

U.S. Municipal Bond Market

State Outlook Remains Negative; Direct Fiscal Relief Still Needed

- We have reiterated our "Negative" outlook on the U.S. state government sector, which we initially lowered back in May 2020.
- State governments need direct relief. There have been zero dollars of direct, unencumbered aid for state and city governments allocated since the COVID-19 pandemic began.
- There has been no tax revenue or federal government windfall to state governments.
- State government revenues were down a little over 5% year over year between April and September 2020 versus 2019, according to Tax Policy Center data.
- State revenue forecasts remain mixed. We review three examples (California, New York, and Texas) in order to give readers an idea of the range of state fiscal outlooks. Downside potential remains if another COVID-19 occurs in the coming months as well.

Tom Kozlik
Head of Municipal Strategy & Credit
214.859.9439
tom.kozlik@hilltopsecurities.com

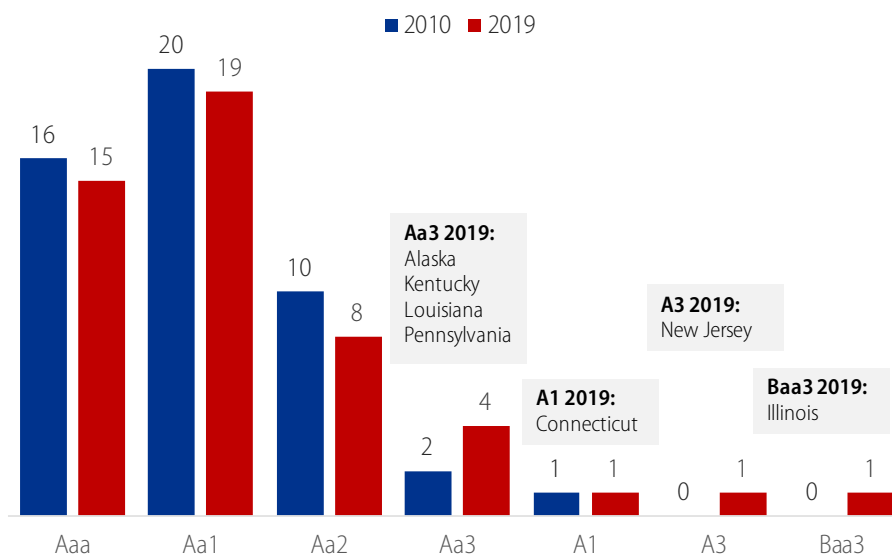
State Fiscal Pressure not as Bad as Forecast, Still Problematic

The near-term fiscal pressure on state governments has not been as bad as originally forecast last summer, but the financial dilemmas in many state capitals across the country are still problematic.

Overall, state revenues were down a little over 5% year over year between April and September 2020 versus 2019 according to Tax Policy Center data. Some deep budget shortfalls, a direct result from lower economic activity due to the COVID-19 pandemic, still exist and require attention. State and local governments have

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Unprecedented State Credit Deterioration Before COVID-19 Crisis Comparison of U.S. State Ratings Distribution, 2010 to 2019



Source: Moody's and HilltopSecurities. Hawaii & New York downgrades in 2020 not included.

shed jobs in three of the last four months and in total have already reduced their workforce by about 1.3 million jobs since April 2020. This is about twice as many job cuts as what we saw state and local governments experience in the years after the 2008 Financial Crisis.

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Worse yet, and often forgotten, is that we saw an unprecedented level of credit deterioration in the U.S. state government sector in the years after the 2008 Financial Crisis. This is even before the mostly negative impact from COVID-19 began. Please see the bar chart which compares the Moody's state government rating distribution in 2010 (post-recalibration) with the ratings distribution almost a decade later at the end of 2019 (keep in mind that this is before COVID-19 related rating actions). About 20% of state ratings shifted lower from 2010 to 2019 and there were seven states rated between Aa3 and Baa3 to end 2019 compared with only three at the end of 2010. We had a "Cautious" outlook assigned to the state government sector even before COVID-19 hit (please [see our August 2019 report](#)).

U.S. state rating data from Moody's shows that since the end of the Great Recession state governments have done their best to keep their heads above water but some were struggling even before March 2020. This is generally because expenditure demand was climbing while revenues were not rising fast enough, and pensions almost always had an outsized impact on states with structural imbalances.

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State Finance Complacency, Says S&P

We are using Moody's rating activity to illustrate our key points, but the state ratings at other rating agencies such as S&P and Fitch were also experiencing deterioration over the last decade. In fact, in 2017 S&P went so far as to warn about "complacency when it comes to state finances." In a commentary piece titled, [Your state is probably facing a new dawn of public finance problems](#) published by The Hill, S&P highlighted that:

U.S. states have entered a new era characterized by chronic budget stress. For the past 130 years, states have mostly been financially resilient through a range of economic conditions. In fact, no state has defaulted on its debt since Arkansas in the 1930s. This long period of relative calm may have lulled some people into complacency when it comes to state finances. It shouldn't have.

The article went on to stress that states should place a priority on funding discipline as it relates to pension requirements. Another primary theme was the importance of building a rainy day, or general fund cushion, for the next inevitable economic slide. What we saw across the state sector was some states who took these notices seriously and others that did not.

Our U.S. State Government Sector Outlook is Still "Negative" to Begin 2021

The rating agencies very quickly into the initial weeks of the pandemic wasted no time lowering the outlooks of many, if not most, of the public finance sectors. This includes the state government sector outlook. We finally lowered our state sector outlook to "Negative" from "Cautious" in May 2020. We are reiterating our "Negative"

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outlook on the U.S. state sector in today's report. This reconfirmation is with the caveat that a near-term factor of meaningful direct, unencumbered aid that flows to state governments in a sixth and or even seventh phase of fiscal relief from D.C. could cause us to raise our outlook back to "Cautious" (probably not "Stable"). We are noting that it is probably not likely that we will move to a "Stable" outlook for states because even with meaningful aid we still expect structural imbalances to remain once economic growth returns. Headwinds like we saw in 2019 (perhaps even worse) will once again be driving the U.S. state government landscape. Already some states are making fiscal choices as it relates to pension funding that may provide budget relief in the near-term at the expense of long-term fiscal balance, [according to Pew](#).

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State Downgrades since COVID-19 Pandemic Began

We have written that we believe that the ratings landscape for the next few years will [see many more downgrades than upgrades within public finance](#), and that is most likely for U.S. state government ratings as well. Since the onslaught of negative news and activity, there have actually only been a handful of adverse rating actions on U.S. states, so far. Fiscal relief from Washington, D.C. may lessen the number of downgrades in the near-term, but downgrades will likely follow in years to come as a result of ongoing structural imbalances.

So far there have only been two Moody's state rating downgrades since COVID-19 began:

- Hawaii downgraded to Aa2 from Aa1 and outlook revised to stable from negative.
- New York (state) downgraded to Aa2 from Aa1 and outlook revised to stable from negative.

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More action has occurred on rating outlooks. The rating outlooks for five states have been lowered by Moody's since COVID-19 began:

- Illinois' outlook lowered to negative from stable.
- New Jersey's outlook lowered to negative from stable.
- Nevada's outlook lowered to negative from stable.
- Louisiana's outlook lowered to stable from positive.
- Oklahoma's outlook was also lowered to stable from positive.

More credit pressure could build in the coming months, especially if the new variants being talked about cause COVID-19 activity to spike again in 6-14 weeks as some health officials have predicted.

Cutting Through the "Windfall" Rhetoric

There has been an increased amount of rhetoric in recent months that has framed the fiscal backdrop for state and city governments as one where their revenues are coming in better across the board than in 2019, and that the states are also awash in direct federal government support.

We describe the true revenue situation below.

Let's be clear. There has still not been one dollar of federal direct, unencumbered aid

Despite an increased amount of "windfall" rhetoric in recent months, let's be clear. There has still not been one dollar of federal direct, unencumbered aid that has flowed to state and city governments since COVID-19 began.

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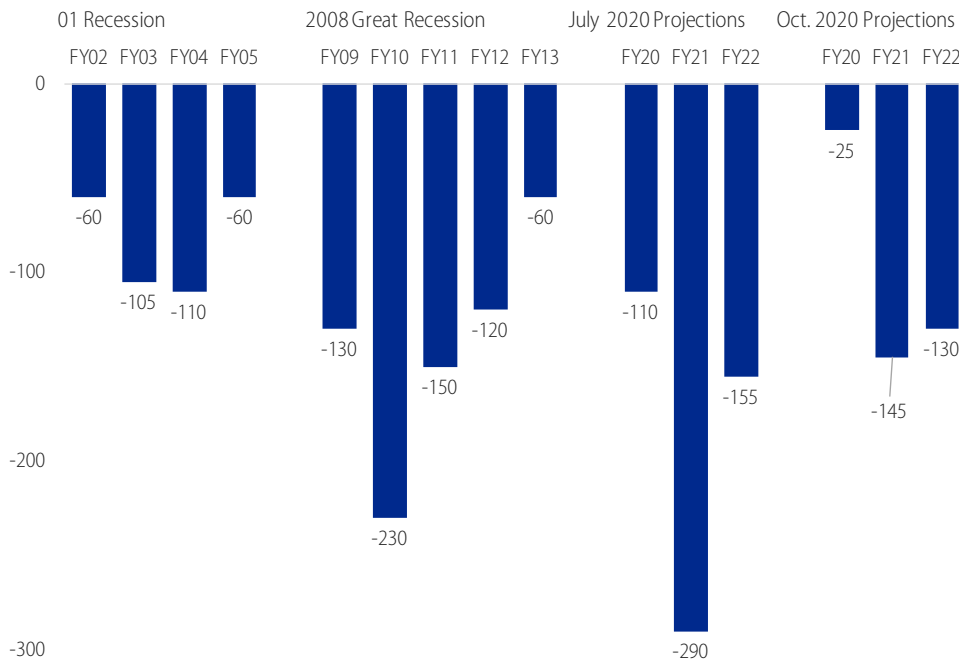
The Wall Street Journal in an opinion piece on Dec. 23 described the \$900 billion included in the fifth phase of COVID-19 relief as The State COVID Windfall. It was anything but a windfall. We went into more detail in this report: Fifth Phase of Fiscal COVID-19 Relief is No State and Local Government Windfall.

In July 2020, the CBPP forecast that state budgets would experience a \$555 billion shortfall between fiscal year 2020 and 2022.

Budget Shortfall Adjustments

Expectations for state budget shortfalls were significant last summer. This was justifiable due to the fact that we have not seen anything like COVID-19 in modern times, economically speaking. The Center on Budget and Policy Priorities forecast in July 2020 that state budgets would experience a \$555 billion shortfall between fiscal year 2020 and 2022. This total shortfall forecast was lowered, to only about \$300 billion, over those same three fiscal years in October 2020.

COVID-19 State Budget Shortfalls Were Adjusted Lower in October 2020



Meaningful budget shortfalls that are a direct result from lower economic activity due to the COVID-19 pandemic still exist and require attention.

Source: Center on Budget and Policy Priorities, Alicia Munnell, and HilltopSecurities.

Meaningful budget shortfalls that are a direct result from lower economic activity due to the COVID-19 pandemic still exist and require attention. Some state revenue streams have held up better than others, but data from the Urban Institute and Brookings Institution’s Tax Policy Center’s State and Local Finance Initiative shows that, “...the actual revenue losses experienced by the states are deep and widespread, if not universal.”

The Tax Policy Center’s State and Local Finance Initiative analysis shows that overall state revenues fell by a little over 5% (see bar chart on page 8 for a state by state list) when comparing the year over year change in revenues from April to September 2020 to April to September 2019. The Tax Policy Center (TPC) uses this period of

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time in order to account for the fact that many states moved their income tax filing deadlines from April to July in 2020, shifting the receipt of income tax revenues.

What we see in the TPC's data is that 10 states surprisingly experienced a year over year revenue increase, led by New Mexico (12%) and Idaho (10%).

The other 40 states experienced year over year revenue declines. Ten of those states experienced double-digit revenue declines, led by Alaska (-33%) and Hawaii (-20%). There are several high municipal bond issuance states that were in the higher echelon of declines such as: Florida (-18%), Texas (-11%), and New Jersey (-10%). California's revenues declined by almost 6% year over year and it is important to note that California's decline made up almost 20% of the national revenue loss. The loss in Texas was about 12.5% of the national revenue decline.

Please see the Tax Policy Center's [State Tax and Economic Review, 2020 Quarter 2-States Saw Freefall Drop in Revenues in the Second Quarter; Partly Offset in the Third Quarter but Still Depressed from the Pandemic, December 24, 2020](#).

Status of U.S. State Budgets to Begin 2021

This is the time of year where state budget officers review the ongoing results from the previous year's financial plan. Then, sometimes, mid-year adjustments are made. This is also the time of year where many states are devising a spending plan for the next fiscal year. Ten states have already updated new revenue forecasts, which can be viewed individually at the [National Association of State Budget Officers page](#).

We have chosen to review three examples of states budget circumstances (California, New York, and Texas) to illustrate how the current conditions are impacting state government finances.

Example 1: True Fiscal Picture From the California Legislative Analyst's Office

It is important to break down California's complete financial picture. In November 2020, The Wall Street Journal Editorial Board wrote, "[California recently reported that tax revenue for this fiscal year is running \\$9.9 billion \(18.6%\) above projections.](#)" In January 2021, Politico highlighted that, "[California Gov. Gavin Newsom on Friday unveiled a record \\$227 billion January spending plan that marks a dramatic reversal from summer fears that the state would head off a financial cliff.](#)"

It would be unfair to describe the financial results in California as anything but better than expected. This result is also very relative to the expectation, and we believe the California budget circumstances needs to be described more in-depth in order to appreciate the nuance. The takeaway, in short, is that there was a higher level of revenue but that was because of the lower-than-normal forecast and revenues came in better than expected. The California Legislative Analyst's Office acknowledged that revenues came in at a level higher than expected and described the budget situation (in December 2020):

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"The magnitude of this unexpected windfall is that it could produce an unprecedented near-term budget surplus."

The Legislative Analyst's Office was quick to temper expectations for the near-term however. Just after that statement the office warned:

"Looking ahead, however, we also identify the emergence of a new ongoing deficit beginning in the budget year 2021-22. This fiscal gap persists and widens through the remainder of our outlook period (2024-25)."

In other words, while the Legislative Analyst's Office is acknowledging the "windfall," they are not describing it as a situation where they expect an ongoing surplus. An ongoing surplus situation might imply a circumstance where lawmakers would be able to add to spending line-items or even include new commitments. In fact, the Legislative Analyst's Office warns that the structural deficit grows to "around \$17.5 billion by 2024-25, and warrants legislative attention."

Example 2: New York Makes Spending Plan Assumptions

In January 2021, New York Governor Andrew Cuomo unveiled a \$192 billion spending plan for fiscal year 2021-22. The governor projected a \$15 billion budget gap for fiscal year 2021 and 2022. The good news is that this shortfall is much lower than the \$59 billion gap forecast in fall 2020. Work still needs to be made in order to close the spending gap if support from Washington, D.C. does not appear. The recently proposed spending plan is making important assumptions about federal government relief in the form of direct aid and potential changes in tax law. If these do not materialize, the state would have to resort to a combination of expenditure reductions and tax increases to make up the shortfalls. The Fiscal Year 2022 Budget Briefing Book can be viewed [here](#).

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Example 3: Texas Revenue Estimates Only Down 0.4% for 2022-2023

The Texas Comptroller released the Biennial Revenue Estimate on January 11, 2021. The result was only a very small, or 0.4%, decrease in funds that would be available for 2022-23 compared to 2020-21. The state is projecting to have \$112.5 billion in general purpose spending available compared to the \$112.96 billion for the current budget. Comptroller Glenn Hegar warned that Texas lawmakers are still going to be faced with difficult spending choices.

"In any case, the Legislature will again face some difficult choices to balance the budget. While savings from agency spending cuts and federal funding could help erase the projected shortfall for this biennium, a substantial supplemental appropriations bill could increase it, thereby reducing revenue available for the next biennium."

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Update on Next Phase of Relief

President Biden and the U.S. House of Representatives [took steps this week](#) needed in order to pass the President's \$1.9 trillion sixth phase COVID-19 relief measure. The proposal would include \$350 billion of unencumbered and direct aid for state and local governments. This amount would go a long way to address the above budget shortfalls.

Presentations during a House Financial Services Committee hearing on Thursday, Feb. 4 saw officials present testimony asserting that state and local governments need \$100-350 billion to solve for their budget shortfalls, according to a [Bond Buyer article](#).

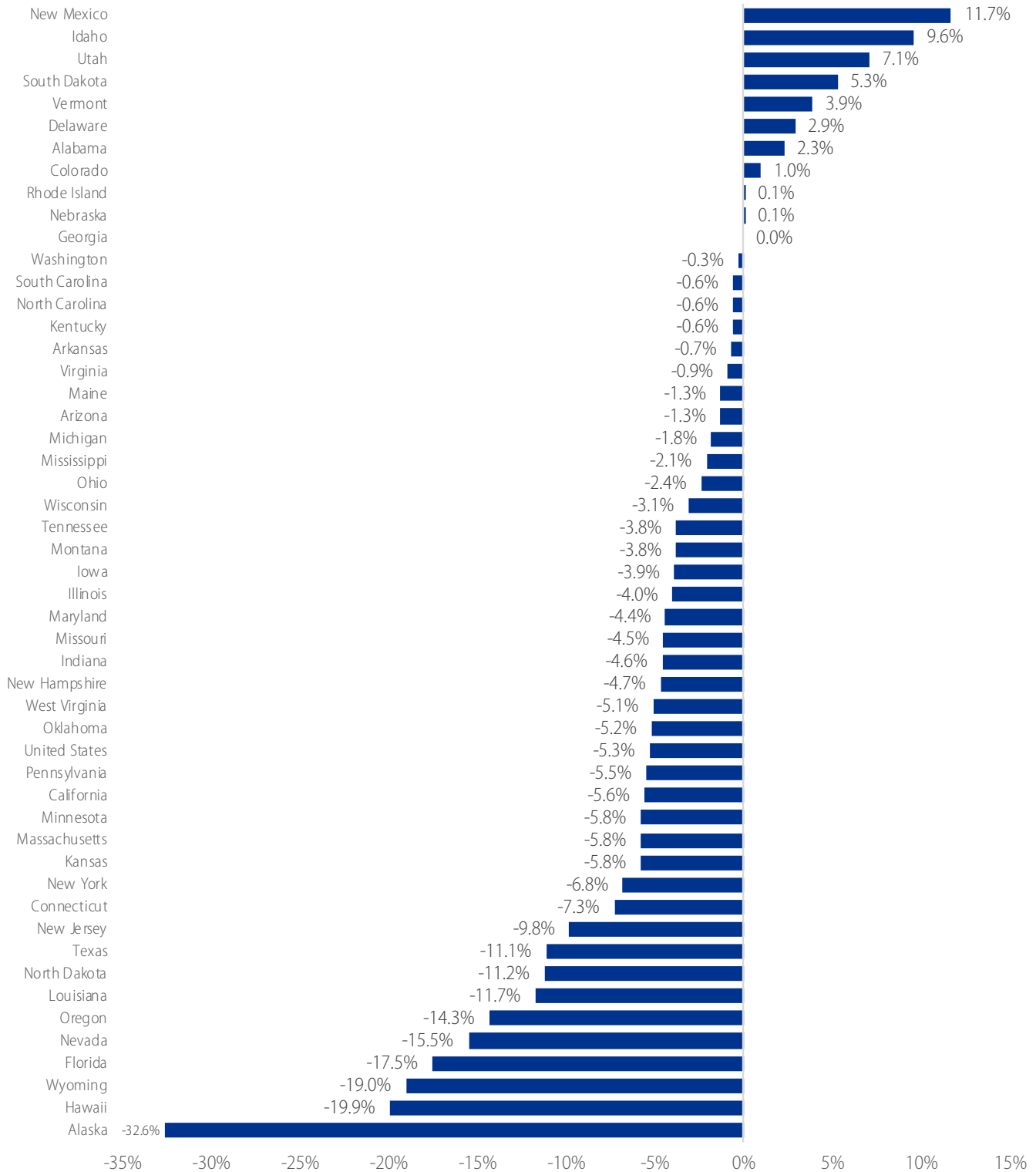
For those looking for a "fair" way to calculate relief for state governments we thought we would mention again the commentary originally published in the Washington Post back in May 2020 by Wharton's Robert Inman and Penn Law: [Opinion: Here's a Fair Approach to Calculating COVID-19 Specific Aid to the States](#). Inman and Skeel present a method that would help state governments with needs related to the unprecedented scope of the COVID-19 worldwide pandemic but not "bail-out past excesses."

View chart on state revenues on the following page.

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State Revenues are Down 5% Nationwide, Range Varies Across the Country

■ YoY % change in state revenues April-September 2020 vs 2019



Source: Urban Institute and Brookings Institution's Tax Policy Center's State and Local Finance Initiative and HilltopSecurities.

Recent HilltopSecurities Municipal Commentary

- [U.S. COVID-19 "Spikes Like We Have Not Yet Seen" Could Be Coming; Sixth Phase Relief Status](#), February 1, 2021
- [Yellen Hearing: Supports Defeat of Pandemic, Loss of Govt. Jobs "Economic Malpractice"](#), January 19, 2021
- [Biden's \\$1.9 Trillion First Stage Rescue Package, What it Could Mean for Municipals](#), January 15, 2021
- [President-elect Biden's First Stage Rescue Package, Prelim Overview](#), January 14, 2021
- [Housing Fundamentals Remain Solid and Our Housing \(HFA\) Sector Outlook Remains "Stable" to Begin 2021](#), January 14, 2021
- [State and Local Government Job Losses in Three of Last Four Months Illustrate Continued Budget Pressures](#), January 11, 2021

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

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