PERSPECTIVES

2019 MUNICIPAL BOND CREDIT OUTLOOK

Despite Overall-Stable Fundamentals, Some Challenges Loom That Necessitate Careful Credit Selection

KEY TAKEAWAYS

- Municipal credit quality remains stable, benefiting from the low unemployment rate and the recent strength in tax revenues.
- The municipal default rate in 2018 was the lowest since the Great Recession.
- However, we continue to closely monitor trends that could challenge municipal markets, such as volatile equity prices or a lack of rehiring by some issuers.

Entering 2019, Breckinridge maintains an up-in-quality credit bias. Municipal credit fundamentals are broadly stable across sectors, and issuers are as liquid and under-leveraged as they have been at any time since the financial crisis.[1] However, modest growth is likely to characterize the next 12-24 months, and the asset-price inflation that has buoyed the U.S. real estate and stock markets for several years shows signs of reversing. The municipal market's structural hurdles, which we highlighted in our 2018 *outlook*, remain entrenched. Given these headwinds, tight credit spreads offer limited value in the current environment. We anticipate more volatility in 2019 and favor periodic credit picking in a market likely to exhibit continued volatility.

MARKET STRENGTHS

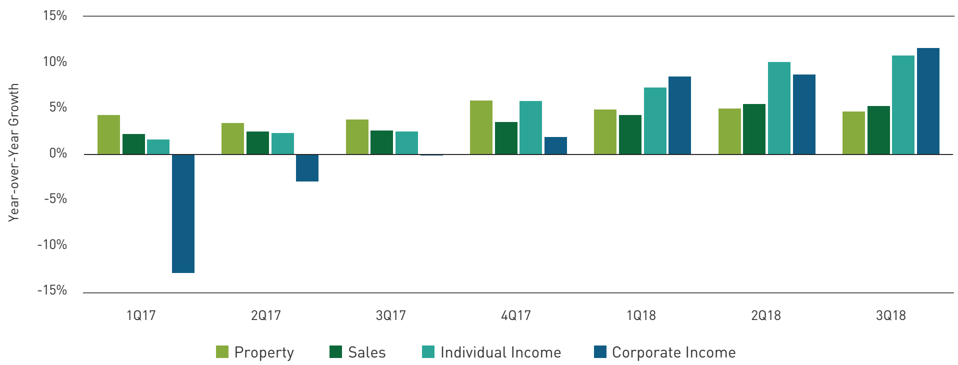
From a credit perspective, most municipal issuers enter 2019 on a strong footing. Supportive credit factors include:

Economy on steady ground. The national unemployment rate is 3.9 percent and average hourly wages rose in December by their largest year-over-year percentage since 2008 (3.2 percent).[2] Retail sales growth remains strong and GDP has exceeded 3 percent for two consecutive quarters. The economic environment appears firm, notwithstanding volatility in the financial markets during 4Q18 and recent softening in some leading indicators (such as the December ISM report[3] or the November JOLTs report[4]).

Tailwinds in the transportation sector. Economic growth is likely to benefit transportation bonds again in 2019. Airport bonds should benefit from growth in enplanements, as more Americans travel for work and pleasure. Low oil prices should support coverage on toll road and gas tax bonds; lower oil prices typically spur more driving and increased toll and gas tax collections; and crude prices are down 40 percent from their 2018 peak.[5] In the port sector, aggregate container volume is projected to grow by 2 percent to 3 percent next year despite new tariffs.[6]

Recent strength in state and local revenues. State and local revenue growth rebounded strongly in 2018 after a lackluster FY17 in which 22 states were forced to cut spending mid-year. In FY18, 40 states exceeded their revenue forecasts—the highest number since the financial crisis (Figure 1).[7]

FIGURE 1: STATE AND LOCAL TAX REVENUE GROWTH ACCELERATING



Source: U.S. Census.

Tax reform expanded the income tax base in several states and stimulated the economy.

The 2018 rebound was partly due to federal policy changes that increased tax growth in 2017. First, the Tax Cuts and Jobs Act (TCJA) induced businesses and individuals to defer income until the new year. The TCJA expanded the income tax base in several states by eliminating or curtailing various deductions and exemptions, including the state and local tax (SALT) deduction. Furthermore, the TCJA stimulated the economy, causing an uptick in jobs and retail sales.

Second, the Supreme Court's decision in *South Dakota v. Wayfair, Inc.*, was also helpful. *Wayfair* confirmed that states can impose sales tax collection responsibilities on e-commerce merchants.

Revenue growth is likely to moderate in 2019 as the one-time effects from these federal changes abate. However, a precipitous decline is unlikely; 19 states expect to exceed their revenue forecast for the current fiscal year.[8] Property tax growth is likely to remain steady in 2019 as well. Through 3Q18, home prices increased 5 percent year-over-year, rising in 99 of the largest 100 metro areas.[9] Recent monthly data suggests growth[10] is slowing in certain markets that have experienced rapid appreciation in the last few years, such as Seattle, San Francisco, Dallas and New York City. However, a modestly slowing housing market is unlikely to result in an immediate slowdown in property tax receipts. In many states, property taxes are collected on a multiyear lag relative to home prices (Figure 2).

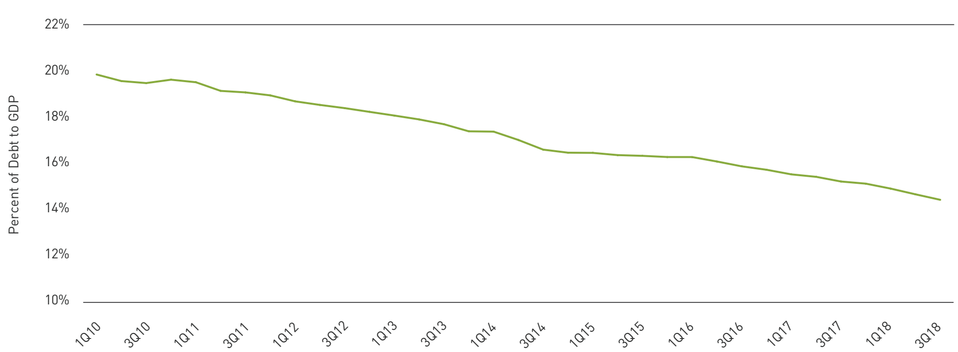
FIGURE 2: PROPERTY TAX GROWTH IS LIKELY TO CONTINUE

Source: U.S. Census of Governments, Annual Survey of State and Local Government Finances (December 2018).

Solid liquidity and leverage metrics. Economic growth and healthy tax collections continue to support higher liquidity and lower debt across most municipal sectors. Mean liquidity (as measured by days cash on hand) now exceeds 2011 levels in the hospital, retail electric, school district, city, airport and county sectors.[11] State reserve balances have also improved, with 31 states increasing rainy day fund balances in FY18, and 26 states expected to add to reserves in FY19.

In terms of debt, issuers have generally deleveraged during the economic recovery. As Figure 3 shows, municipal debt levels continue to decline relative to gross domestic product.

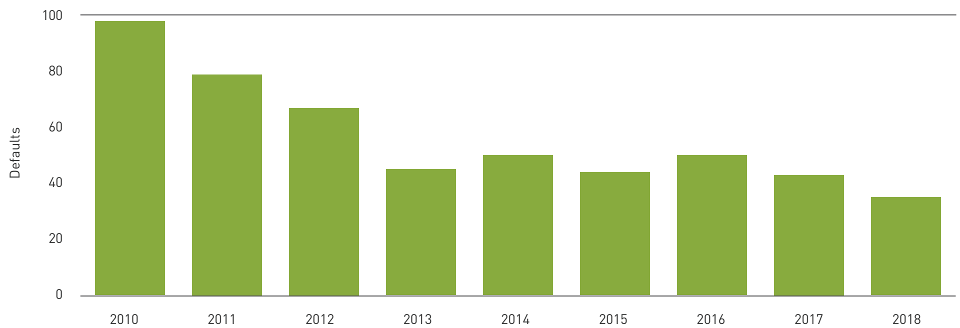
FIGURE 3: STATE AND LOCAL GOVERNMENTS CONTINUE TO DELEVERAGE



Source: Federal Reserve Flow of Funds, as of December 31, 2018.

Still-low default rates. Strength in revenue, liquidity and debt metrics continues to contribute to low default rates, with only 35 municipal defaults occurring in 2018—the lowest total since the financial crisis (Figure 4). Excluding Puerto Rico bonds, only 0.2 percent of total municipal par outstanding was in default in December.[12]

FIGURE 4: MUNICIPAL DEFAULTS REMAIN LOW



Source: Municipal Market Advisors (through December 2018).

The prospects for a meaningful federal infrastructure initiative have reached the highest point in the past few years.

Increased prospects for an infrastructure bill. The prospects for a meaningful federal infrastructure initiative have reached the highest point in the past few years, notwithstanding the government shutdown that began the 116th Congress. An uptick in federal spending that would accompany a federal infrastructure bill would be a credit-positive for some issuers. It would improve coverage on bonds backed by federal gas taxes, and enable state and local issuers to better address deferred infrastructure maintenance.

To be clear, a substantial revamping of infrastructure is unlikely this year. Legislative gridlock is more likely. However, in our view, the odds are higher than most observers believe. U.S. Rep. Richard Neal, the new Ways and Means Committee chairman, and President Donald Trump share an interest in upgrading the nation's infrastructure. More than 80 percent of registered voters support increased spending on "roads, bridges, mass transit and other infrastructure."[13] In addition, if the economy slows more than expected, policymakers may find more room for compromise on a stimulative infrastructure bill. Certainly, infrastructure funding is likely to be top of mind for federal lawmakers.

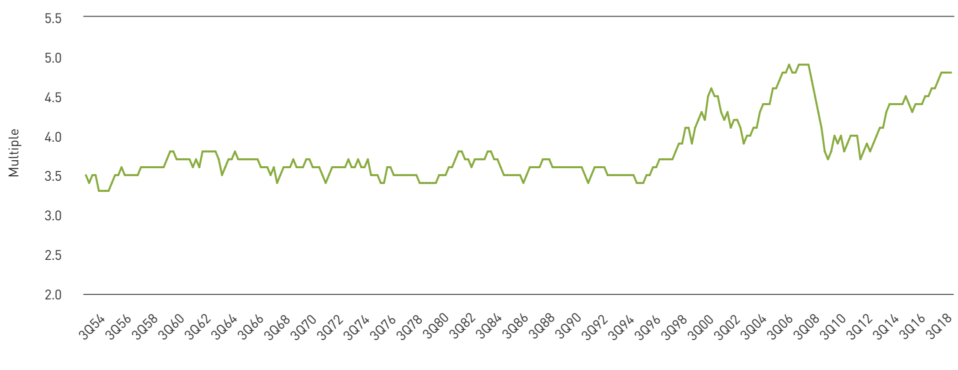
MARKET RISKS

Despite the strengths outlined above, lingering challenges require monitoring. We are keeping a close eye on the following areas:

Volatility in asset prices. Entering 2019, volatile asset markets are among the most-salient credit risks for municipal investors. The recent correction in the stock market, and slowdown in certain real estate markets remind investors that today's municipal credit fundamentals are correlated with asset markets to an unprecedented degree.[14]

We make no judgment as to whether asset values are "too high," and we acknowledge that prices may rise further; however, asset values are plainly elevated relative to certain important benchmarks, such as personal income or gross domestic product (Figure 5).

FIGURE 5: ASSET PRICES HAVE INCREASED RELATIVE TO GDP

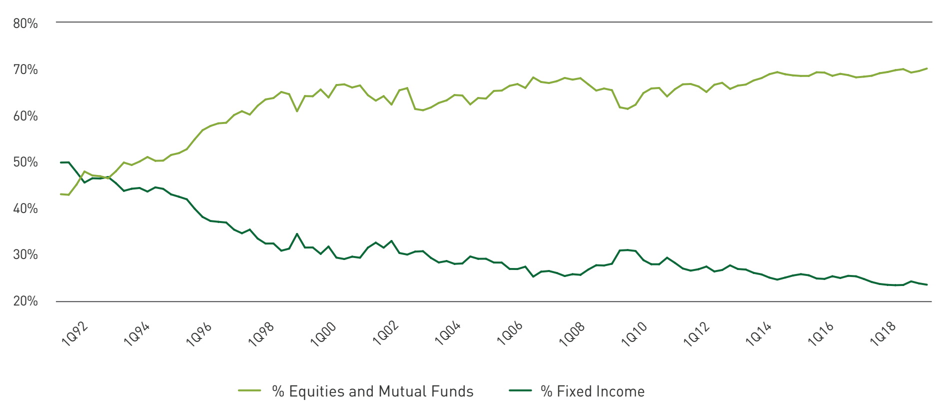


Source: Federal Reserve Flow of Funds, and Breckinridge Capital Advisors (December 2018).
Note: Household net worth mostly comprises home and corporate equity.

Asset-price declines flow through to credit fundamentals via three main channels:

Pension plan exposure to equities. Equities and mutual funds make up as much as 70 percent of public plan assets (Figure 6). "Equity exposure exceeds 50 percent of plan assets for 79 of the largest 169 public plans, including the notable New York City Police plan, Georgia Teachers plan and Illinois' plan for municipal workers.[15]

FIGURE 6: PUBLIC PENSION ASSET MIX



Source: Federal Housing Finance Agency.

For well-funded plans, an asset-price correction can reveal to taxpayers and creditors a fiscal weakness that might have gone unnoticed.

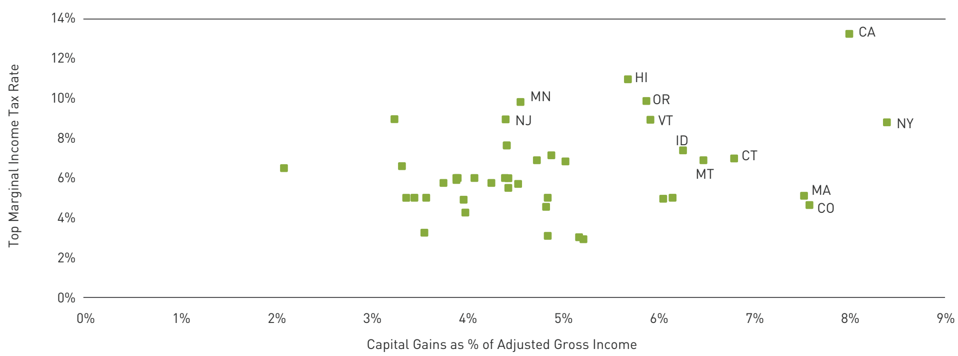
Overexposure to riskier asset classes presents a credit risk for issuers—regardless of their plans' funding ratios. An asset-price correction exacerbates challenges for poorly funded plans. And for well-funded plans, a correction can reveal to taxpayers and creditors a fiscal weakness that might have gone unnoticed. From a pricing perspective, there is a strong argument that an asset-price correction will increase spreads *more* for otherwise-healthy issuers (such as California, Massachusetts and New York) compared to credits that have fiscal weakness already known to the markets (Connecticut, New Jersey). At bottom, it is risky to fund a pension liability that grows at a fixed annual rate (usually around 7 percent)[16] with volatile assets, such as equities, that may see values stay flat or decline.

Property tax revenues' vulnerability to home price changes. Several years of low interest rates and strong job growth have contributed to a reflation in home prices in many parts of the country. As we saw in the last recession, a drop in home prices can lead to a decline in property tax collections and a deterioration in municipal credit fundamentals. In places like New Jersey and New York, home-price declines often trigger assessment appeals that can crimp cash flow.

Usually, there is a lag between a real estate slowdown and a property tax decline. Home price growth has been strong for several years, so a housing market correction today is less of a risk than a stock market downturn, in our view. Nonetheless, an asset-price correction would likely lead to a smaller property tax base for some issuers, and the risks should be understood given today's elevated home prices. Property taxes make up 72 percent of all local government tax revenue in the U.S., according to the latest available U.S. census data.[17]

Greater impact of asset prices on tax revenue. Issuers are more reliant now than in the past on asset-market performance to produce tax revenue. Volatile capital gains income has grown as a share of gross income over the past few decades.[18] States like California and New York rely heavily on both capital gains income and high income-tax rates to balance operations (Figure 7).

FIGURE 7: CAPITAL GAINS INCOME OFTEN USED TO BALANCE RECURRING EXPENDITURES



Source: Internal Revenue Service Statistics of Income (2016 capital gains data), Tax Foundation, and Breckinridge Capital Advisors (January 2019).

The market's heightened connection to today's high asset prices adds a layer of unwanted risk for the typical municipal investor. Municipal bonds are often used to balance risk taken elsewhere in client portfolios. The injection of capital market performance into the municipal credit environment is, therefore, unwelcome. It increases the likelihood that some credits will exhibit pro-cyclical behaviors, such as rising pension debt, falling home values and falling income tax collections—precisely when municipal returns are most valued.

Fortunately, this procyclical credit behavior is likely to lead to downgrades, *rather than defaults,* given the issuers' existing reserves and the typical lag time between an asset-price correction and pension contribution requirements/tax collections. Still, this asset-price performance risk is a new feature of the municipal market and investors have yet to contend with it during a downturn.

Structural challenges still entrenched. In each of the last few years, we have highlighted several lingering structural risks that have loomed over the municipal market since the recession, weakening municipals' long-term resiliency (see *2018 Municipal Bond Credit Outlook*). We believe each of these risks remains in place in 2019. Broadly, these include:

- **Failure to restaff.** Despite the 114-month economic expansion, issuers in some parts of the U.S. remain reluctant to rehire workers. A failure to rehire typically reflects a strained ability to deliver essential services.

  In 2018, teacher strikes and walkouts occurred in states where teachers' pay had been flat for several years (Arizona, Kentucky, North Carolina, Oklahoma and West Virginia). This year kicked off with a strike at the Los Angeles Unified School District (LAUSD), the nation's second-largest. A hiring backlog suggests that rebuilding reserves may be a challenge for some issuers.

- **Inadequate funding of legacy costs.** In addition to the asset-price risk that state and local governments have taken in their pension plan portfolios, many plans continue to shortchange contributions to their funds. Two-thirds of plans contributed less than 80 percent of the amount recommended by their actuaries in 2017.[19]

  Retiree healthcare costs (other post-employment benefits, or "OPEB") also continue to burden a subset of issuers. Investors will gain better understanding of the scale of these benefits in 2019, as new OPEB accounting rules take effect and issuers are compelled to disclose more detail on these costs.[20] We do not expect any downgrades from the enhanced reporting of OPEB liabilities, but the new disclosures will further underscore that many governments offering these benefits are underfunding them.[21]

- **Infrastructure maintenance backlog.** State and local government construction spending was up 6 percent year-over-year through October 2018. Overall, new money issuance was up 16 percent in 2018 versus 2017.[22] However, issuers have significant unmet capital needs that will require a mix of higher fees and taxes, more support from the federal government and, likely, more borrowing. We estimate that the funding shortfall in 2018 was $115 billion (see *Asset Monetization in the Muni Market: It's More Likely Than You Think*).

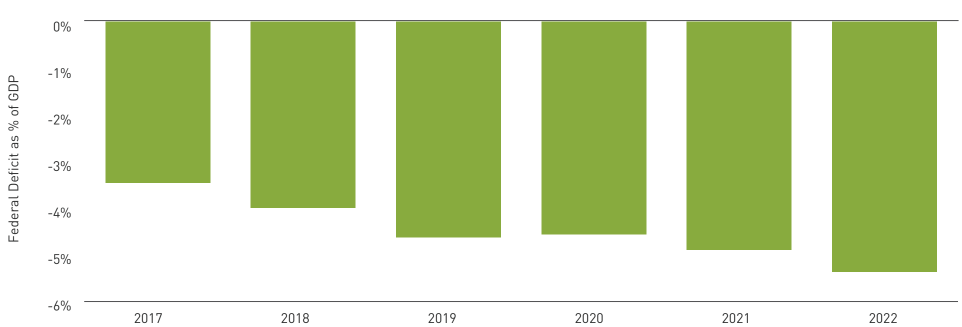
- **Increasing willingness risk.** Although default rates remain very low, the recession has altered municipal market repayment norms. For example, in 2018 all three gubernatorial candidates in Connecticut suggested that the state erred in guaranteeing Hartford's debt as part of a recovery plan for the city. Instead, each candidate supported "more sacrifice" from creditors.[23] The City of Jacksonville endured ratings downgrades across its capital structure when its otherwise reputable and well-managed utility repudiated a take-or-pay contract associated with the failed Vogtle nuclear project in Georgia.[24] Officials in affluent Platte County, Missouri, refused to appropriate debt service for a struggling parking garage project despite previously agreeing to do so.[25] While not directly related to a bond deal, the Georgia state legislature permitted the de-annexation of a development known as Eagle's Landing from the town of Stockbridge. The de-annexation plan was rejected by Stockbridge voters, but the state legislature was plainly willing to allow a plan that would leave Stockbridge with half its tax base, but 100 percent of its debt. These situations suggest that lawmakers fear the loss of bond market access less than they once did.

- **Declining federal government support.** As we noted in *Thoughts on Modern Populism and the Muni Market*, the municipal bond market's low default rate and overall fiscal stability relies, in part, on a reliable federal partner. Unfortunately, the federal policymaking environment has become increasingly sclerotic over the past 10-15 years, and the federal government's fiscal trajectory is unsustainable. The combination of heightened political dysfunction and rising debt levels suggests federal conditions that are less supportive of municipal issuers.

The partial government shutdown to begin 2019 illustrates that gridlock is likely to characterize the federal policymaking environment over the next 12 months.

A less-supportive federal partner could translate into reduced Medicaid or transportation funding, or more tinkering with the tax exemption for municipal bonds (Figure 8). Alternatively, with the weight of federal debt levels, it could contribute to an overall slower rate of economic growth. The partial government shutdown to begin 2019 illustrates that gridlock is likely to characterize the federal policymaking environment over the next 12 months.

FIGURE 8: GROWING FEDERAL DEFICITS CREATE MEDICAID, TAX POLICY AND OTHER RISKS

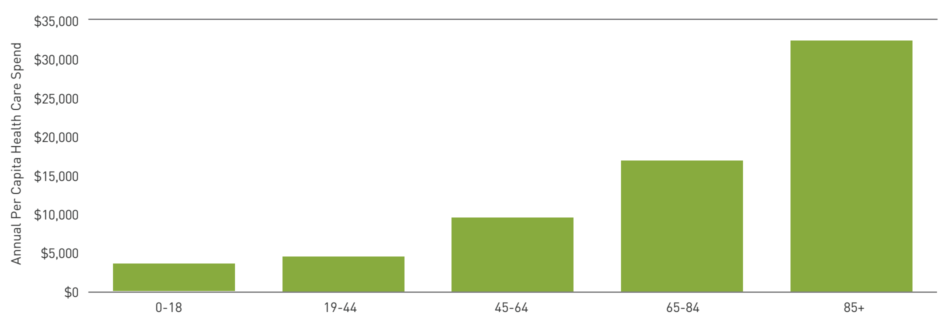


Source: Congressional Budget Office, 10-year projections (April 2018), and Breckinridge Capital Advisors.

- **Climate risks a more-significant factor in credit evaluation.** Each year, the credit implications of climate change become more top of mind for credit analysts. Notably, the major rating agencies have begun to publish more on the topic (see *Rating Agencies and Municipal Climate Risk*). In 2018, Moody's Investors Service published several commentaries on green bonds and a cross-sector methodology for assessing environmental, social and governance (ESG) risks. These pieces addressed climate-related challenges in the public finance space.[26] S&P Global Ratings published commentaries on how it incorporates ESG risks in ratings, noting that the analysts evaluate climate-related risks across credit sectors; these risks include sea level rise, carbon regulation and supply chain disruptions.[27] We are unaware of any ratings downgrades stemming from climate-related risks, but the agency's increased attention to climate change suggests one is more likely today than at any point in the past. The recent insolvency of Pacific Gas & Electric (PG&E), which stemmed from the company's failure to adequately manage wildfire risks, only underscores that reality, in our view.

- **Challenges for nonprofit hospitals.** Hospital operating margin and balance sheet strength have remained mostly consistent for several consecutive years.[28] However, the sector faces several headwinds, including heightened merger risk and policymakers' schizophrenic approach to implementing (or not) Medicaid expansion and the Affordable Care Act. Aging is also a particular concern for hospital credits, as private insurers, individuals and government payers may find it difficult to finance a large and growing number of expensive patients (Figure 9).

FIGURE 9: AGING WILL LIKELY STRESS HOSPITAL BUDGETS



Source: National Health Expenditures, Centers for Medicare and Medicaid Services, and Breckinridge Capital Advisors (December 2018). Per capita spending is as of 2012, the earliest data available.

- **Budgetary hurdles facing private higher education.** The other revenue sector that continues to face meaningful headwinds is private higher education. The population of high school graduates has stagnated, and the high cost of college tuition—especially in the private college space—is driving students to become more cost-conscious. Competition in the higher education space has risen in the past few years and high-tuition, small schools continue to close. This month, Hampshire College in western Massachusetts announced that it is seeking a merger partner. Hampshire is a reasonably selective and well-known liberal arts college, ranking 21st in the "Most Innovative Schools" category by U.S. News & World Report. Hampshire President Miriam Nelson said, "When we look several years out, we are concerned about our future."[29] Among private colleges, 20 percent now report first-year discount rates of 60 percent.[30] Higher discounting is effectively a price cut, and it signals issuers' weakening ability to maintain pricing power over a slimmer, more price-sensitive pool of students (see *Higher Ed and New Student Demographics*).

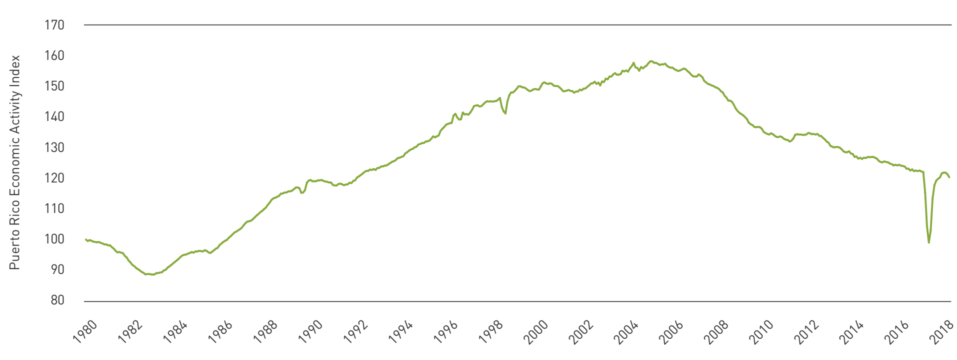
- **Ongoing Puerto Rico concerns.** The Commonwealth's ongoing restructuring of $74 billion in bonded debt and $49 billion in unfunded pension liabilities remains a credit negative for certain issuers in the market. The restructuring continues to taint the credit reputation of a handful of other issuers with significant debt, unmet capital needs and unfunded obligations to retirees (e.g., Illinois, Chicago and New Jersey).[31]

  In 2019, several issues surrounding Puerto Rico debt obligations are likely to make news. These matters include the ongoing dispute between general obligation (GO) and Cofina[32] creditors, and the appeal of Judge Laura Taylor Swain's Puerto Highways and Transportation Authority (PRHTA) bond decision that PRHTA bonds lacked "special revenue" status despite facts that strongly suggest otherwise (see *What Happens in Puerto Rico No Longer Stays in Puerto Rico*).

Until the local economy improves, parties involved in Puerto Rico's restructuring are likely to fight for every available dollar.

  The pension reform proposal from Puerto Rico's Financial Oversight and Management Board (FOMB) will also be put to the test. That proposal includes a 10 percent cut to pension benefits along a graduated scale, with no cuts for those with more-modest pension benefits, and up to a 25 percent reduction for higher-income pensioners.[33] A recently agreed-to plan to restructure the Commonwealth's Cofina bonds and the repudiation of $6 billion in GO debt has also set the stage for additional legal wrangling. In our view, Puerto Rico is likely to make halting progress toward a meaningful resolution of its debt obligations in 2019. Until the local economy improves, parties involved in the Commonwealth's restructuring are likely to fight for every available dollar (Figure 10). (In the graph, the sharp reduction and rebound in growth in 2017 reflects the impact of Hurricane Maria.)

FIGURE 10: PUERTO RICO'S ECONOMY IS STAGNANT



Source: Economic Development Bank of Puerto Rico, Economic Activity Index, and Breckinridge Capital Advisors, as of January 2019. The Puerto Rico Economic Activity Index is a proxy for GDP.

CONCLUSION

Entering 2019, broad municipal market credit fundamentals remain sound. Liquidity is up and debt is down. The default rate remains low, and the economy, although slowing, continues to grow at a sufficiently robust pace to support credit stability across most revenue sectors and for states and local governments, in our view.

However, the market's structural, long-term credit characteristics remain on a slow, negative trajectory. A portion of today's credit repair continues to be purchased with tomorrow's dollars. To varying degrees, governments and issuers have failed to rehire staff at a sufficient pace to support essential services. They have delayed necessary infrastructure spending, have shortchanged pension contributions and remain exposed to an asset-price correction to an unprecedented degree. The federal government's weakened fiscal condition and entrenched political gridlock continue to suggest a marginally weaker federal partner going forward.

Breckinridge continues to believe that credit quality is diverging across issuers, as some credits are better than others at managing long-term headwinds. We are maintaining our up-in-quality bias given the tight spread environment in municipals, and given our mandate to preserve capital and income in client portfolios.

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