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U.S. Municipal Bond Market

No Mass of Public Finance Downgrades Yet, Movement After Evaporating Government Support Better Indicator

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Summary

- After the Global Financial Crisis of 2007-08, we saw U.S. public finance downgrades (by Moody's Investor Service) peak in 2012 and outpace upgrades from 2009-2014.
- Downgrades have only slightly outpaced upgrades in the second and third quarters of 2020, but the pace will likely increase as federal relief evaporates.
- We continue to expect downgrades will outnumber upgrades, probably for years. Future federal relief, or its absence, will be a chief contributor to the magnitude of the future public finance rating downgrade to upgrade ratio.

Why Have More Public Finance Ratings Not Been Downgraded?

Public finance downgrades will likely materialize, and just like after the Great Recession, we expect downgrades to outpace upgrades for some time. In our Aug. 13 report, Public Finance Downgrades to Outpace Upgrades, Probably for Years, we emphasized that after the Great Recession public finance downgrades outpaced upgrades between 2009 and 2014. We also stressed that the number of downgrades did not peak until 2012. This summit was years after the National Bureau of Economic Research reported the Great Recession officially ended in June 2009.

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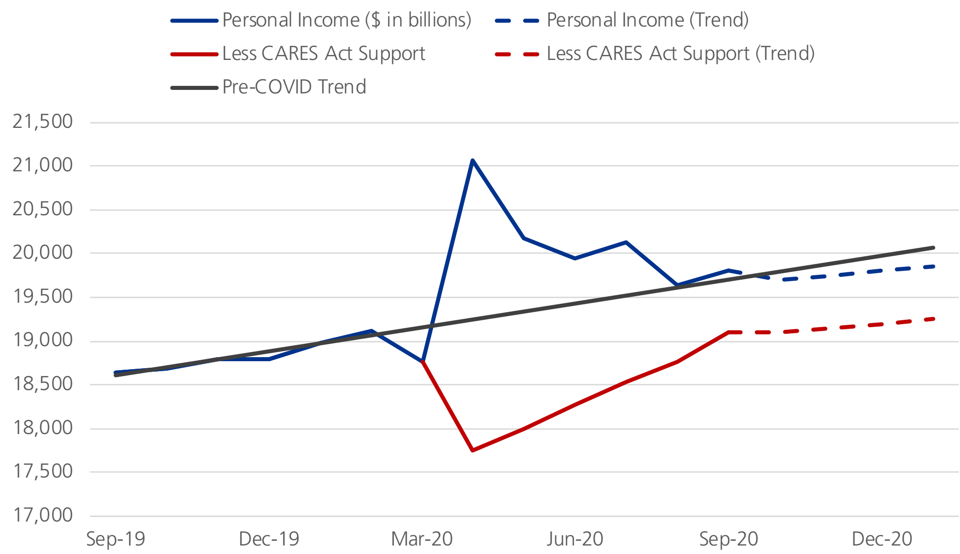
Federal Personal Income Data Illustrates CARES Act Support Crutch



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

A key reason public finance downgrades were not more plentiful and did not occur more quickly after the 2007-08 financial downturn was the fiscal relief included in the 2009 Recovery Act targeted toward state and local governments. This federal government aid helped boost state and local government spending between FY09-FY11 compared to FY06-FY08, according to the Congressional Research Service

Insight report, State and Local Fiscal Conditions and Economic Shocks. Another reason downgrades occurred later, and in some cases years after the recession, is an inherent lagged effect. Usually it takes time for the revenue impact from sources like property taxes and lower state aid allocations to work through the system. For example, this Brookings analysis, State and Local Budgets and the Great Recession, by Tracy Gordon shows the cumulative change in state and local government own-source receipts did not bottom out until two years after the beginning of the 2007-08 recession. In addition, from FY08-FY12 state governments relied heavily on spending cuts (45%) and emergency federal aid (24%) to close budget gaps, according to the Center on Budget and Policy Priorities.

A significant amount of fiscal relief was included in the March 2020 CARES Act in the form of individual stimulus payments, unemployment insurance, and other forms targeted to support U.S. businesses, individuals, and the larger economy.

A significant amount of fiscal relief was included in the March 2020 Coronavirus aid, Relief, and Economic Security Act in the form of individual stimulus payments, unemployment insurance, and other forms targeted to support U.S. businesses, individuals, and the larger economy. The impact of this relief can be seen in the personal income line chart we included. (We want to highlight the fact that we developed the idea to show federal personal income data in this format from an Oct. 30, 2020 tweet by Julia Coronado, MacroPolicy Perspectives.) In the coming months, because this relief has expired or is expiring, we expect incomes could decline and track below the pre-COVID-19 trend. Municipal credit deterioration will build as this lack of support progresses, and lower than forecast government revenues could accumulate at the state and local levels over the coming months and years.

Public Finance Downgrades Barely Outpaced Upgrades in 3Q 2020

On Monday, third quarter 2020 rating activity was tabulated and reported by Moody's Investor Service, showing that while public finance rating downgrades (73) outpaced upgrades (72), it was not by much and it still seems the outright number of downgrades is lagging expectations. However, we expect that downgrades will pile up as credit deterioration mounts.

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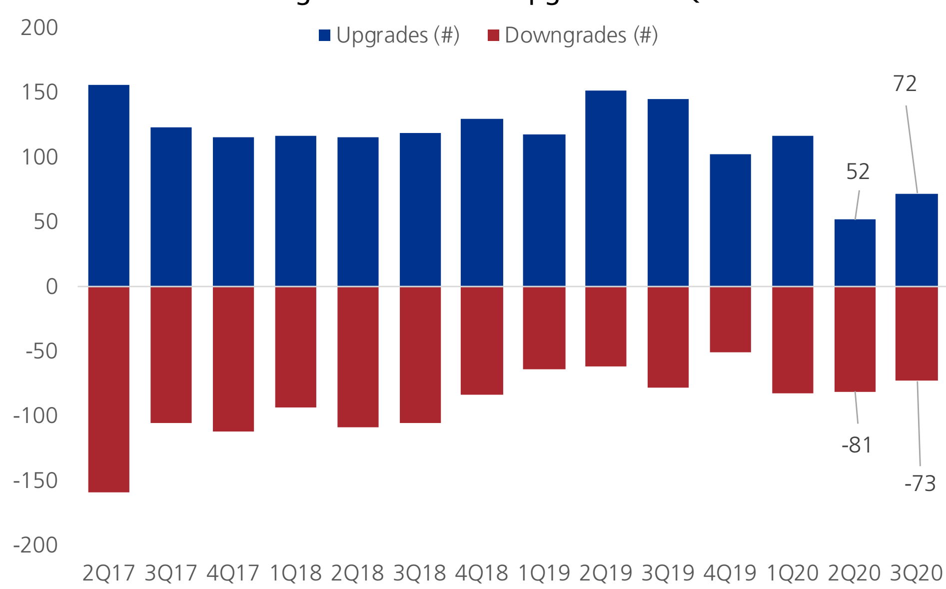
73 Public Finance Downgrades Versus 72 Upgrades in 3Q20



Source: Moody's and HilltopSecurities.

Local Government Sector Hardest Hit by Third Quarter Downgrades

The first two largest public finance downgrades were assigned to the New York Metropolitan Transit Authority (MTA) and the state of Hawaii. Both of these high-profile downgrades were influenced to a large extent by a reduced amount of economic activity related to the COVID-19 pandemic. Local governments, in the form of school districts and cities, accounted for 74% of the third quarter 2020 Moody's Investor Service public finance downgrades activity. The upgrade to the Municipal

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Electric Authority of Georgia (MEAG) Power Plant was the largest Moody's public finance upgrade in 3Q20 in terms of dollar amount.

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