Municipal Market Update

Constructive on Credit Quality, but with a Guarded View

Michael Korzenko, CFA
Director, Municipal Credit Research

As the economy slows toward the end of a business cycle, we wanted to share a friendly reminder that the safety of municipal bonds is of the utmost importance for investors who take a skeptical view of the quality of their municipal bond portfolio. Nearly four years removed from the pandemic and having delivered remarkable budget performance since FY 2021, state and local governments are preparing for a more moderate pace of growth in the coming months. While we readily acknowledge the potential for some issuers to confront challenges, the asset class is well-positioned to continue its long-standing mission of providing investors with a stable source of tax-efficient income and diversification benefits. With its approximately $4 trillion in outstanding securities, about 50K unique issuers and various sectors, the municipal bond market offers investors the opportunity to attain significant value with proper credit due diligence and sound portfolio construction.

Key Points

- Municipal bond credit quality should remain mostly stable next year.
- Healthy reserves should reduce operating risk from slowing economic conditions.
- Proper due diligence and surveillance are critical to navigating the market.

How strong are state budget reserve funds?

Think of reserve funds as a savings account for states. During good economic times, states tend to build up reserves, which are available to be drawn upon when budget conditions weaken as the cycle turns or unforeseen events take hold. Favorably, states have accumulated record levels of rainy day funds over the past several years. The substantial budget performance following the pandemic and the various federal stimulus programs allowed states to augment their balance sheets. We have observed that most states proactively strengthened their reserve fund policies as a "lesson learned" from the financial crisis. Reserve funds provide states with budget flexibility. Current reserve levels should help blunt the impact of a slowing economy on state operations.

Did states anticipate revenue declines this year?

Most states enacted FY 2024 budgets anticipating weaker revenue growth than in previous years. States reported exceptional surplus operations during FYs 2021 and 2022, but were not regarded as sustainable, in part, because of one-time or temporary "fiscal boosters," such as federal pandemic aid. FY 2023 mostly closed with surplus operations, albeit smaller. We expect leaner budget margins this year and next, with some states incurring shortfalls in their spending plans as the economy cools. Implications from inflation, consumer behavior and state-specific tax relief

City National Rochdale, LLC, is an SEC-registered investment adviser and wholly owned subsidiary of City National Bank. Registration as an investment adviser does not imply any level of skill or expertise. City National Bank and City National Rochdale are subsidiaries of Royal Bank of Canada. City National Bank provides investment management services through its subadvisory relationship with City National Rochdale, LLC.

Non-deposit Investment Products: ▪ are not FDIC insured ▪ are not Bank guarenteed ▪ may lose value

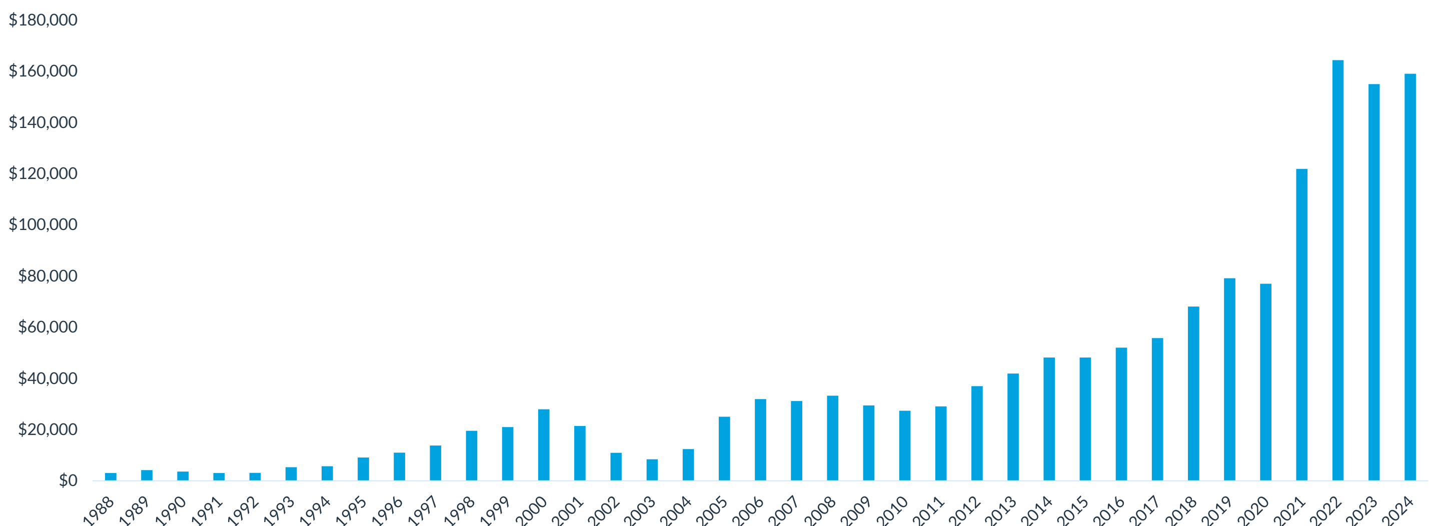
measures, among other factors, may contribute to budget volatility over the medium term. Still, ample balance sheet resources and broad fiscal authority should allow states to maintain budget balance and preserve credit stability.

What is the outlook for local governments (LG)?

We expect LGs to respond well to a slowing economy. Since the pandemic, LGs have accrued sizeable reserves that should soften budget volatility. Like state governments, LGs received large amounts of pandemic stimulus, much of which remains available, further supporting their credit stability over the next year. With solid state financial positions, we expect manageable cuts to governmental aid. Still, we will monitor budget strategies for potential implications on LGs if more aggressive actions develop. A fundamental strength of local governments is their revenue mix. Most local governments rely on property taxes, which have a history of stable performance throughout the cycle. The relative stability is due to assessment practices that tend to lag changes in economic conditions, providing LGs with time to respond to projected budget pressure (e.g., adjust tax rates/levies, albeit subject to state law, or implement expense reductions). An evolving risk that will likely play out over the next several years is the impact of commercial real estate (CRE) disruptions on assessed values, particularly as office vacancies remain elevated and high-value leases roll off (primarily affecting larger metro cities). CRE dependency and tax systems are vital considerations, as are the ability and willingness to enhance other revenues or modify cost structure to maintain budget balance. Credit stability will hinge on effective governance and medium-term budget planning (an observable characteristic of the local government sector).

What is our view on revenue bond sectors?

The gradual strengthening of many revenue bond sectors post-pandemic has contributed to their relative stability heading into next year. Key financial metrics have recovered reasonably well, while operating risk has diminished for most sectors. Each sector has its own contributing factors that ultimately drive fundamental quality. For example, public utilities, like water and sewer systems, benefit from rate-setting autonomy and usually operate monopolies that underscore the essentiality of their businesses. These "defensive" bonds should remain well-secured over the near term. We also expect the airport and toll road



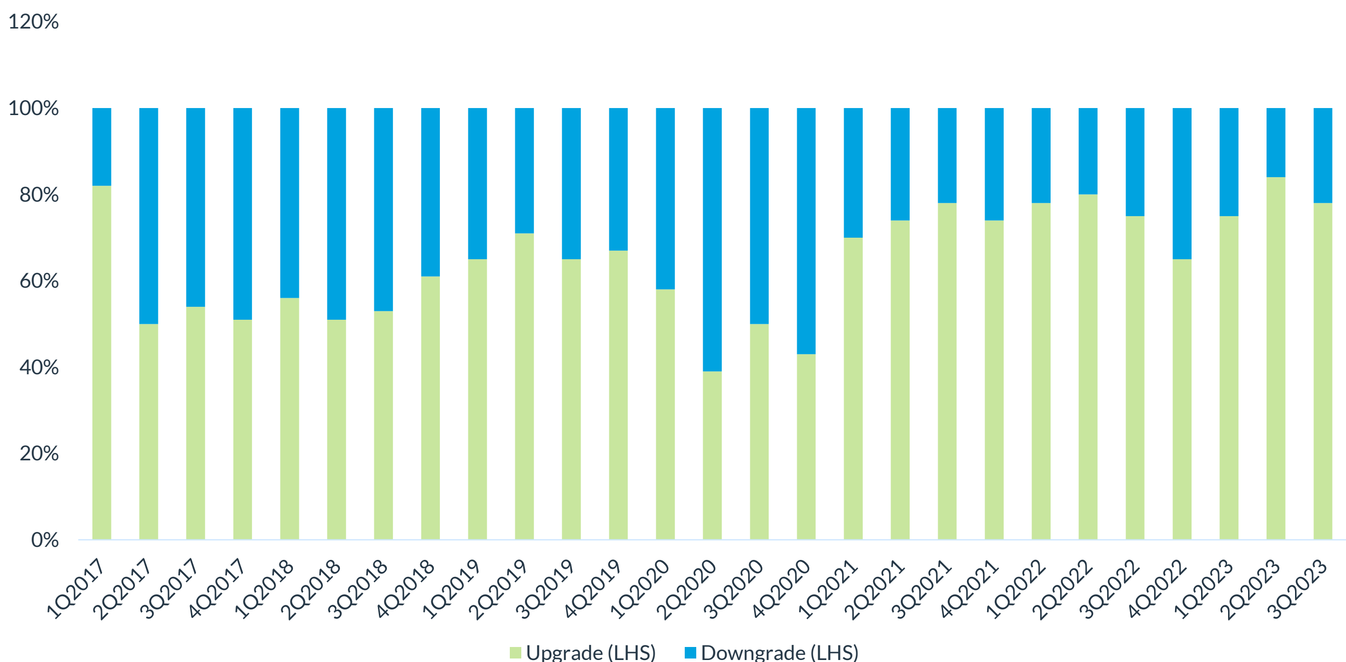
Source: National Association of State Budget Officers Spring 2023 Survey of States; FY 2023 is an estimate, and FY 2024 is projected. Information is subject to change and is not a guarantee of future results.

Non-deposit Investment Products: ▪ are not FDIC insured ▪ are not Bank guarenteed ▪ may lose value

sectors to display stability as most enterprises that comprise these segments have largely recovered their customer demand from pandemic lows. High cash balances coupled with structural features of their bonds, like contractual agreements for airports and toll rate adjustment mechanisms for toll roads, should generate durable cash flows to counter potential moderation in passenger and traffic volume. Within higher education, a bifurcation in quality has emerged between smaller, less selective schools and larger comprehensive institutions with pricing power and enrollment flexibility. As the competitive landscape (for students) intensifies against a backdrop of "value choice" optionality between public and private schools, the sector is poised to confront isolated margin pressure throughout next year as the uneven performance of revenue and expense growth persists. Private institutions with brand recognition and strong liquidity should fare well, while public universities should benefit from continued state support, especially flagships. The hospital sector has confronted profitability challenges from labor shortages and costs, as well as fluctuating patient volume. System operators with size and scale, big balance sheets and favorable market positions should weather continued industry pressure relative to smaller stand-alone facilities.

How stable are municipal issuer credit ratings?

Published credit ratings are the market standard for evaluating the risk of a particular issuer. While we apply a proprietary approach to credit assessment, credit ratings influence market valuations and liquidity. Since 2021, the quarterly trend of the ratio of upgraded issuers versus those downgraded has been positive, according to Moody's. The data shows only two negative quarters (i.e., more downgraded issuers than those upgraded) since 2017. The flow of direct and indirect federal pandemic aid bolstered issuer recovery over the past three years, helping propel the wider margin of upgrades relative to downgrades. However, a deceleration in the economy will likely to slow the pace of upgrades, but credit quality remain mostly stable across core



Source: Moody's as of September 30, 2023.
Information is subject to change and is not a guarantee of future results.

Non-deposit Investment Products: ■ are not FDIC insured ■ are not Bank guarenteed ■ may lose value

sectors. S&P Global Ratings reported that 98% of their rated issuer universe is either on a stable or positive outlook as of November 2023*. Rating transition is relatively small within traditional investment grade municipal bonds.

Is credit diversity achievable?

The municipal market benefits from significant issuer heterogeneity as it is conceivable to have two adjacent communities yet possess vastly different credit profiles. In other words, municipal issuer quality is unique, with varying economic bases, demographics, governance, policy, finances, business and industry composition. According to the U.S. Census Bureau, there are approximately 100K government units. While not all governments have or will issue municipal bonds, the Municipal Securities Rulemaking Board estimates about 50K municipal issuers are in the market. Municipal issuer types range from states, cities and counties to higher education, hospitals, housing and essential service utilities, to name a few. With dozens of sectors, bond structures, ratings and the ability to diversify geographically, the municipal market offers asset managers the opportunity to optimize portfolio construction and credit risk.

Final comments

As we close the books in 2023, we are cautiously optimistic on municipal credit conditions despite noted areas of concern across certain issuers and sectors. Entering from a position of strength, most municipal issuers should maintain quality despite the anticipated slowdown in the economy. The lingering effects of monetary policy should keep credit due diligence on its toes for some time. Federal pandemic aid will wind down over the next two years. Thus, budget alignment and structural balance will come into focus as resource management needs intensify. We expect most issuers to manage emerging risks, but implementing ongoing credit surveillance will remain critical to successful municipal bond investing.

* S&P Global Ratings, *Market Insights*, *Sector Intelligence*, *U.S.*, *Public Finance*, published Dec. 11, 2023, data as of Nov. 30, 2023.

Spotlight on the Safety Record of Municipal Bonds

Moody's annual default study found an investment grade municipal bond default rate of 0.9% from 1970 to 2022. Not all bonds are rated (particularly, high yield municipal bonds). Thus, looking at the entire market can indicate broad levels of risk within the asset class. According to Municipal Market Analytics, as of November 2023, the market default rate for all municipal bonds (rated and non-rated) was about 0.4%, and has averaged less than 0.5% over the past 15 years (not including Puerto Rico). Municipalities typically issue longer-term amortizing bonds (like mortgage payments) with the ability to refinance if needed, which reduces rollover risk. Maintaining a good standing within the capital markets is in the self-interest of municipal issuers since their bonds finance critical public works and essential services. Municipalities have a strong track record of making tough decisions to address budget imbalances and pressure. Whether backed by a general obligation or a pledged revenue stream, debt service is usually prioritized over other budget items. Credit developments in investment grade municipal bonds tend to stretch over time, providing research analysts with early warning signals to proactively manage and respond to risks as needed.

Source: S&P Global Ratings, as of November 30, 2023.
Information is subject to change and is not a guarantee of future results.

Non-deposit Investment Products: ▪ are not FDIC insured ▪ are not Bank guarenteed ▪ may lose value

INDEX DEFINITIONS

The S&P 500 Index, or Standard & Poor's 500 Index, is a market-capitalization-weighted index of 500 leading publicly traded companies in the U.S. The index actually has 503 components because three of them have two share classes listed.

IMPORTANT INFORMATION

The views expressed represent the opinions of City National Rochdale, LLC (CNR) which are subject to change and are not intended as a forecast or guarantee of future results. Stated information is provided for informational purposes only, and should not be perceived as personalized investment, financial, legal or tax advice or a recommendation for any security. It is derived from proprietary and non-proprietary sources which have not been independently verified for accuracy or completeness. While CNR believes the information to be accurate and reliable, we do not claim or have responsibility for its completeness, accuracy, or reliability. Statements of future expectations, estimates, projections, and other forward-looking statements are based on available information and management's view as of the time of these statements. Accordingly, such statements are inherently speculative as they are based on assumptions which may involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such statements.

Past performance or performance based upon assumptions is no guarantee of future results. All investing is subject to risk, including the possible loss of the money you invest. Fixed income securities involve interest rate, credit, inflation and reinvestment risks, and possible loss of principal. As interest rates rise, the value of fixed income securities falls. Portfolios focused on a single state are subject to greater risk of adverse economic and regulatory changes in that state than a geographically diversified portfolio. Changes in the credit rating of a bond, or in the credit rating or financial strength of a bond’s issuer, insurer or guarantor, may affect the bond’s value.

© 2023 City National Rochdale. All rights reserved.

17703150

Non-deposit Investment Products: ■ are not FDIC insured ■ are not Bank guarenteed ■ may lose value