

U.S. Municipal Bond Market

## The Municipal Market in 2022

- The Golden Age of Public Finance will continue into 2022.
- Outsized fiscal policy that was already approved will continue to support public finance and municipal bond market credit quality.
- Federal lawmakers provided a meaningful amount of direct and indirect legislative support for public finance in 2021. We do not expect the same type of assistance in 2022, nor is it needed at this time.
- We also do not expect that the municipal bond friendly elements will be added back into the Build Back Better social spending plan when lawmakers reconsider it this or next year.
- The discovery of the Omicron variant provides yet another test to the resilience of public finance.
- Total municipal issuance in 2021 could come close to our 2021 forecast of \$460 billion. We expect \$495 billion of issuance in 2022.
- We expect public finance upgrades to continue to outpace downgrades in 2022, mostly because of the outsized fiscal policy support offered by the U.S. federal fiscal policy.

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### Positive & Negative Impact from Outsized U.S. Fiscal Policy to Endure in 2022

The impact from the outsized amount of U.S. fiscal policy that has become law since March 2020 will continue to positively support U.S. public finance and the municipal bond market in 2022. The \$7.6 trillion of federal relief already approved by Congress could be joined by another \$1-2 trillion of Build Back Better social spending, making the total amount of fiscal policy closer to \$10 trillion. New federal fiscal policy would not cause us to adjust our 2022 outlook in either direction.

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The vast amount of federal relief significantly contrasts the amount offered up during and in the wake of the Great Recession 10 or so years ago. Therefore, we are not expecting public finance entities to recover as slowly as they did from 2011 to 2015. This time around, public finance entities will have more resources available to them so they can better manage through uncertainties COVID-19 and its variants are likely to offer. The Golden Age of U.S. Public Finance began this year, and we reiterated our Golden Age call in November after the House passed the bipartisan infrastructure bill, which President Biden signed into law.

Readers should keep in mind there are still underlying matters pressuring public finance organizations, and these issues will require ongoing attention and maintenance. The state and local government labor market, like the U.S., has its challenges. State and local government employment began to make a comeback in the spring and summer of 2021 but began to dip, and state and local government jobs have fallen in August, September, and October. Retirements may be mounting, and this could be challenging for public finance leaders to overcome in 2022.

## Outsized U.S. Fiscal Policy from 2020 and 2021 Will Continue to Support Municipal Credit in 2022

Phase	Became Law (Status)	Legislation	Details	Amount (billions)
Phase 1	March 6, 2020	Coronavirus Preparedness and Response Supplemental Appropriations Act	Research and development, health-care services and supplies	\$8.30
Phase 2	March 18, 2020	Families First Coronavirus Response Act	Testing funds, paid leave, food stamp funding	192.00
Phase 3	March 27, 2020	Coronavirus Aid, Relief, and Economic Security (CARES) Act	Expanded unemployment, PPP, Fed Reserve & industry loans, payroll tax credits, created MLF, other	2,700.00
Phase (3.5 or) 4	April 24, 2020	Paycheck Protection Program and Healthcare Enhancement Act	Expanded PPP, hospital & testing funding	733.00
Phase 5	Dec. 27, 2020	The \$1.4 trillion Consolidated Appropriations Act, 2021 was a federal govt. funding measure & included \$910 billion of COVID-19 relief provisions	Unemployed. relief, PPP, funds for education, transportation, health care, vaccine distribution, etc., but no direct unencumbered state and local govt. relief	910.00
Phase 6	March 11, 2021	American Rescue Plan Act of 2021	\$1,400 payments, \$350B state & local govt. aid, expanded unemployed relief	1,900.00
Infrastructure & Jobs	Nov. 15, 2021	Infrastructure Investment & Jobs Act of 2021 (bi-partisan)	Funding for roads, bridges, rail, mass transit, ports, airports, water, broadband, and more	1,200.00
Social Spending	Passed House, has not passed Senate	Build Back Better	Clean energy, climate invest, child care, pre-school, home care, housing, SALT cap repeal	1,950.00
<b>Total Passed into Law</b>				<b>\$7,643.30</b>
<b>Total</b>				<b>\$9,593.30</b>

Source: HilltopSecurities.

Problems with public pensions have not been making headlines. The issue is on the back burner for now, but the problem is still very real for some in public finance. The lack of funding for public pensions continues to be exacerbated by the underestimating of the actual costs of public pensions. State and local governments will still need to come up with revenues to pay for increasingly expensive pension payments. This remains an outstanding challenge for public managers, and it will resurface as a key issue.

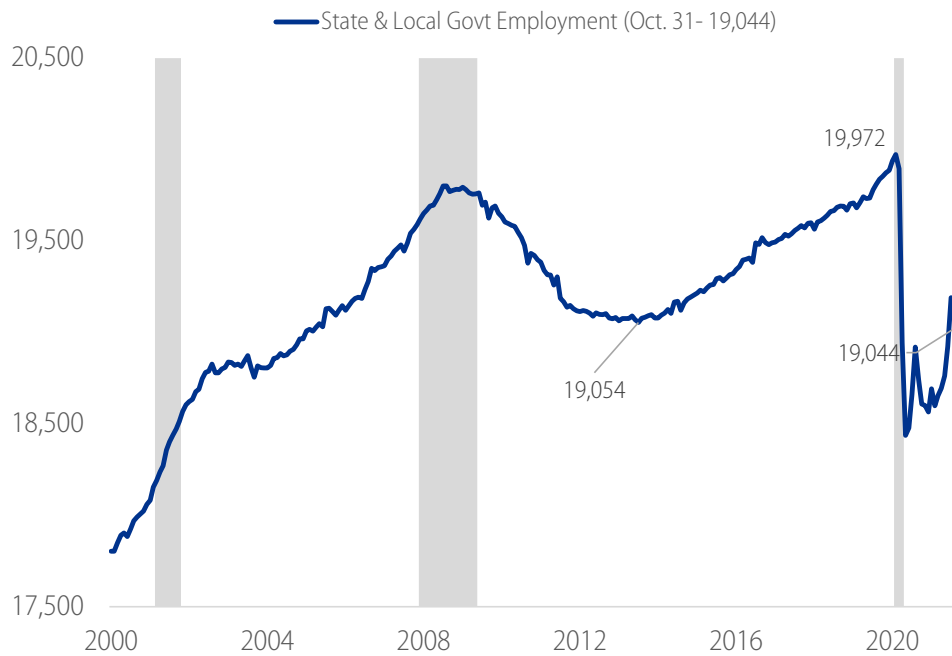
The bipartisan infrastructure package, or the \$1+ trillion Infrastructure and Jobs Act (IIJA) of 2021, was signed into law in November, but it did not come close to narrowing the U.S. infrastructure gap. About a half a trillion of the \$1+ trillion simply extended existing federal funding and programs and another half a trillion went to fund roads, bridges, rail, transit, etc. However, the IIJA is not likely to increase infrastructure spending by more than \$100 billion per year over the next decade. Infrastructure, generally, and the needed upgrades for public finance entities nationwide remain problems without meaningful answers or proper funding.

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## State and Local Governments Jobs Still 928k Below Pre-COVID Level (thousands)



Source: Bureau of Labor Statistics and HilltopSecurities.

Other topics like the rise of cybercrime and the impact from the increasing pace of technological change, issues related to changing weather patterns and climate change, and the economic fallout from remote work trends are all challenges that will need to be addressed in 2022 (and beyond). The trouble is that many state and local governments are not equipped to handle multi-year planning on the scale that is required to manage complicated forward-type issues like these. Federal funds will help in the near-term, but the staffing issues we are seeing could further complicate an already difficult management landscape.

## Federal Legislative Outlook, Future of Build Back Better

The municipal market watched closely how events in Washington unfolded in 2021. Victories by the Democrats in the Georgia Senate runoff elections set the table for the \$1.9 trillion Rescue Plan Act to pass in March. This provided a substantial boost to public finance credit that will be realized in 2022 and over time. At least \$650 billion of the \$1.9 trillion will directly or indirectly flow to public finance specific sectors, according to our analysis.

Another issue municipal market observers followed closely in 2021 was whether municipal bond friendly elements would appear in either the bipartisan infrastructure or Build Back Better (BBB) legislation. These elements were dropped in November as lawmakers considered different iterations of the BBB social spending package. It is not likely they are going to be re-included. They were never identified as being key to the progressive Democrats' agenda, therefore it was easy for them to be abandoned. If they realistically were going to have a chance to become reality, they would have been included in the bipartisan infrastructure package that already became law. It was unlikely that elements so expensive were going to be included in

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### \$650 Billion for Public Finance from the American Rescue Act of 2021

Provision	Amount (billions)	Sector(s) to Benefit Most
State and Local Govt. Aid	\$350.00	U.S. state, local, and tribal governments
K-12 School Aid	129.00	U.S. state and local govts.
Affordable Care Act (ACA) Tax Credits & COBRA Coverage	63.00	Healthcare
Higher Education Relief Fund	39.60	Higher Education
Additional Aid to Mass Transit Operators	30.50	Mass Transit
Incentives for non-expansion states under ACA to expand Medicaid	16.40	State govt., Healthcare
Coronavirus Capital Projects Fund	10.00	U.S. state, local, and tribal governments
Homeowner Assistance Fund	10.00	Housing
Emergency housing vouchers	5.00	Housing
<b>\$653.50</b>		

Source: Moody's Investors Service, House Oversight Committee, Joint Committee on Taxation, Committee for a Responsible Federal Budget, and HilltopSecurities.

Now, lawmakers have several items to address in December and thereafter. This list includes, but is not limited to, the need for a continuing resolution to fund the government, movement on the debt ceiling, and attention to the Build Back Better legislation. We are not expecting a fight over the first two items. The debt ceiling needs to be addressed, most likely by the end of the month, according to the CBO. Build Back Better passed the House before Thanksgiving, but the Senate is unlikely to approve in the same form. So, this could be punted to January.

Overall, we are not expecting that 2022 will be as meaningful on the legislative front, even if Build Back Better passes. Those municipal friendly elements are not likely to be included. If anything, we are expecting federal policy to be a headwind for public finance if deficit reduction measures become popular. We have already indicated that while there is not a specific identifiable threat to the municipal bond tax-exemption, a threat could grow in strength in the coming years.

### Omicron Uncertainty

Uncertainty is the new certainty. The overall economic revival took a hit over the summer as recovery efforts were dampened by the rise of the Delta variant of the coronavirus. Now as we begin December 2021, there could be a new wave of infections which could be heightened by the recently discovered Omicron variant. Questions exist about the effectiveness of current vaccines against Omicron. It is possible that travel restrictions could be heightened or reinstated. The medical community may advise us that variant vaccines booster shots may be needed. Science proved to be a saving grace when vaccines were quickly rolled out at the

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beginning of 2021. Time will tell how Omicron impacts the landscape.

## Expect a Record \$495 billion of Municipal Issuance in 2022

We have been communicating that if issuance comes in at an average pace in November and December of 2021 that annual issuance for this year would be very close to the \$460 billion we forecast. November issuance was just over the nine-year average at almost \$39 billion and December issuance could be close. It is possible that uncertainty from Omicron causes a delay in issuance plans to end 2021. We expect those transactions would most likely be pushed to the beginning of 2022. Remember, our 2022 issuance forecast was \$495 billion. Supply chain (imbalance) and employment (labor force participation) concerns are the key risks to our 2022 issuance forecast. Financial resources are plentiful going into 2022, while materials and specialized workers are not. We are also assuming COVID-19 becomes less and less of an issue going forward. Omicron provides a test to this assumption.

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### Monthly Glance at Municipal Issuance

Month	Municipal Issuance 2020	Municipal Issuance 2021	9-Year Average
Jan	\$32.793	\$28.260	26.062
Feb	42.229	36.604	26.997
March	20.262	47.642	32.375
April	31.650	36.892	33.145
May	30.994	34.989	34.357
June	52.390	50.013	39.487
July	47.782	37.320	31.276
Aug	43.408	42.432	34.956
Sept	53.513	44.414	31.348
Oct	73.448	39.284	43.854
Nov	21.359	33.818	31.763
Dec	34.822	<b>30.000</b>	33.690
	\$484.650	\$431.667	Sum through Nov.
		<b>\$461.667</b>	Potential 2021 total

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Source: Refinitiv, The Bond Buyer, and HilltopSecurities.

### Our Credit Related Outlook for 2022, Upgrades to Outpace Downgrades

Although the discovery of the Omicron variant has created a heightened amount of uncertainty as we end 2021 and move into 2022, we are not expecting that we will need to change or update our municipal sector outlooks. We published a similar message back in August with the rise of the Delta variant in our commentary, [Virus Strikes Back: Our Municipal Credit Outlook in the Face of COVID-19's Fourth Wave](#). Again, we are not expecting the outlook changes will be needed this time around.

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## Still No Changes to HilltopSecurities' Municipal Sector Credit Outlooks

Sector	Hilltop Credit Outlook	Recent Action (March 2021)	Key Sector Trends (Updated to Reflect pre-Omicron Variant Themes)
State Government	Stable	Raised two notches	We do not see evident cracks in state credit at this time.
Local Government	Stable	Raised two notches	We do not see evident cracks in local govt credit at this time.
School Districts	Stable	Raised two notches	AV growth has been surprisingly strong through COVID, \$129 billion plus will flow directly to schools per the Rescue Plan Act.
Airports	Stable	Raised two notches	It will take years for enplanements to ramp up to pre-COVID levels.
Health Care	Negative	None	Health care could be the sector most negatively impacted by the a Omicron-wave.
Higher Education	Private: Negative Public: Cautious	Raised Pub Sect Outlook	College campuses are not as safe as we expected from virus spread, the sector will continue to be pressured in the near to medium term.
Housing	Positive	Raised	Strong relative value in this sector. State Housing Finance Agencies (HFA) were less impacted than other sectors.
Public Power (Elec.)	Stable	None	Recovery to 2019 usage ongoing but federal support has provided a base.
Tobacco	Negative	None	MSA numbers were slightly higher in 2020 YOY, we continue to expect more downside risk in this sector going forward.
Toll Facilities	Stable	Raised two notches	Vehicle miles traveled fell to 2004 levels, full recovery will take years.
Water and Sewer	Stable	None	Essentiality remains important driver, one of the approved uses of the Rescue Act funds is for water and sewer infrastructure. More funds approved in IJA too.

Source: HilltopSecurities.

In fact, the outsized amount of federal aid we saw in 2020 and 2021 boosted credit quality overall. We expect that rating upgrades will outpace downgrades in 2022. It will take some time for the rating agencies to update their analysis. As they do, we believe the positives from the federal aid will outweigh the challenges in the near-term, and financial profiles will appear stronger, not weaker.

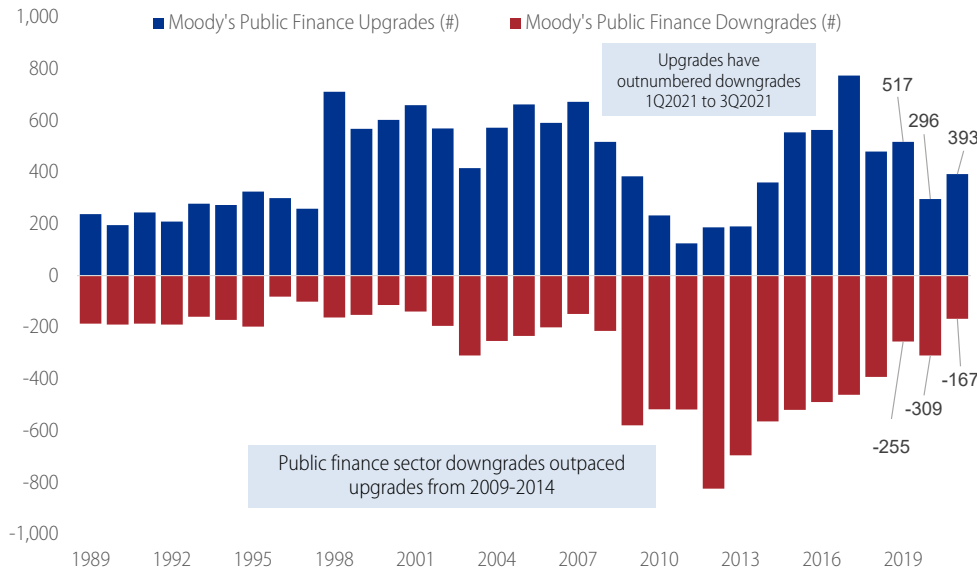
This relationship is an important driving factor and contrasts significantly with state and local governments' positions in the wake of the Great Recession and especially from 2011 to 2014. State and local governments were struggling to repair their balances sheets for years after the Great Recession. You can see on the following page that overall municipal credit quality fell significantly in the years after the 2008 Financial Crisis. Public finance downgrades outpaced upgrades from 2009 to 2014. This dynamic is very different this time around. In 2020, downgrades briefly outpaced upgrades but the pendulum quickly swung in the favor of municipal entities mostly as a result of federal aid. Upgrades have outnumbered downgrades over the first three quarters of 2021, and we expect this trend to continue in 2022 by a healthy margin.

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## Moody's Public Finance Upgrades and Downgrades



Source: Moody's and HilltopSecurities.

## Conclusion

If anything has been reinforced to us in how COVID-19 has impacted public finance, it is that state and local governments and other public finance entities are resilient. We saw this resilience play out for years after the Great Recession, and we will likely see it play out in an even more encouraging manner as public finance manages through COVID-19 and the variants. This resilience was enhanced over the last two years with \$7.6 trillion of federal government fiscal policy. In many cases, the combination of the resilience and the federal aid are key reasons we still expect the Golden Age of U.S. Public Finance to continue in 2022.

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## Recent HilltopSecurities Municipal Commentary

- [Our 2022 Municipal Bond Issuance Forecast](#), Nov. 22, 2021
- [Employee Retirement – An Unexpected But Very Real Obstacle for State & Local Governments](#), Nov. 18, 2021
- [House Passed \\$1.2 Trillion Infrastructure Plan on Friday, Boosting What We Deemed \(in March\) as the Golden Age of Public Finance](#), Nov. 8, 2021

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

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