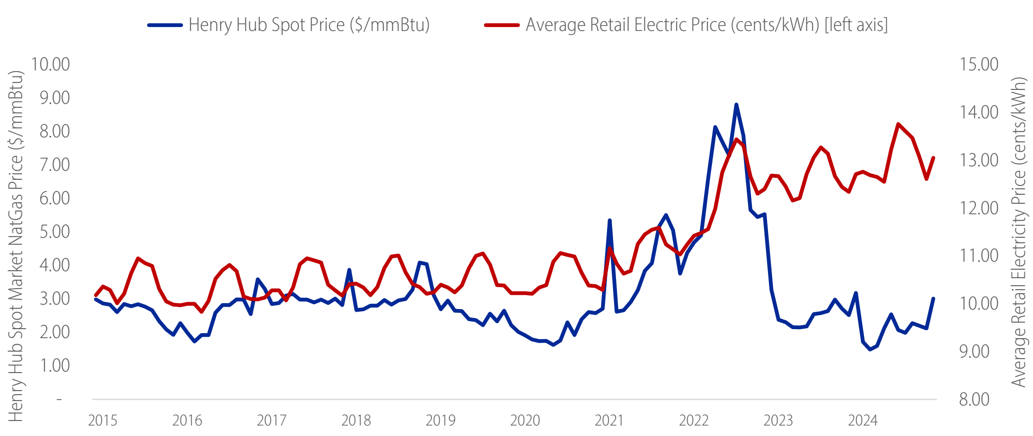
How much the new administration's policies will stabilize prices to electric utilities remains to be determined, as growth in liquefied natural gas exports continues to skyrocket: just in the last year the Gulf Coast has three new facilities will be at or near full operations by 2025-26.

Natural Gas vs. Retail Electric Prices, Last 10 Years



Source: U.S. Dept of Energy's Energy Information Administration and HilltopSecurities.

Senior Living

HilltopSecurities Credit Outlook: "Stable"
Recent Change: Raised to "Stable" from "Cautious" in our Dec. 17, 2024 analysis.
Author: Yaffa Rattner

HilltopSecurities has revised its outlook on the senior living sector to "Stable" from "Cautious."

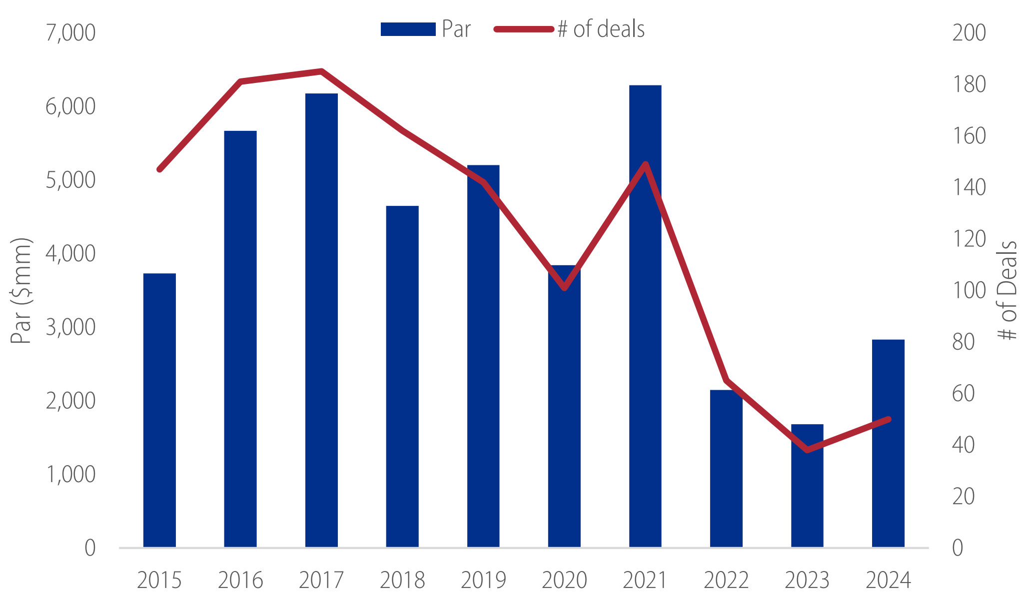
HilltopSecurities has revised its outlook on the senior living sector to "Stable" from "Cautious." This change is due to reported increases in occupancy approaching pre-COVID levels, higher monthly community revenue, and stabilized expense pressures, including labor and food costs. This update is especially relevant given the explosive growth in municipal bond issuance for senior living to $3.19 billion from $1.68 billion, a trend that is expected to continue into 2025.

The American population is aging rapidly. From 2010 to 2020, the U.S. population aged 65 and over grew by 38.6%, the fastest rate since 1900. In the past three years, this demographic has increased by 9%, now comprising nearly 60 million people. At the same time, fewer children were born from 2010 to 2020, leading to a future with more older adults and fewer younger adults available for homecare.

The U.S. dependency ratio, which compares the population under 15 or over 64 to the working-age population (15-64), continues to rise. It increased from 49 in 2010 to 53.7 in 2019 and is projected to reach 64 in 2024. As this ratio grows, there are fewer working adults to care for the very old or very young, driving the need for more congregate care facilities for American seniors. However, the effects of the current immigration policy, to our knowledge, are not factored.

From 2010 to 2020, the U.S. population aged 65 and over grew by 38.6%, the fastest rate since 1900.

Annual Senior Living Bond Issuance



Source: SDC Data and HilltopSecurities.

The U.S. dependency ratio, which compares the population under 15 or over 64 to the working-age population (15-64), continues to rise.

Tobacco

HilltopSecurities Credit Outlook: "Negative"
Recent Change: None
Author: Doug Nelson

The generally low rates of cigarette and e-cigarette usage may stem from the perception that these products can cause harm.

The U.S. cigarette smoking rate has plummeted to an 80-year low in 2024, according to a recent Gallup poll. Fewer young adults smoke cigarettes and or more likely to smoke e-cigarettes. The generally low rates of cigarette and e-cigarette usage may stem from the perception that these products can cause harm. As a result, cigarette consumption in the U.S. continues to decline which helps to explain why the payments the tobacco companies have made to the states under the Master Settlement Agreement (MSA) continue to decrease. These payments secure the tobacco settlement revenue securitization bond issues.

Regulatory risk in this sector also remains high. In 2023, the Food and Drug Administration (FDA) submitted two rule changes to the White House Office of Management and Budget (OMB) for final review. These rule changes are to end the sale of menthol cigarettes and to end the sale of flavored cigars. The rules are waiting on final approval from the Biden administration, which may not happen before the change of administration. Massachusetts and California have banned menthol cigarettes, and more than 190 cities and counties in at least eight states have also restricted their sale. State and local governments continue to tighten restrictions on smoking in public areas. Recently, the FDA submitted a proposed rule to the OMB that would require tobacco companies to significantly reduce the amount of nicotine in traditional cigarettes.

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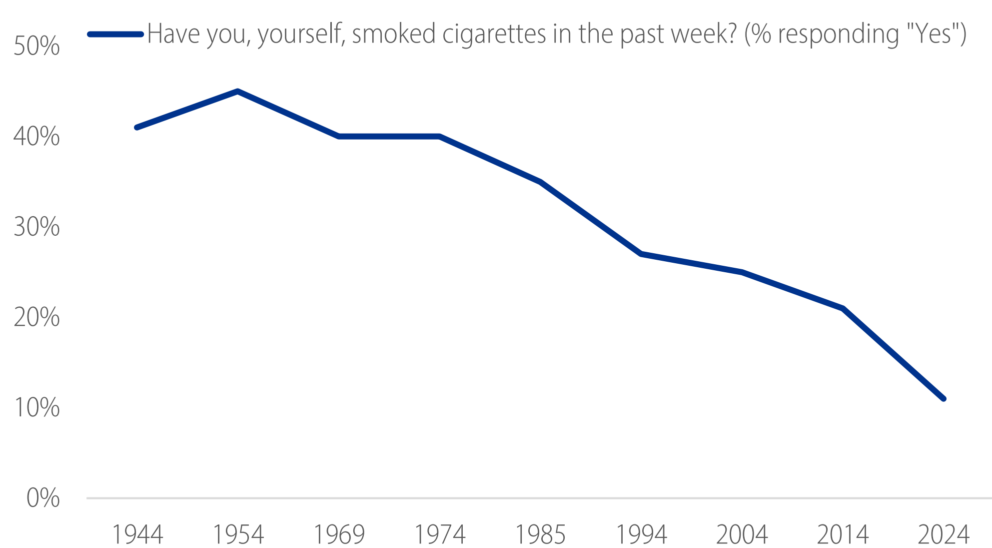
These rule changes could accelerate the already gradual reduction in cigarette consumption, therefore our outlook on the tobacco sector remains "Negative."

Cigarette Smoking Among U.S. Adults



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Source: HilltopSecurities.

Toll Facilities

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

We expect the near-term credit conditions to support our "Stable'" outlook: vehicle-miles traveled have rebounded and now exceeded pre-pandemic levels; slow but steady economic growth; and the probability that any federal actions such as trade policies and tariffs would not be impactful to this sector. We also view the years-in-the-making implementation of the New York City MTA's congestion pricing program – currently a $9 toll, increasing to $15 by 2031 – is an isolated policy that, while it may over time be replicated in some markets, is unlikely to be a sector-wide disruptor.

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Single asset and stand-alone toll roads, many of which are privately managed, are the most susceptible to tail risks, as most tend to be rated in the 'A' or 'Baa' categories. Toll road systems enjoy the economies of scale of serving larger metropolitan areas and have generally been able to withstand the new, post-pandemic commuting patterns, and also have more flexibility and demonstrated willingness to adjust tolls (sometimes tied to CPI) if- and as-necessary. In our view the most pressing challenge will be managing construction sector inflationary pressures, especially for mature systems or roads that are being challenged by growth-driven needs such as adding managed lanes. Post-pandemic, both capital expenditures by state and local governments on all highways and streets, tolled or otherwise, and office occupancy rates have stabilized into what we view as the new normal, though any longer-term correlation is yet to be determined.

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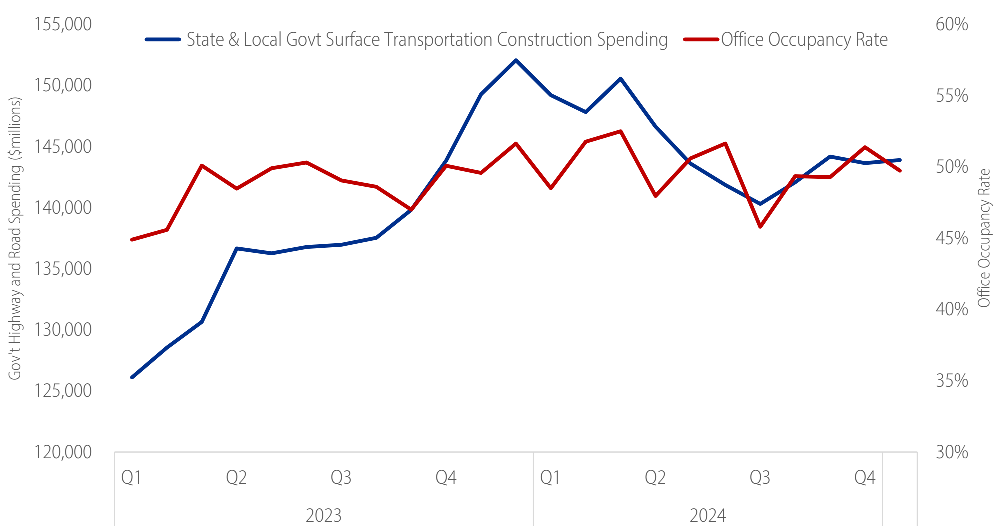
SLG Surface Transportation Spending and Office Occupancy Rates



Source: Federal DOT Transportation Statistics Bureau; FRED; Kastle Back to Work Barometer; HilltopSecurities.
SLG = State and Local Governments

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Water and Sewer

HilltopSecurities Credit Outlook: "Cautious"
Recent Change: Lowered to "Cautious" in this analysis.
Author: Ted Chapman

We lowered our outlooks for the Water and Sewer sector to "Cautious" from "Stable" in this analysis.

We lowered our outlooks for the Water and Sewer sector to "Cautious" from "Stable" in this analysis. The headwinds to water and sewer utility credit quality are the same as they have been for more than a quarter century: sensitivity to the ever-present need for rate adjustments to keep up with ever-increasing operating and capital budget pressures; being able to pivot to whatever Mother Nature throws at them; the high and increasing cost of compliance with regulatory requirements; and attracting and retaining the next generation of workforce talent.

This is the leading reason why we made the move lower to "Cautious." In December 2024, the U.S. Environmental Protection Agency EPA reported to Congress that 12.1 to 19.2 million US households lack access to affordable water services. Resuming past intentions to cut EPA's budget, on his first day in office in 2025 President Trump signed an executive order that pauses the disbursement of certain IRA and IIJA funds. Though the EO targets electric vehicle (EV) infrastructure, it also suspended release of the funding boost that EPA deploys for State Revolving Fund programs. The SRFs are funded mainly by EPA grants, with state matching funds that come from state appropriations and - for many states - supplemented by bonds. Large municipal systems comprise most of the principal outstanding of these low-cost loans. Yet, the total number of borrowers reflects the U.S. at large: there are about 49,000 community drinking water systems in the US, and the largest 4,000 or so serve more than 80% of the population. That means there are tens of thousands of small and rural systems that were already being challenged by natural and manmade risks; retirements and lean operations; and lack of economies of scale. Most are not rated and may also opt for USDA financing programs. Still, even highly rated large and very large utilities utilize the SRF programs. It now seems making the cut will become even more competitive for a sector that has at least $625 billion in needs just to maintain the status quo over the next 20 years. That number was reported to Congress before utilities were required to submit their inventory of lead service lines, nor does it reflect the full cost of treatment upgrades likely to be required to rid drinking water of PFAS and related contaminants.

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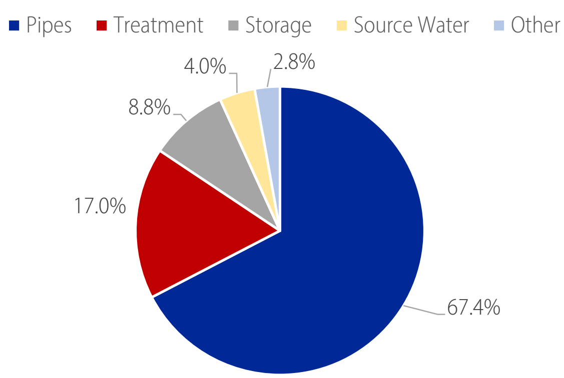
Drinking Water Needs by Category, Next 20 Years



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Source: EPA and HilltopSecurities.

Recent HilltopSecurities Municipal Sector Outlooks

Stable Outlook for Senior Living into 2025, Dec. 17, 2024

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The Municipal Market in 2024, Hilltop's Municipal Sector Credit Outlooks, Jan. 22, 2024

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.

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Forecasting $745 Billion in Municipal Bond Issuance for 2025 Amid Potential Tax-Exemption Elimination, Nov. 24, 2024

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