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MUNI OUTLOOK FOR 2017: CALM BEFORE THE STORM?

December 29, 2016

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Economists indicate that the December 2007 Recession ended in the 2Q of 2009, even though many of us felt the recession lasted far beyond that. So then why are some U.S. governments (like Illinois, Chicago and the Chicago Board of Education) not making hay before the next recession, but instead are reeling from deficits?

The deficits and fiscal stress are all self-inflicted wounds, coming from governors, legislatures, mayors and councils. The pattern is almost always the same: when revenue shortfalls occur, elected politicians are reluctant to balance budgets with tax hikes or spending cuts.

New Jersey, Connecticut and Illinois have already seen downgraded bond ratings, which usually would not occur until there was a recession. And while California is riding high now, sudden budget deficits and unplanned increases of short-term borrowing have caused California's bond ratings to bounce like a "yo-yo" over the last 35 years. To me, California's cash flow is usually a leading indicator that rating downgrades on other state and local governments are about to accelerate.

Before I depress all of my readers, let me assure you that the great majority of state and local governments prepare for recessions well before they occur. So despite the muni market's "trouble children", most local governments are well managed and well "behaved". So let's go to key issues:

1. Was Meredith Whitney correct in her 2010 forecast of hundreds of billions of debt going into default?
2. Puerto Rico will have wide-scale defaults, but recovery values will be better than current prices in the market;

3. Illinois, Chicago and the Chicago Board of Education will avoid defaults;
4. Tax exemption for municipal debt will stay intact; this facility is crucial if demands for infrastructure repair, improvement and expansion can ever hope to succeed;
5. Rising interest rates will not be positive for state and local revenue, and raise the specter of a recession within the next two years;
6. If recession grips the economy in 2017, state and local budgets and deficits may not occur until 2018, a natural lag because of the timing of tax receipts for income and property taxes; and finally
7. The President Trump Factor.

Was Meredith Whitney correct in her 2010 forecast of hundreds of billions of debt going into default?
Not even close. Puerto Rico and Detroit, the two largest entities in bankruptcy, present a combined default of less than $100 billion since 2010, even in Puerto Rico's worst case. And defaults industry-wide have been average to below average since 2010. Bankruptcies by cities in California hardly make a dent in a debt market that has been estimated to be as large as $3.7 trillion.

<u>Puerto Rico will have wide-scale defaults, but recovery values will be better than current prices in the market</u>

I believe that the new Promesa Control Board over Puerto Rico will keep finances from getting worse, but since they don't have hired expertise to guide their decisions, Puerto Rico faces a rocky road. The new Governor has already indicated there are no funds available to repay debt; I believe this is political posturing, like making a bluff in a poker game. Recently, he proposed that the Government Development Bank should be shut down, a suggestion I made in August 2016, and reprinted in Barrons magazine on September 24.

I am disappointed so far by the new Control Board, because it seems to be running by the seat of their pants. Their last formal report was full of platitudes, and short on detail. I believe any eventual restructuring will yield higher prices for Puerto Rico debt than currently seen in the market right now. The reason? Puerto Rico cannot maintain any form of economic or political stability without being able to borrow money. And the Control Board is charged with positioning Puerto Rico to be able to return to the bond market for normal needs. Both bode well for recovery of losses if Puerto Rico continues to default on its debt.

It's also interesting to see that the Electric Authority (PREPA) just announced it will pay 100% on January 3rd. Most believed they would be the first Puerto Rico default. With massive fuel cost savings in the last 2 years, there is no compelling reason for PREPA to default.

<u>Illinois, Chicago and the Chicago Board of Education will avoid defaults</u>

Chicago Board of Ed's problems stem directly by budget impasses at the state level. The City of Chicago has now adopted measures that will keep their unfunded pension crisis at manageable levels. Finally, it is unfathomable that a state like Illinois, with its sovereign powers over taxation and spending, would be the first state to default since Arkansas in the 1930's.

<u>Tax exemption for municipal debt will stay intact; this facility is crucial if demands for infrastructure repair, improvement and expansion can ever hope to succeed</u>

President-elect Trump has indicated that infrastructure will be a main priority for his administration. But it is unrealistic to believe that bureaucrats in Washington can propose or implement projects that are local in nature, like roads, bridges, jails and the like. Tax-exempt bonds issued by local governments remain the most cost-efficient way for diverse local governments, from Hawaii to Maine.

Rising interest rates will not be positive for state and local revenue, and raise the specter of a recession within the next two years

Common opinion has been that the U.S. recovery since 2009 has been fragile and spotty in the various regions of the U.S. While raising interest rates is the main federal tool to prevent inflation, it is only effective by curbing demand. I'm not predicting a recession, but higher interest costs on an economy that struggled even when rates were at all-time lows will certainly dampen U.S. job creation.

If recession grips the economy in 2017, state and local budgets and deficits may not occur until 2018, a natural lag because of the timing of tax receipts for income and property taxes

It's just normal that a recession will create budgetary problems for state and local governments. In most cases, it could be a year or more before states have severe budget shortfalls. It has to do with the timing of property taxes due, and the timing of sales tax collections and the due dates for state income taxes (usually April 15). I believe that receipts coming in through June 30 2017 will be mostly on the mark. But looking out until 2018, it would be likely that sales tax collections would be the leading indicator of fiscal distress. In my experience, covering California since 1978, revenue shortfalls and the need to do unplanned short-term seasonal borrowing would be the leading indicator of rough seas for state and local governments across the nation.

The President Trump factor

No predictions here, as President-elect Trump has clearly said he intends to be unpredictable. I believe he wants to be active in helping state and local governments maintain and improve the nation's infrastructure. I also believe that he is not likely to push to cancel tax-exempt financing for state and locals, because it has been the biggest driver of important public works projects since the New Deal of the 1930's. Federal aid to local K-12 education has never been significant, and I don't see it rapidly expanding in a Trump Administration. Proposed changes or the elimination of "Obama Care" will be difficult to predict, since the old program barely got off and running long enough to make meaningful long-term projections of health care costs, both to individuals as well as health care providers.

The real problems won't come until 2018.

Rising interest rates will begin to dampen economic activity, but severe budget deficits at the local level usually lag a recession by 6-12 months. My expectations for credit and potential defaults in 2017 will follow normal trends of less than $10 billion per year (in a market of $3.7 trillion of outstanding municipal debt), and that defaults by the like of Detroit and Puerto Rico will not be seen anytime soon, not even in the transition year of 2018. But 2018 could be a sieve which could test municipal bonds' reputation as the "second safest investment after U.S. Treasury debt.

(Do we want some blurbs on specific sectors like tobaccos, IDBs, Healthcare, senior living , can 2017 volume even come close to the record of 2016 (MY ANSWER: NO)

About the Author

RICHARD P. LARKIN, Stoever Glass & Co., Inc.

Richard Larkin, a recognized 40 year industry veteran, has joined SG & Co. as Director of Municipal Credit Analysis. Mr. Larkin began his career in credit rating analysis at Standard & Poor's in 1975. After rising through the ranks in various analytical and management positions, Dick left S&P as its Chief Municipal Rating Officer, responsible for municipal rating policy, practices, governance and criteria. In 1998, Mr. Larkin joined Fitch Ratings as Chairman of its Public Finance Criteria Committee.

"Dick will be a unique resource to Stoever Glass' municipal clients. His knowledge in specific issues and areas of the municipal bond industry will aid our representatives and their clients in making educated decisions, in a sector where this type of research is unique," said Roland Stoever of Stoever Glass.