Q4 2018 Credit Commentary and a Look Ahead to 2019

Has The Municipal Credit Cycle Plateaued?

Many positive indicators suggest that the municipal credit cycle has yet to plateau. Upgrades continue to outpace downgrades; the US economy is still growing; federal tax reform boosted revenues in fiscal 2018; and rainy day funds or reserve levels in many localities are strong. However, pressures continue to confront municipalities. Pension burdens and retiree healthcare costs continue to rise, while infrastructure underinvestment and affordability of living in cities, along with rapidly changing technology, are among the other challenges. These and other factors are discussed in our Nov. 19th commentary, "Is the Municipal Market Sleepy?! Pension Doomsday?" (see http://www.cumber.com/is-the-municipal-bond-market-sleepy-pension-doomsday/). More recently, the limit on deductibility of state and local taxes, along with higher mortgage rates, seems to have driven down or slowed home price appreciation in some areas, and that trend could reduce property tax growth in the future. John Mousseau mentions this in his recent commentary http://www.cumber.com/4q2018-review-munis-turn-it-

around/.*Stable* may be the catchword for municipal credit over the near- to mid-term, which could indicate a plateau.

Moody's recently released outlooks for state (Dec. 5) and local government credit (Dec. 6) over the next 12–18 months and considers them stable. Moody's projects that states will see tax revenue increases of 3.5% to 4.5% in 2019, reflecting continued but slowing growth. Moody's notes that this projection, if realized, would represent the tenth consecutive annual tax revenue increase. The outlook factors in continued spending pressure to fund pensions and retiree healthcare costs as well as anticipated pressure to increase education and Medicaid spending. The outlook anticipates, as a result of improved investment returns, a reduction in increases in the funded status of pension plans, a projection that may not materialize unless the market recovers. (See David Kotok's "Stock Market and Tariff Truce," http://www.cumber.com/cumberland-advisors-stock-market-and-tariff-truce/.)

With regard to federal funding, Moody's outlook does not foresee large changes in spending for education and Medicaid. However, Medicaid, at 29.7% of state spending according to the National Association of State Budget Officers' 2018 *State Expenditure Report*, is the largest and fastest-growing segment of state spending, at 7.3%. The stable outlook takes into consideration the buildup of adequate reserves by most states, which could provide a cushion and flexibility to manage through an economic downturn or changes in federal spending.

The December 14th ruling by the US District Court in Fort Worth, Texas, held that the Affordable Care Act (ACA) is unconstitutional because of the individual mandate. However, the decision is expected to be appealed, and the case is ultimately expected to head to the US Supreme Court, while the law would remain in effect during the process. Thus, Moody's anticipates that the decision will not have immediate credit implications for states, hospitals, or health insurers. Full

repeal of the ACA would mean reduced federal spending on Medicaid and subsidies to individuals. Those states that expanded Medicaid would be most affected. Alternatively, there could be a partial repeal of the ACA or no repeal at all.

Moody's stable outlook for local governments projects modest growth of 2–3% in property tax revenue and a 3% increase in total revenue, including sales and use taxes and state funding in 2019. Property tax revenues grew 3.7% in 2017 because many people paid their 2018 taxes early. Spending pressure is expected, mostly from increases in the personnel costs necessary for the management of pension and healthcare issues, as well as a need to have competitive salaries and benefits. Moody's notes that most cities, counties, and school districts hold healthy reserves to manage through a downturn.

Of course, there are some states, such as Illinois, New Jersey, and Connecticut, and some cities that have outsized burdens and management and budgeting issues. Their lower ratings reflect those challenges.

State Ratings

Following two quarters of high activity (see our Q3 commentary: http://www.cumber.com/q3-2018-municipal-credit-commentary/), the only state rating actions this quarter were the downgrade of the State of Vermont by Moody's from Aaa to Aa1 and the revision of two state outlooks by Moody's. The State of Vermont's downgrade reflects low growth prospects from an aging population, coupled with relatively high debt as compared with GDP and with shortfalls in funding for post-employment benefits. However, the still-high rating reflects a solid financial position and strong management. S&P has rated Vermont AA+ since 2000. Moody's revised the State of North Dakota's outlook to stable from negative as a result of progress towards structural balance coupled with rapid restoration of reserves as the economy and revenues continue

to recover from the 2016 energy recession. Recent declines in oil prices will likely result in some economic and revenue volatility; however, the state's energy economy and financial reserves are well-positioned to weather some short-term disruptions at this time. Also, Moody's revised the outlook for Mississippi to stable from negative to reflect stabilization of revenue and economic trends and a resumption of deposits to the rainy day fund. The outlook also incorporates the expected continuance of conservative fiscal management, which will help manage elevated debt levels and potential future revenue weakness.

Midterm Elections Included Numerous Ballot Initiatives

In "Midterm Elections: The Quick Muni Note" (Nov. 7th – see http://www.cumber.com/midterm-elections-the-quick-muni-note/),John Mousseau discusses the bond-related advantages of a divided Congress. Here we recap ballot initiatives.

Medicaid expansion: Three states – Idaho, Nebraska, and Utah – voted to expand Medicaid, while Montana voters, by not approving a rise in tobacco taxes, struck down a measure to continue funding Medicaid expansion beyond the June 30th sunset date. Depending on the legislature's actions, Montana could be the first state to end Medicaid expansion after having accepted it. Moody's notes that 36 states, encompassing two-thirds of the US population, have approved Medicaid expansion. This broad implementation may make it more difficult to repeal or make changes to the ACA.

Infrastructure spending: Many state and local bond measures were passed, supporting housing, hospitals, education, transportation, and other infrastructure. In California numerous proposals for statewide bond issues funding housing and children's hospitals were approved, including a vote not to repeal an increase in fuel taxes that was due to expire and helps fund transportation spending. However voters in the

Golden State turned down a $9 billion water infrastructure initiative. Further detracting from the spending trend, voters in Colorado, Missouri, and Utah voted down increases in taxes for roads and schools.

Restrictions in state flexibility: Six of ten ballot initiatives were passed that reduce legislative or executive flexibility to raise or manage revenue, an outcome that is generally credit-negative. For example, a two-thirds majority in the Florida Legislature will now be required to raise statewide taxes and fees, while Arizona now prohibits taxes on services, and North Carolina has voted to place limits on state income taxes.

There were numerous local bond and fee initiatives that passed as well. The results of the initiative process can affect credit quality and issuer flexibility, so it is important to watch how implementation evolves.

Trend to Fewer Ratings

The number of issuers seeking multiple ratings has declined since the financial crisis. Until the crisis, issuers often had debt ratings from two or more rating agencies. According to data collected by Municipal Market Advisors (MMA), issuers that were triple-rated (by Moody's, S&P and Fitch – data on Kroll is not able to be queried yet) declined steadily from 55% in 2007 to 34% through 2017. Viewed another way, by the end of Q3 2018 there were 1.91 ratings assigned per dollar par issued, down from 2.29 ratings assigned per dollar par issued in 2007. The par value of bonds that are rated by just one rating agency has grown to 25% from 21% in 2007. The trend is likely a function of municipalities' looking to reduce costs. Additionally, in the recent low-interest-rate environment with narrow credit spreads, fewer ratings on bonds have been sufficient to gain market acceptance, especially as investors chase yield. If credit spreads were to widen, a differentiation in yield might become visible among bonds with

just one rating compared to those with two or more ratings, and this development could reverse the trend.

The trend to fewer ratings is a negative for investors. There could be “rating shopping” going on. The criteria, or areas of emphasis, applied by the rating agencies are different, and an issuer can choose the rating agency that it thinks will give its debt a higher rating. Having only one rating means there are fewer “eyes on” the credit and less frequent reviews. A bond with one rating is also subject to changes in the rating agency’s criteria, which could cause an abrupt change in the rating, up or down. With two or more ratings, there is more stability. This falloff in the number of ratings makes the case for active bond management and investment in higher-quality bonds, which is the strategy that Cumberland Advisors employs.

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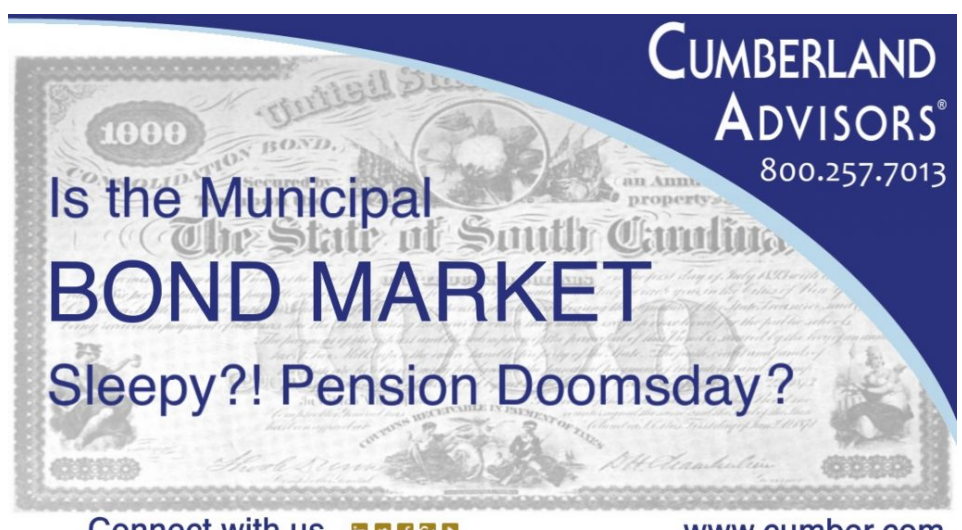
Is the Municipal Bond Market Sleepy?! Pension Doomsday?

Today’s municipal bond market is anything but “sleepy,” as Spencer Jakab characterized it in his *Wall Street Journal* article “Prophet of Muni Market Doom Wasn’t Wrong, Just Early” (10/26/2018). The Prophet of Doom he referred to was Meredith Whitney, who shortly before the financial crisis successfully predicted the damage to Citibank by bad mortgages. In 2010, on *60 Minutes,* she contended that municipal market participants were not addressing or recognizing pension risk that would contribute to “50 to 100 sizable defaults” on municipal bonds over the next year. This comment caused a rout in the municipal bond market, but we now know that a large number of defaults did not materialize.



The market is heterogeneous. There are over 80,000 municipalities in the United States, and each of those entities can issue various types of debt, from general-obligation bonds backed by the taxing power of the municipality to revenue bonds that are secured by user fees such as water and sewer rates. Municipal bonds fund everything from fire trucks to schools to major road projects. Bond maturities can exceed 30 years. Thus, there are many investments to choose from. Municipal bonds offer tax-exempt income and can be used for impact investing, because municipal bonds finance projects that have environmental, social, and governance (ESG) implications.

Many participants in the marketplace are aware of pension-funding shortfalls as well as the growing burden of providing healthcare to retirees and paying for long-term debt. They understand that if the problems aren't dealt with, the financial implications down the road could be severe. Jakab's article does not mention the states and municipalities that are taking action to improve pension funding status and what those actions are. That perspective could have helped WSJ readers and others, whether they are taxpayers, pensioners, or bond investors, to understand their towns and states better and take some action instead of being afraid.

Pension obligations are long-term and large. Just as an ocean liner takes a long time to turn, so, too, municipalities must

anticipate in advance how to proceed. The pension issue does need to be addressed; however, it may not be an immediate threat in many jurisdictions. Actions that can improve pension funding include lowering the assumed rate of return on investments and fully funding or overfunding the actuarially required annual contribution (ARC) to the pension, (funding at this level keeps the funded level growing to meet future obligations). The municipality can alter certain pension benefits, for example by reducing cost-of-living adjustments or changing the level of benefits for future employees – all difficult decisions. Because liabilities can mushroom, it is important for municipalities with underfunded plans to make changes sooner rather than later. An increasing pension burden, just like your personal credit card debt, can balloon if you do not make more than the minimum monthly payment. These payments can compete for spending on other items.

States that have been able to implement pension reforms include Ohio, Colorado, Minnesota, and Kentucky. Although the Kentucky changes are being challenged, there is now more recognition in the state that something needs to be done.

Many observers look at the unfunded status of a plan. For example, Pew Charitable Trust annually calculates those figures. The average funded level of a state pension fund based on 2016 data is 66% with the lowest funded at 31% for New Jersey and Connecticut and the highest funded plan was Wisconsin at 99% funded. Moody's calculates an Adjusted Net Pension Liability (ANPL) by making changes in assumed rates of return, among other variables, to all state pension funds. This makes state funded levels more comparable and realistic. Moody's uses discount rates between at 3.0%–4.0% while most pensions still assume 6.5% to 7.5%. A lower discount rate increases the unfunded status of a plan so is more conservative. Moody's compares the ANPL with state revenue to rank the states based on the metric. The highest ratios are for Illinois (600%), Connecticut, Kentucky and New Jersey

(290%) while North Carolina, North Dakota, Wyoming and Utah have ANPL well lower as a percent of revenue at 45% or under.

Other post-employment benefits (OPEB), mostly healthcare, were historically funded on a pay-as-you-go basis. OPEB liabilities are now required to be recognized in accordance with accounting standards recently implemented for periods beginning after June or December of 2017, specifically Governmental Accounting Standards Board (GASB) Statements 74 and 75. This is a positive development, allowing a municipality and its citizens a more transparent view of fiscal health. It is even more important as retirees live longer and the cost of healthcare rises. Many healthcare benefits are not contractually fixed, as pension benefits are; however, reducing benefits may be politically unpopular, in effect making healthcare benefits almost as difficult to change as pensions are.

Technological improvements have helped improve efficiency at municipalities, but the improvements have also led to there being fewer current employees to support a growing retiree population, which further exacerbates the pension issue. Further developments in technology may give municipal managers pause as they determine which direction to invest in for the future.

There are other risks to the long-term economic viability of municipalities – exploding pensions are just one of them. There is the widely publicized issue of deferred infrastructure spending, which reduces livability and could be a negative for economic development and a safety risk to a community. Deferred spending also makes projects more expensive. In addition, there is the prospect of having to prepare for sea level rise, coastal erosion, and more extreme weather and fire events.

The increasing wealth gap and affordability issues affect social service spending and tax-rate and service-fee-rate

increase management. Municipalities have many competing spending needs.

I'm not trying to paint a dire picture, but I am trying to impress upon readers and casual observers of the municipal market that market participants are in fact aware of long-term challenges. Ratings and credit analysis are based on many factors, including the strength of the service area economy, financial operations, long-term plans, and management performance. Ratings are not based on one item unless that one factor is overwhelming.

The fear of widespread municipal defaults in 2010 and the ensuing rout in municipal bond prices created a buying opportunity for investors that knew the market. For many investors, the timing of when to exit a bond is the issue. Do investors exit as soon as they see the light of the pension crisis train barreling down the track, or just before the train wreck? Conservative investors generally do not invest in the state obligations of Illinois, New Jersey, or Connecticut because of those states' burgeoning pension and OPEB obligations (additionally these states suffer from slow or negative growth in population and dysfunctional governance). Cumberland, as a conservative investor, has avoided the bonds that would have suffered from the multiple downgrades of those states.

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