U.S. MUNICIPAL BOND MARKET

The Municipal Market in 2018: When Serendipity Becomes Zemblanity

Investors: Know and Follow Your Municipal Credits in 2018 and Beyond

We are just over eight years into the most recent U.S. economic expansion. It has been a long, slow, uneven economic advance that began in June 2009. The Conference Board’s Leading Economic Index has continued to gain ground, indicating the overall U.S. economic outlook is still improving, while the economic divide among income groups has gapped out. It may seem that economic gains for individuals in the U.S. economy are actually running at two speeds. Ray Dalio, chairman and chief investment officer of Bridgewater Associates, recently wrote that there are now two economies: the top 40% and the bottom 60% in the United States. The recent populist political movement is partially a reaction to this growing divide. The trends driving this differentiation are likely to intensify and drive the gap even wider.

In the near to medium term, manufacturing jobs will likely be lost due to automation, even though productivity likely will rise. Meanwhile, complete industries will be turned upside-down. We may see transportation, health care, and other industries revolutionized. Traditional jobs will be shed, requiring more workers to retrain for new jobs. This will all happen because of more technological change. The pace of that technological change has been and will continue to accelerate, not slow. This high-tech shift, along with globalization, cannot be stopped despite some political rhetoric.

All this is happening, or will happen, at a time when state and local governments and other municipal bond issuers are struggling to deliver on their core missions. Revenues have not kept pace with expenditure demand. Issuers are seeing expenditure demand grow with every budget cycle. Citizens are frustrated with growing tax burdens, but they have nothing to show for the higher payments they have made. Government leaders are at a loss for solutions. State government credit quality has been falling at an unprecedented pace, and local governments are being downgraded at a mark that is not typical, especially considering we are almost to the ninth year of an economic recovery.

Serendipity of Municipal Bond Investing

Serendipity can be defined as a “fortunate happenstance” or “pleasant surprise.” Sometimes I reminisce about the good old days of investing. I like to think that, for many investors, it is exactly what putting money into the municipal bond market has felt like. It was serendipity, or a pleasant surprise. This was probably the case for years, if not decades. Investors purchased their municipal bonds, placed them in a drawer, and collected principal and interest. Headline risk was rare. Returns were relatively rewarding. Credit quality was considered high, or at least mostly stable as the baby boom fueled the U.S. economy. There were few credit hiccups, and those that existed were isolated and commonly referred to as outliers. Municipal bond defaults were low. Even when a default occurred, principal recoveries were often bondholder friendly. In contrast, the preparation and oversight required for municipal bond investing have increased. Municipal investing will necessitate investors concentrate on important industry, sector, and issuer-specific credit trends. Investors will no longer be able to put municipal investments in a drawer and forget about them. Municipal bond credit quality must be regularly questioned and assessed.

What is Zemblanity?

On the other hand, zemblanity is the inevitable discovery of what we would rather not know, an “unpleasant surprise”—the opposite of serendipity. This is what municipal bond investing
has become for some in recent years. We expect the municipal investing experience will worsen for those investors who do not focus on important industry, sector, and issuer-specific credit trends. Almost nothing that has occurred this year has been a boon for municipal market credit quality. There is also no reason to believe near-term prospects will help improve credit quality. I reviewed the subtopics highlighted in this 2018 outlook report as I searched for a broader theme to summarize the status of municipal credit conditions. Those subtopics are:

- **Tax Cuts and Jobs Act, federal funding bill:** Mostly negative for municipal bond issuers and credit.
- **Municipal bond market volume forecast for 2018:** Most factors point to volume that will trend down. If this indicator was trending positive, we would see more issuers selling new money debt in order to invest in their missions or related infrastructure.
- **Debt restructuring:** It is a difficult decision, and in the near term this will be an operational and political headache for the relatively small number of issuers who go through it. Although in the long term, this might be considered a positive because it should allow issuers more flexibility and help them repair their credit positions.
- **Ability to pay:** It is never good when an issuer’s ability to pay is questioned.
- **Pensions:** Too much in liabilities, investment shortfalls, unrealistic assumptions, and minimal understanding about math are behind the plans.
- **Credit conditions:** Some are improving, but these are the exceptions; some profiles are stable while others are worsening at an unprecedented pace. This should be concerning for investors, especially at a time when the economy has been expanding for close to a decade.
- **Natural disasters/climate change:** Recent examples illustrate the importance of preparation. Credit has generally not been affected but could as time passes and events build.
- **Municipal bond insurance:** Some investors have been thankful, and usage has been stable but low. Some insurers have exposure to distressed credits.
- **Accelerating pace of tech change:** This is good for some individuals but will increase the socio-economic and political divide that globalization widened. It should be on the radar of state and local governments.

During this search for a broader theme is when I decided to call the period we are in “zemblanity.” This might be a word I just added to my vocabulary, but conceptually I have been observing this shift in the municipal landscape for several years. I published some details on what I was noticing in summer 2016. I summarized how credit conditions were developing in An Evolution in Thinking About Municipal Credit: From Collective Indifference, to Panic and Back Again. You can check out the report by following that link, but in summary I wrote:

In just a few years, many investors went from not paying close attention to municipal credit (and/or relying on insurance) to questioning credit quality (many fearfully). Most municipal credit analysts vehemently defended municipals, and now some are missing the formation of a bi-furcated state and local government market as it relates to credit quality.

The majority of U.S. state and local governments, or about 80%, possess stable or even improving credit profiles. In recent years, however, about 20% of state and local governments have not adjusted to the new fiscal reality and have seen their underlying credit quality decline, some significantly.

This marks an important shift in municipal credit. We do not expect widespread defaults in the near term, but the above-noted shift could be a precursor to the redefinition of a “distressed” credit. Ask investors who purchased the following bonds and only recovered the noted amount: San Bernardino, Calif. (55% recovered); Stockton, Calif. (50%); Vallejo, Calif. (60%); or Detroit, Mich. They will tell you how unpleasantly surprised they were compared to their initial expectations. Recoveries from Puerto Rico investments are not expected to be much better. Which issuer is next is anybody’s guess, but there are some getting closer especially as they try to manage unsustainable (even unpayable) liabilities.
Moral of This Story
So, what is the main theme that investors should take away from this summary of the current landscape? Know and follow what is happening to the municipal credits in your portfolio. While there are general obligation and revenue bond pledges that may fit closer to the traditional municipal bond mold, there are significant factors changing the face of municipal bond investing, with many of those factors detailed below. As a result, investors are in a position where they must understand what state and local governments and other municipal issuers are dealing with before they invest. Fiscal progress also must be followed regularly because it can change and potential expenditure pressures (like pensions) are mounting.

For example, a general obligation pledge does not mean taxes will be raised to pay bondholders in all circumstances. Just because a pension funding level is 70% now does not mean pension payments are not crowding out other spending or, worse, that pension liabilities have far outpaced a credit’s ability to pay creditors (pensioners and bondholders) now or in the near term.

Again, what is the moral of the story for investors? Don’t look at this transition as zemblanity. Take advantage, and remember credit fundamentals will matter more in 2018 and beyond than ever before when municipal bond investing. Don’t overlook an issuer’s finances, and hope for good old-fashioned municipal bond market serendipity.

So, what are and will be the hottest topics in municipals bonds in 2018? Here are some we believe are among the more important.

Tax Cuts and Jobs Act, Federal Funding Bill
Since early November, much attention has been paid to the House and Senate tax cut proposals. Republicans hope to finalize their tax cut legislation by the end of the year. Federal lawmakers also need to extend government funding past the December 8 deadline to avoid a possible government shutdown. Most representatives, less than a year before the midterm elections, do not want a government shutdown. Nonetheless, the risk remains. Little time is left in the first session of the 115th Congress to complete these significant tasks.

- The Senate Budget Committee passed the Senate tax cut bill on a partisan basis by a count of 12 to 11 on Tuesday, November 28.
- Senate Republicans approved their version on Saturday, December 2, with a 51–49 vote.
- Process from here: Lawmakers in the U.S. House and Senate are now set to begin/continue analyzing their tax cut proposals, with the goal to compromise to get a final tax cut package on President Donald Trump’s desk by Christmas.
- Reminder: The House version eliminated both private activity bonds and advance refundings. The Senate version only eliminates advance refundings.
- Only four days are left on the official Congressional calendar when both the House and Senate will be in session after the December 8 funding deadline. Lawmakers will likely need to work extra hours to pass tax cuts in 2017. Even then, little time remains.
- We still expect a 30% chance that the tax cut is signed into law this year. See pages 4 and 5 of our report Federal Tax Proposals and the Municipal Bond Market for more details about our scenarios.

Municipal Bond Market Volume Forecast for 2018
We estimate total municipal bond issuance for 2018 of $315 billion, a significant drop. A leading influence on our forecast are the potential tax cuts and the pace at which issuers accelerated about $40 billion of issuance into the end of November and December 2017.
Issuance Accelerated into 2017; 2018 Volume at Lowest Level Since 2011

We revised our 2017 volume forecast from $365 billion to $405 billion after issuers began accelerating bond financings. Based on the building calendar, even $405 billion could be light.

Our 2018 anticipated issuance of $315 billion includes a big “IF.” The “IF” is related to the tax cut package currently being negotiated; we assume our Scenario number 2 outlined on page 4 in our November 15, 2017 commentary. Briefly, we assume tax cuts do not happen in 2017. A scaled-down version passes in March 2018 and only reduces advance refunding and private activity bond issuance over the first three months of 2018. If a package passes in 2017, the tax cut debate goes past March or if advance refundings (or even private activity bonds) are eliminated then we would adjust our forecast.

We see about $195 billion of new money issuance and $120 billion of refunding issuance for a 2018 total of $315 billion. This will be down considerably from 2016’s record year of $445 billion and from our expected 2017 number. There already was $325 billion of 2017 issuance through the end of October 2017.

The PNC Economics team noted that the job market quickly bounced back after the hurricanes and unemployment is the lowest since 2000.

President Trump nominated Jerome Powell to be the Federal Reserve chair when Chair Janet Yellen’s term expires on February 3, 2018. PNC Economics calls the Powell nomination a “continuity choice.”

Our Economics team also continues to expect a 25-basis-point rate hike at the December 12–13 Federal Open Market Committee meeting, according to the PNC November 17 Market Expectations Survey.

Debt Restructuring

One of the most meaningful events not only for 2017 but for the entirety of the municipal bond market occurred on May 3, 2017, when the Puerto Rico oversight board began the process of restructuring the island’s general obligation debt.

While the restructuring is still occurring and will likely take some time, we expect the results will add to the “reordering” of the municipal bond market. It would have been unimaginable about 10 years ago to suggest that such a restructuring would occur, mostly because of the constitutional priority placed on bond debt service.
- We do not think a Puerto Rico contagion will cause distressed U.S. state and local governments to restructure as well. Future defaults, Chapter 9 filings, and restructurings will occur because of a lack of ability to pay, partly caused by excessive leverage or debt. The contagion example is not appropriate.

- Ability and willingness to pay: We do think investors are likely to take the distinction between an issuer’s ability and willingness to pay more seriously. Some opposed Puerto Rico’s former governor when he said, “This is not politics, it is math.” Some may even still have unrealistic expectations about state and local governments’ ability versus willingness to pay. Puerto Rico likely lost the ability to pay compared to its debt burden years ago. When assessing Puerto Rico and other distressed situations, investors should consider why governments exist. Governmental entities exist so they can deliver public sector services to residents and taxpayers. More on what Title III under PROMES means and does not mean is in this report.

**Ability to Pay**

Hartford, Conn., Mayor Luke Bronin said the city “will negotiate with bondholders and the state to ‘end up with a debt-service burden that is manageable over the long term,’” a week after a Connecticut budget gave the city some breathing room.

- Mayor Bronin and the governor of Connecticut warned that creditors (bondholders and unions) would need to be part of a financial solution if Hartford was to fend off filing for bankruptcy protection. This is a troubling but not surprising message for municipal bond investors, not just in Hartford but also countrywide.

- While it is only a small sample size to date, outcomes from San Bernardino, Stockton, Vallejo, and Detroit have not been bondholder friendly. Investors should continue to monitor future bondholder-friendly restructurings because if these examples offer any guidance, it seems as though investors will not be well taken care of during the process.

**Pensions**

There is no good news on the pension front. Over eight years into this economic expansion and pension liabilities still remain a drag on credit quality for some state and local governments. Positive equity market performance since the 2016 elections is not enough to make up for lax funding, lower-than-expected returns, and liability growth. Municipal bond market credits, including some high profile issuers, have been and will continue to be downgraded as a result.

- Pension reform has only occurred on the fringe. Changes have not made any meaningful impact to credit quality or helped structurally balance budgets.

- Pension funding solutions that move the needle remain elusive and extremely politically unpalatable. This is especially true in the most severe cases. There is nothing that leads us to believe prospects for reform will become easier in the near term.

- The state and local government aggregate public pension funded ratio fell to 68% in fiscal 2016 from 73% in fiscal 2015, according to The Center for Retirement Research at Boston College’s July 2017 report *State and Local Pension Plan Funding Sputters in FY2016*.

  - The good news is that pension liabilities should fall in fiscal 2017. The assumptions used in Moody’s upside scenario (see exhibit 12 on page 8 of the Moody’s report) were close to reality. The average investment rate of 11% Moody’s used is close to where asset performance is likely to be. The 3.9% discount rate is also close.
  - The bad news is that lower returns or investment losses could be painful for state and local government credit when you think about what could happen in Moody’s base case or downside scenarios.
Moody’s also made a startling conclusion, writing that “funding for typical public pension plan could resemble today’s most challenged if investment losses materialize in next several years” (see exhibit 11 on page 7 of Moody’s report).

Credit Conditions
Credit status for municipal bond market issuers that have actively adjusted to the new fiscal reality remains constructive and should remain largely stable into 2018. What used to be described as patches of weakness in the state and local government sector have become more widespread. We still believe state and local government credit is being bifurcated into two branches. This process is not currently being reflected in a widening of credit spreads, however. Several factors are keeping most credit spreads rather narrow:

- Efforts like the Volcker Alliance and Pew Trusts States’ Fiscal Health analyses help shed some light on the good and bad in state credit, budgeting, and related topics. The National League of Cities does the same for city governments.
- Related to the current conditions of U.S. state government, I recently wrote in a November 1, 2017, report A Lesson from a Post-Recession Municipal Miscue that “the credit stress and resultant downgrades I suggested we could see as a precursor to the scenario suggested by Meredith Whitney in 2010 are now happening.”
- An unprecedented number of U.S. states have been downgraded in recent years. Standard & Poor’s even indicated that “your state is probably facing a dawn of public finance problems” in an April 2017 report.
- On the local government side, economic growth, housing markets, and consumer spending largely continued to slowly advance in 2017. Most tax bases continued to recover, and Moody’s local government revenues as a percent of general fund median rose to a strong 35.4%.
- 2015 was the first year Moody’s public finance upgrades (555) outpaced downgrades (506). That continued in 2016 when upgrades (563) outpaced downgrades (489) and in the first half of 2017 when upgrade (269) also outpaced (236) downgrades.
- Through the first three quarters of 2017, upgrades (391) have outpaced downgrades (340). But downgrades remain stubbornly high.
- In third-quarter 2017, local government upgrades were led by Texas issuers as a result of tax base growth. Downgrades were led by Pennsylvania local government issuers, and the leading factor driving the downgrades was declining reserves.
- Some structural imbalances persist, mostly for the public finance issuers that have not reacted to the new fiscal reality or for those with outsized leverage in the form of fixed costs.

Natural Disasters and Climate Change
Municipal issuers will need to begin to plan for climate change and prepare for natural disasters. Hurricanes Harvey, Irma, and Maria swept through the southwest, southern, and southeast United States, including Puerto Rico and the Virgin Islands, with cost estimates ranging from $150–200 billion. Much of Puerto Rico still does not have electricity or access to clean water.

- Municipal credit conditions are typically not affected on a widespread basis after even the most devastating natural disasters since federal funds help dampen the blow. Short-term liquidity is usually the chief financial concern, but this could change.
- Moody’s did place 37 Texas municipalities on review for downgrade in September 2017, and some credits have been downgraded.
- These events may bring renewed attention to the impact of natural disasters and rising water levels on municipal credit.
- Washington legislators extended the National Flood Insurance Program until December 8. Disaster relief has become more of a priority as a result of the recent storms. Lawmakers will be busy in coming weeks deciding what to include as the debt ceiling suspension and the budget’s continuing resolution are set to expire the same day.

Credit status for municipal bond market issuers that have actively adjusted to the new fiscal reality remains constructive and should remain largely stable in 2018.

We still believe state and local government credit is being bifurcated into two branches.
A recent rating agency report, *Evaluating the Impact of Climate Change on U.S. State and Local Issuers,* indicated: "In coming years, climate change is forecast to result in a higher frequency and severity of extreme weather events, in turn heightening U.S. exposure and vulnerability to economic loss across industries and geographic regions."

### Infrastructure

D+ is the grade the United States earned on the *2017 Infrastructure Report Card* assigned by the American Society of Civil Engineers. The need for infrastructure investment remains very strong, but the tax-exempt bond financing mechanism remains underutilized.

- President Trump’s proposed $1 trillion over 10 years for infrastructure has not materialized.
- The near-term importance of infrastructure to lawmakers is currently uncertain, illustrated by the anti-municipal bond components included in the tax cut proposals.
- Talk about a renewed financing tool structured like the American Recovery and Reinvestment Act’s (2009) Build America Bond (BAB) program has died down.
- Even so, the problem with renewed BABs is that issuers who sold BABs in 2009 and 2010 have no reason to feel anything but burned. The BAB subsidy (direct pay to issuers of 35%) has been reduced every year since the 2013 U.S. budget sequestration. 2017 BAB payments were reduced 6.9% and 2018 will be reduced 6.6%.

### Municipal Bond Insurance

Demand for mono-line insurance for municipal debt remained constant in 2017 compared with recent years. About 5.6%, or $16 billion, of all issues were insured through the third quarter of 2017 compared with 5.7%, or $25 billion, in all of 2016.

- The four top municipal bond insurers wrapped $16 billion of municipal bonds through the first nine months of 2017, including Assured Guaranty Ltd. ($9.1 billion), Build American Mutual ($6.5 billion), Municipal Assurance Corporation ($639 million), and National Public Finance Guarantee Corporation ($627 million).
- One overlooked point where municipal insurance is concerned is that the insurers have delivered on claims in recent years. Detroit and Puerto Rico stresses have made headlines, but what is often overlooked is that the insurers have made payments when necessary on insured bonds.
- National Public Finance Guarantee was hit with a two-notch downgrade from AA- to A by Standard and Poor’s in June 2017. The rating agency noted that National “struggled to gain market-wide acceptance” but also that “National’s financial risk profile, the company’s capital adequacy is very strong.” National has not insured any new issues since the downgrade.9
- Assured and National both have Puerto Rico exposure. A June 2016 Standard & Poor’s report indicated that “exposure to insured Puerto Rico issuers appears manageable for legacy bond insurers.”10
- After Hurricanes Harvey, Irma, and Maria, Standard & Poor’s wrote, “We find that each company [National & Assured] has sufficient liquid resources to meet claim payments in this scenario [pay 100% of debt service through 2020]—the incremental risk presented by Irma and Harvey does not change our assessment,” in a September 20, 2017 report.11

### Accelerating Pace of Technological Change

The accelerating pace of technological change and its impact is often misunderstood. I think that the pace of technological change is one key reason why trust in government is at an all-time low.

- Globalization and technology have been key reasons why the United States has been losing manufacturing jobs for decades, despite rising production. This relationship has given rise partially to the new populist movement.
• There is some good news related to the pace of technological change, which has been rising exponentially. For some, we are likely to see more “improvement” over the next 20 years than we have seen in the last 100.

• The bad news for others is that the economic conversion that began with globalization is strengthening and is not going to reverse. The pace of technological change is gaining steam.

• An aggressive but not completely unrealistic estimate says that nearly half (47%) of jobs in the United States are at risk due to automation or artificial intelligence.

• Many governments, especially state and local governments, are not ready for this transition. This affects a number of areas, including cyber security, jobs, and taxation. This will be a topic that unfortunately may not receive enough attention, but it will as technological advances begin to change the landscape.

Notes
1 See National Bureau of Economic Research data.
3 A 2017 McKinsey report estimates 31% of predictable physical work jobs will be lost between now and 2030.
4 See The Fragmentation of Society for examples in the mining, transportation, and health care industries in John Mauldin’s October 29, 2017 commentary.
6 Zemblanity is not in the dictionary yet, but its definition is commonly understood to be as described. Please also see 20 Words that aren’t in the dictionary yet.
11 Standard & Poor’s, Bond Insurers’ Capital and Liquidity Not Likely to Be Strained Due to Insured Issuer Credit Quality and Performance in the Wake of Irma and Harvey, September 20, 2017.