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ConnText Podcast

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TRANSCRIPT

State of the States with Karel Citroen, Managing Director and Head of Municipal Credit Research

Conning ConnText is a quarterly podcast that features our firm's view of capital markets, trends and investment strategies for the insurance industry, hosted by Rich Sega, Conning's Global Chief Investment Strategist.

[OPENING MUSIC]

SEGMENT 1 – OPENING

[Rich Sega (RS)]

Welcome all - it's a month into the third quarter of 2023 and it's been a long year for market participants already! I'm Rich Sega, hosting the Conning ConnText podcast from our Hartford Connecticut office. Today I'll be joined by Karel Citroen, who is managing director and head of municipal credit research here at Conning.

We've made it past some challenges this year: a threatened winter energy crisis and the debt ceiling fight are examples of such. Some are in remission but not completely done with; the stress on the banking system in the wake of the failure of several banks last spring comes quickly to mind. And others yet persist, with the toll of ever-expanding war in eastern Europe and, of course, inflation. Capital market returns have been remarkably resilient in the face of all this, with the S&P up over 18% year to date, NASDAQ well above 35%, and even bonds, despite rising rates, have turned in both positive nominal and excess returns across all sectors.

[FADE TO MUSIC]

SEGMENT 2 – ECONOMIC/CAPITAL MARKETS OVERVIEW

[RS] (Time stamp – 1:17)

As we wind our way through the third quarter of 2023, we find ourselves, our country, and the global economy still contending with the stubborn specter of persistent inflation. While it seems to be on the downswing, it's not over yet. Will the path that it's now on, along with the policy actions already taken, be enough to stop the Federal Reserve's Open Market Committee (the FOMC) from continuing to tighten financial conditions? This is a key question for investors in all segments of the capital markets as the risk of recession versus continuing the expansion hangs in the balance. The data is mixed, the street is unsure, the FOMC members are divided, and the investment community is apprehensive.

It took many months for U.S. inflation to peak in this cycle, rising from below 2% in 2019 to over 9% in June of last year. This has started to reverse, and while that's likely to continue to move lower year over year, it's probably not enough to convince the central bank to stop tightening.

After what turned out to be the June skip, the FOMC resumed pushing upward on its target rate.

Inflation certainly has been stickier than most market participants expected. The US money supply has been dropping for over a year and since money supply changes take effect with significant lags (12-18 months), inflation is likely to show signs of slowing in the next quarter or two. It's already started. The pace and degree of price responses to policy varies by sector so the path to the Fed's target is unlikely to be smooth or steady.

Recent labor market and housing data is conflicting and confusing, but the key question though is what the Fed will do with the information. Clearly from their statement and Powell's press conference comments, they believe the toll that inflation places on the whole population is more serious than causing a couple of million more unemployed individuals, so they will continue to raise rates until the unemployment rate approaches the mid-4% range, probably by first quarter of next year.

We think most central banks. including the Federal Reserve, will continue to lean toward fighting inflation versus supporting economic growth. That, combined with actions already taken, suggest a slowdown and possibly a mild recession toward the end of the year into early 2024.

[FADE TO MUSIC]

SEGMENT 3 – STATE OF THE STATES WITH KAREL CITROEN

[RS] (3:42)

Municipal bonds, both taxable and tax-exempt, have long comprised meaningful portions of insurers' portfolios. While seemingly isolated from many of the risks that directly challenge other credit sectors – threats like geopolitical conflict, currency fluctuations, and trade wars - they are surely not immune from the other stresses that markets and investors are facing such as inflation, demographic shifts, interest rate policy, and domestic politics. Again, I have with me, Karel, managing director and head of municipal credit research. I'll now invite him to talk about the $4 trillion municipal bond market.

Hi Karel, welcome.

[Karel Citroen (KC)]

Hi Rich.

[RS] (4:20)

Let's start by highlighting the headline conclusion of your recently published State of the States report, that we moved the 2023 outlook on state credit quality to "declining," a change from the "stable" outlook we've had since 2021. Clearly, we've ranked them so our analysis still shows a significant tiering of credit quality across the states, and we aren't suggesting that holders of state-issued bonds should worry about their positions. So how should municipal investors interpret that outlook?

[KC]

Well thanks again for having me back on the podcast.

For municipal investors, the State of the States can help identify areas of relative strength in the country. Generally speaking, reserve levels for the states have improved significantly since the Great Financial Crisis, with many states having their rainy-day funds reach all-time highs. This is an important credit metric to focus on for municipal investors because when a state's revenues come in below expectations, it might have to tap some of these reserve monies to pay bills. Cutting expenses for municipalities is hard to do because so much of the costs are labor and labor-related and those tend to be hard to reduce.

So, having said all that, our "Declining" outlook is based on the increasing signs that we are seeing that the extraordinary tax-revenue growth of the past few years will moderate. With high inflation keeping expenses up, we think this will pressure state budgets. And with easily half of the states having pushed through some sort of tax cuts, this could make things worse for some of those states in particular. Lastly, states benefitted from a lot of fiscal aid and a strong stock market, which boosted their pension funding ratios. These are all areas in which we expect conditions to decline.

And inflation is another aspect municipal investors should focus on, especially as it pertains to a state's tax climate. For example, inflation drove up the price of goods and services which, in turn, translated into higher sales-tax revenues for the states. The flip side of that is, with inflation dropping and all else being equal, the sales-tax revenue growth will likely decline. Similarly, the health of the financial and labor markets affect income tax collections; when they weaken it has an immediate impact on state income tax collections.

Back to your question about how municipal investors should interpret this. Well, based on our analysis of these aspects and more, the State of the States report can help a municipal investor identify states that might under- or outperform under various economic scenarios. For Conning, it's a key resource for us to evaluate municipal bonds.

[**RS**] (6:57)

Thanks for that perspective. Back in May there was a news story about New York City finances, a nearly $6 billion deficit going to over $7 billion next year. Similar news from other major cities around the country. Since local governments exist at the pleasure of the states, how do cities that have gotten themselves into deep financial trouble affect their state's finances?

[**KC**]

Well some of this has to do with the budget process and cycle for these cities.

Most municipalities must produce balanced budgets for a fiscal year that often runs from July 1 through June 30, and initial negotiations start several months prior to that start date. So when you think about where we were in January of 2022, and how that compares to how fiscal year 2023 played out, one can see why some revenue projections were too lofty, especially in New York City, one place that's heavily reliant on income taxes. With some of the finance industry-related layoffs and disappointing stock market returns in 2022, it made for some poor headlines for cities like New York.

But it is important to remember that audits for fiscal year 2023 are not available yet so the real impact has yet to be observed. Moreover, lots of what you see in the news should be discounted, as much of it is political posturing. In times when things are going well, some will want to lower tax rates or spend more money, while others will paint a more dire picture to avoid being pressured to do either.

Now, to be clear, the fiscal situation for some cites will be challenging going forward because of some of the beforementioned factors. Additionally, some are hit by working-from-home dynamics where people have been spending less money in urban centers than previously, causing sales-tax revenues to decline. Furthermore, a lot has been made of commercial real estate valuations and what that will do to property tax collections; this is something to watch, for sure.

[RS] (8:52)

We've long heard a lot about several states' debt and deficit problems, notably New York, Illinois, California, Connecticut, etc. But as noted in your report, there's not a strict delineation between so-called 'red' states and 'blue' states' economic performance. What are the most relevant drivers of state credit quality in today's environment that seem to bridge the politics of state government?

[KC]

One thing that comes to mind when you mention those states is that they have been hit the hardest by a combination of having a relatively large debt burden and then seeing many residents leave. This means that for the people that stay, the fiscal picture worsens: there are fewer residents to carry that significant financial burden. This is dangerous as you can see a snowball effect: a state might have to raise taxes or lower services and thus make living conditions even worse.

That is why we focus on where people move to, what a state's debt burden looks like, and what the different tax regimes are. Some of these patterns, such as people leaving the northeast for the southeast and mountain west states, we have observed for some time. But rather than look backwards, it is important to see what is going to happen going forward. Incoming residents may drive up housing prices and create issues of affordability, which we are seeing play in some states such as Utah. And other factors – like quality of schools, infrastructure, public services, weather, family, etc. – also determine people's decisions to live one place and not another and is something to be mindful of as a municipal investor.

[RS] (10:25)

So employment growth and labor market conditions are key contributors to states' results. Recently Rhode Island passed a law (state bill 427) making it more difficult for 'gig' workers, freelancers, and independent contractors to operate. These folks have been a significant player in the post-pandemic recovery and the work-from-home-or-anywhere demographic trend. As 427 has been cited as a potential model for other states to follow, what's your take on the possible impact on state employment dynamics and tax revenue?

[KC]

I think this is an example of states looking for additional revenue sources. An annual $50 designation fee is not necessarily that significant and it's not uncommon. For example, lawyers often pay multiples of that for a state-bar registration.

However, as you bring up work-from-home dynamics, it is fair to say that for some the question of where to live will come down to where regulations are most conducive to less oversight and a lower financial burden. I already mentioned affordability as it pertains to housing, but you are correct in pointing out that other regulatory issues could also impact the cost perspective.

And don't underestimate how important tax issues are to states – and taxpayers. For example, during the pandemic, New Hampshire sued Massachusetts, it's neighbor to the south, as the latter was levying income taxes on New Hampshire residents who had worked in Massachusetts but due to COVID-19 were now working at home. The Supreme Court didn't take up the case, but it is indicative of the sensitivity of the matter.

[RS] (11:58)

Thanks Karel. Changing focus a little bit, the recent banking crisis, stress and forthcoming possible regulatory response to that stress, accelerated an upward trend in price discounts and even foreclosures in offices, malls, and commercial real estate generally. Now as you mentioned earlier, commercial real estate is important to state revenues. Largely a local government issue, but how have you been sizing up the potential impact on city and county finances of a significant repricing of commercial property values?

[KC]

Yes, we have studied the reliance on commercial real estate taxes and the impact of stressed property valuations to see how cities could be affected by declining property values. For most, the reliance on commercial real estate property taxes is much less than their reliance on residential property taxes. Furthermore, it will take some time to see the impact materialize. For example, commercial property reevaluations might not take place for several more years.

Additionally, some local laws prevented assessed valuations from increasing to market values pre-pandemic, so their assessed values – which is what their taxes are based on - may be artificially low already. Even a significant market-value drop of 25% might not have much impact on the assessed value. This is all to say that we think the credit impact will be manageable, although negative for sure.

[RS] (13:24)

We've focused our attention so far mostly at the state level and a little bit at local governments, but there are far more issuers of water & sewer, public health, education, airports, and other subsectors than there are states. Where does the Conning team see value and opportunity amid today's volatility and uncertainty?

[KC]

Turning to the sectors, we are seeing opportunities in those most impacted by the pandemic. For example, health care and higher education issuers have borne the brunt of some of the pandemic-related headwinds, like inflation, labor shortages and business interruptions. But within these sectors we can still find excellent issuers of municipal debt. Similarly, airport and some transportation credits have done well and, although the positive momentum seems to have eased, we don't foresee a full sector slowdown anytime soon. We have talked about inflation and what that does to sales tax collections, and similarly we discussed income taxes, and those are some dedicated tax subsectors I would be careful with, making sure revenues are somewhat diversified and balance sheets are healthy.

SEGMENT 4 – CLOSE

[RS] (14:32)

Thanks Karel, for your time today, and to you and the team for producing Conning's insightful State of the States study.

We face several significant risks moving into 2023's second half:

1. A significant repricing of commercial real estate is possible as a fallout from the stress in the banking sector. About $1.5 trillion of commercial real estate debt is coming due in the next two years and almost two thirds is held by small and mid-sized regional banks, whose deposits and margins continue to be stressed by high competing interest rates.
2. A liquidity crunch is possible. The U.S. Treasury's General Account (TGA) has spent $400 billion over the first five months of the year, compensating for the halt in Treasury bill, bond, and note issuance during the debt ceiling conflict. The TGA must be replenished so that the Treasury can resume regular operations; the withdrawal of funds from the system drains liquidity.
3. There is always the risk of central bank overtightening. Sticky high inflation readings might compel the FOMC to tighten past the equilibrium point and precipitate an even more serious economic slowdown than is already likely.

Thanks for listening in on our discussion.

We hope this information is helpful and we always welcome your feedback and questions. You can get messages to us through your relationship manager, your portfolio manager, or send them directly to us at ConnText@Conning.com (that's ConnText w/ 2 Ns).

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