Q4 2018 Credit Commentary and a Look Ahead to 2019

Has The Municipal Credit Cycle Plateaued?

Quarterly Review

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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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