

U.S. Municipal Bond Market

School District Credit Quality is Strong, Former Mayor Bloomberg is Overreaching

- Former mayor of New York City Michael Bloomberg’s analysis suffers from selection bias, and his conclusion that classrooms will be “half-empty” is an overreach.
- We still have a “Positive” outlook on the school district sector. We continue to expect public finance, and school district rating upgrades will outpace downgrades in 2022.
- The substantial amount of federal aid to public finance entities, including schools, will allow a softer landing during this and near-term budget planning. However, we are on the look-out to make sure that individual entities do not lose structural balance.

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The Former Mayor of New York’s Conclusion is Too Narrow

The founder of Bloomberg LLP and former mayor (2002-2013) of New York City Michael R. Bloomberg today published an opinion piece titled [A Wake-up Call for Public Education](#)- Falling enrollment in America’s schools is a sign of a system in crisis. His numbers are somewhat correct, in some places enrollment is dropping. But, he misses the fact that other locations are also gaining enrollment. It is important to note that this exchange was happening in many places even before the COVID-19 pandemic. The pace of this exchange was accelerated, along with other trends as many of us have observed since 2020.

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The former mayor’s analysis suffers from selection bias. His over-arching conclusion that, “the public will soon be paying teachers to lead half-empty classrooms is an overreach to say the least. In fact, we believe school district credit quality overall is currently quite strong. We continue to expect public finance and school district upgrades to outpace downgrades in 2022.

Golden Age of Public Finance is Not Over

We first indicated that we expected a “Golden Age of Public Finance” back in March 2021 just after the \$1.9 trillion American Rescue Plan Act of 2021 was signed into law in [American Rescue Plan Provides Massive Economic Boost, U.S. Public Finance Could Be on Brink of a Golden Age, Especially if Infrastructure Stimulus Follows](#). This Golden Age was further strengthened (somewhat so) when the [\\$1+ trillion bipartisan Infrastructure Investment and Jobs Act \(IIJA\)](#) was passed into law in the beginning of November 2021.

\$650 billion was set to flow directly to public finance entities as a result of the March 2021 Rescue Plan Act. This was an important development that boosted public finance credit quality. For much of 2020 there was a political barrier to aid for state and local governments but the surprise victories in the Georgia run-offs allowed the Democrats to approve the Rescue Plan Act legislation using budget reconciliation. \$350 billion was (is being) sent to state and local governments and about \$130 billion was earmarked for school districts ([see page 5 for a summary](#)). This is on top of what was already shared with schools in prior COVID related legislation.

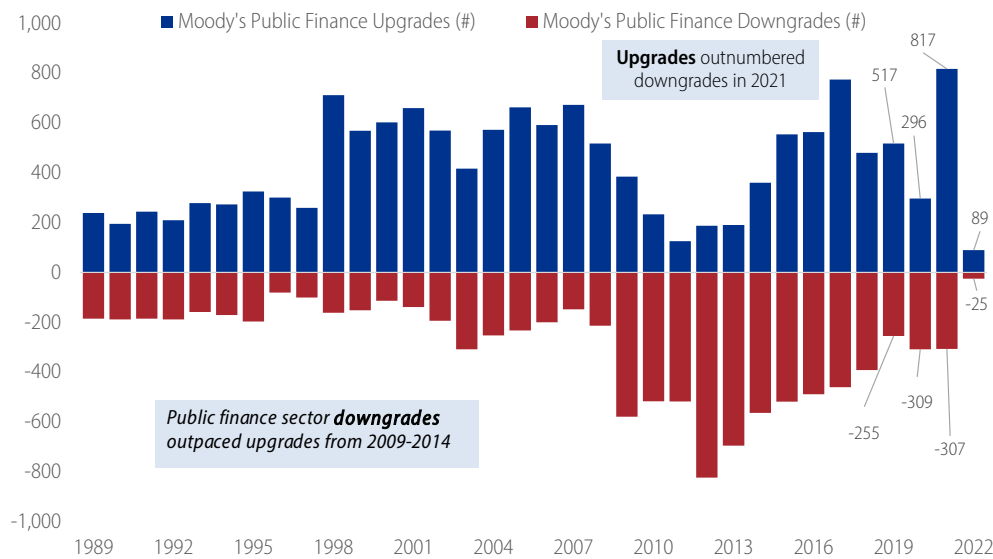
HilltopSecurities has a “Positive” Outlook on the School District Sector

We raised our sector credit outlook for school districts to “Positive” from “Stable” in Feb. 2022, citing the positive growth in assessed valuations and the noted federal relief as key reasons. Our “Positive” sector outlook means we expect upgrades to outpace downgrades in the sector. We also continue to expect that public finance upgrades will outpace downgrades in all of 2022.

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In 2021 Moody’s Public Finance sector upgrades significantly outpaced downgrades 817 to 307. The majority of these upgrades were for tax-backed secured issues, which makes sense because of the substantial amount of aid that flowed through to those types of public finance entities. Upgrades also outnumbered downgrades in the first quarter of 2022. More specifically, at the beginning of this year there were 22 school district rating actions in 1Q22, and 18 of them were upgrades.

Public Finance Upgrades Outpaced Downgrades Recently



Source: Moody's (2022 is through 1Q22, other totals are annual) and HilltopSecurities.

Federal Aid Will Provide a Bridge for Schools to the New Post-COVID Fiscal Reality

We suspect school budgets are being adjusted to the new post- COVID-19 reality as we write this and the process will evolve in coming budget cycles. Enrollment is down in some places. But enrollment is also up in other places. There is potential fiscal stress for some schools on the horizon to be sure. This is most likely going to be from pension funding requirements, migration and demographic changes, the potential for lower state aid when federal relief is exhausted, the new normal as it relates to impact from work-from-home, and other, perhaps, structural issues.

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Many of these real and or potential stresses existed even before COVID-19. After the 2008 Financial Crisis there was a string of years when public finance downgrades outpaced upgrades and schools were often a leading sector where we saw downgrades. This will not be the case in 2022 as we wrote above. The former Mayor

can try to make the argument that the system is in crisis. But, I just don't see it from a credit quality perspective.

There could also be an opportunity in some individual situations. At the same time that enrollments are dropping, teachers are also leaving. Therefore, this could be a good chance for schools to right-size the number of teachers they employ along with their enrollments. This dynamic could help some schools achieve a structurally balanced budget.

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In May of 2021 [Treasury Secretary Janet Yellen wrote](#) positively about the Rescue Plan Act funds:

“Today is a milestone in our country’s recovery from the pandemic and its adjacent economic crisis. With this funding, communities hit hard by COVID-19 will be able to return to a semblance of normalcy; they’ll be able to rehire teachers, firefighters and other essential workers – and to help small businesses reopen safely,”

We still believe this federal aid will provide a bridge to state and local governments and school districts by providing a softer landing than they experienced coming out of the 2008 Financial Crisis and Great Recession. After the 2008 crisis, governments were forced to make draconian cuts to public budgets and they had no time to plan. This time is different. They have time and resources to strategize. However, we are on the look-out to make sure that multi-year spending is sensible and that budgets are in fact structurally balanced. This is an equilibrium that can weigh to the negative quickly without steadfast management.

Definitions of HilltopSecurities Municipal Sector Credit Outlooks

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

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

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

Negative: HilltopSecurities Municipal Research believes there are factors which point towards weakening issuer or credit quality that will likely result in a higher number of credit ratings downgrades versus upgrades.

We still believe this federal aid will provide a bridge to state and local governments and school districts by providing a softer landing than they experienced coming out of the 2008 Financial Crisis and Great Recession.

Recent HilltopSecurities Municipal Commentary

- [Voters Want Normalcy – This is Not It – More Political Change is Likely](#), May 31, 2022
- [Municipal Bonds are an Exceedingly Appealing Fixed Income Opportunity Right Now](#), May 11, 2022
- [FAQ: The Impact of ESG Disclosure on the U.S. Municipal Market](#), May 9, 2022
- [2022 Municipal Bond Analyst Survey](#), April 11, 2022
- [Will War in Eastern Europe Lead to Cyber-Attacks on U.S. Public Finance & Infrastructure](#), Feb. 24, 2022
- [REVISED: The Municipal Market in 2022, Due to the COVID-19 Paradigm Shift](#), Feb. 7, 2022

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

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