NORTHERN TRUST
ASSET MANAGEMENT

2023 MUNICIPAL BOND CREDIT OUTLOOK

EVEN WITH A U.S. ECONOMIC SLOWDOWN, MUNICIPAL BOND ISSUERS LIKELY TO PROVE RESILIENT

Since the onset of the pandemic, most municipal bond issuers have recovered substantially, supported by robust increases in revenues and cash reserves along with federal aid. Looking forward, we believe this will broadly help issuers to maintain stable credit ratings as they may lose revenue in the coming year while the economy moderates or possibly enters recession.

In 2023, we expect slowing economic growth that potentially could turn into recession, especially if inflation proves persistent and employment falls. Deteriorating economic conditions will likely drive down revenues while persistent inflation pushes expenses higher. We think key tax revenue streams will pull back from the record-high growth in 2022 because of a sputtering economy. Further, investment losses from 2022 may have weakened pension funds, forcing issuers such as states to increase cash contributions to pensions.

Even as these challenges mount, we think the majority of issuers have built up sufficient cash reserves to overcome or survive them intact. With the exception of higher education and healthcare, we see stability across most municipal bond sectors to support the credit quality outlook for 2023 (see Exhibit 1).

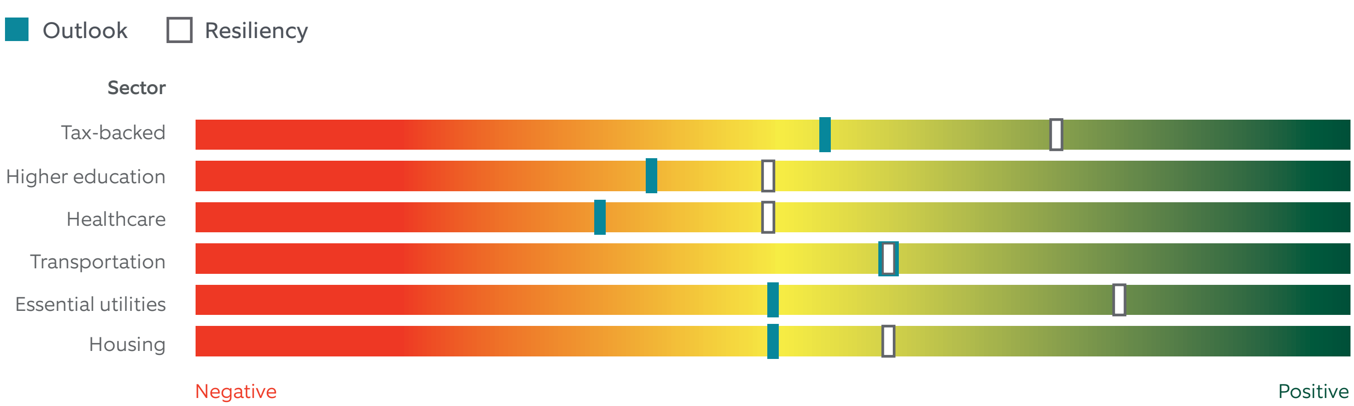
Key Takeaways

- Our municipal bond credit quality outlooks for sectors have generally shifted closer to stable for 2023 from a more positive stance in 2022.
- Deteriorating economic conditions will likely drive down revenues while persistent inflation pushes expenses higher for municipal bond issuers.
- Even as challenges mount through 2023, we think the majority of issuers — having built up sufficient cash reserves — will exhibit resiliency.

EXHIBIT 1: CREDIT OUTLOOKS MIXED WHILE RESILIENCY REMAINS SOLID

While we set the credit outlooks for most municipal bond sectors as stable or positive, healthcare and higher education have weaker outlooks due to sector-specific challenges.

NTAM 2023 Credit Outlooks and Resiliency Assessments by Sector



Source: Northern Trust Asset Management, as of January 2023. The tax-backed sector includes states, municipal governments and school districts.

TAX-BACKED (STATE AND LOCAL GOVERNMENTS & SCHOOL DISTRICTS)

Outlook

The slowing economy likely will cut into tax collection (see Exhibit 2) to dampen revenue growth from record levels for tax-backed issuers such as states, local governments and school districts. Still, we expect strong resiliency (see below) to offset the potential revenue decline, resulting in a stable credit outlook. Income tax revenue may decline because of weaker investment returns in 2022 and the potential softening of the labor market throughout the year. We see a mixed outlook on sales tax receipts, with likely lower consumer demand offset some by higher prices because of inflation. We think the routine lag in property assessments may aid property tax revenues, as assessment cycles are not likely to capture price corrections in some areas in 2023 collections. This could provide stability for local governments reliant upon property taxes.

Resiliency

Despite the step back in revenues, we expect credit quality to remain stable as the majority of tax-backed issuers are benefitting from substantial cash reserves sufficient to weather economic headwinds. We expect issuers to draw down their cash reserves to support spending, with the magnitude dependent on the length and severity of a potential economic downturn.

High Yield Outlook

The deteriorating economy could exacerbate risks to chronically stressed high yield issuers. As federal stimulus fades, we believe weaker issuers will wrestle again with long-term challenges associated with demographic changes, pension burdens and inadequate spending controls.

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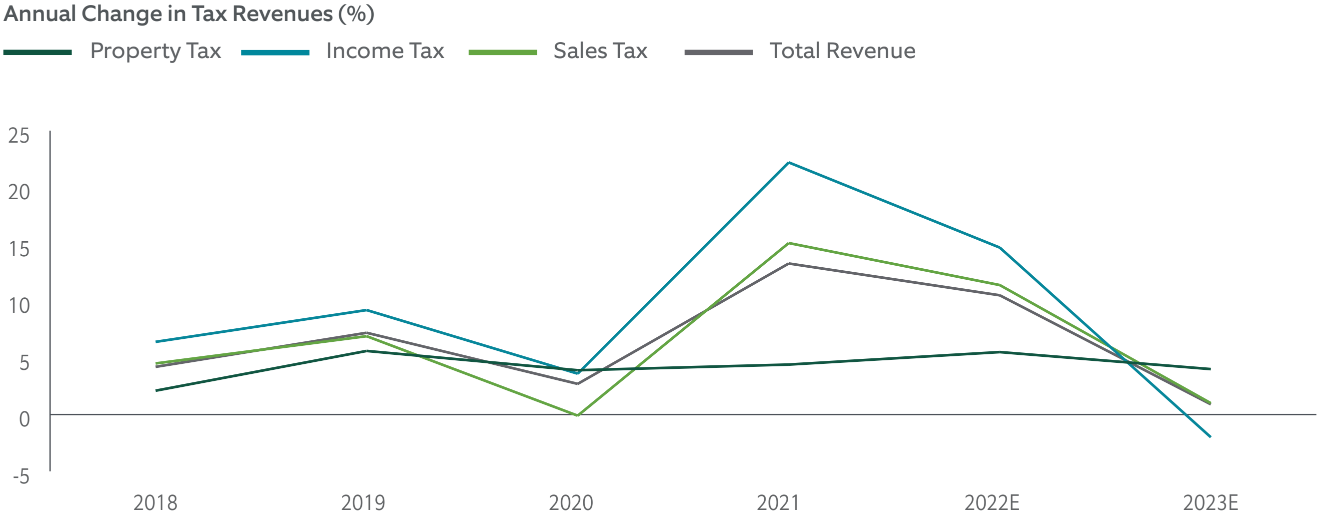
EXHIBIT 2: A SLOWDOWN IN TAX REVENUES

A potential decline in income tax revenue while the economy slows may drag down total tax revenues for issuers.

Annual Change in Tax Revenues (%)



Source: Northern Trust Asset Management, U.S. Census Bureau. Data as of June 2022. Data for 2022 and 2023 are estimated.

HIGHER EDUCATION

Outlook

While admission-selective public and private institutions are enjoying healthy enrollment demand, regional public universities and small, lesser known private colleges remain vulnerable. This results in a slightly negative credit outlook. As Exhibit 3 shows, enrollment challenges persist, particularly in the Northeast and Midwest. Declining high school graduation rates and slower population growth in some regions translate to heightened competition for a declining pool of applicants. We expect net tuition revenue growth to fall below inflation, with some schools projecting a decline because of competition and lower enrollments. We think strong state government revenue recently will provide stable funding for public universities, but support could dampen if state tax revenues decline more than expected in 2023.

Resiliency

We think the majority of institutions will struggle with recent investment losses in their endowments and net tuition growth that falls short of inflation-induced higher expenses. This may temper resiliency in the sector.

High Yield Outlook

We expect credit deterioration for lower rated issuers because of pressures on enrollment and pricing, as demand for a college education is falling short of supply in certain regions.

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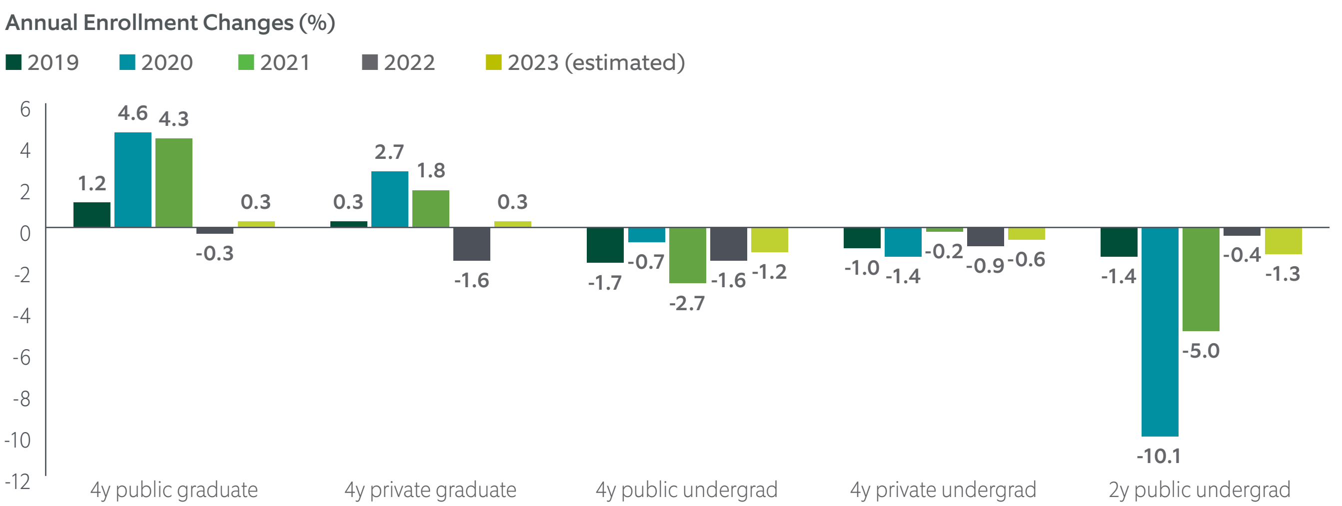
EXHIBIT 3: DECLINING ENROLLMENT DAMPENS CREDIT OUTLOOK

Some colleges are struggling with lower enrollments because of lower high school graduation rates and competition, dampening the credit outlook for higher education.



Source: Northern Trust Asset Management, National Student Clearinghouse Research Center. Data is based on graduate and undergraduate fall enrollments for four-year public and private colleges, and two-year undergraduate public colleges, as of September 29, 2022. Data for 2023 are estimated.

HEALTHCARE

Outlook

The credit outlook for hospitals is negative as we believe they will struggle with lower profit margins (see Exhibit 4). Revenue growth may be subdued as hospital admissions are still below pre-pandemic levels and we don't expect a material upswing while the payor mix continues to shift towards lower-reimbursing government payors. Expense growth may outpace revenue as labor shortages and wage increases persist. Still, we see some moderation in the cost and usage of expensive temporary traveling nurses as spikes in the number of pandemic patients wane. We project cash reserves to come down from all-time highs because of investment losses and repayment of Medicare advanced payments that temporarily boosted balance sheets.

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Resiliency

Hospitals have demonstrated resiliency throughout the pandemic and continue to adjust to a tough environment. Larger hospital systems with geographic diversity, strong balance sheets and solid management likely are more equipped to handle these challenges.

High Yield Outlook

We expect occupancy levels among senior living centers to fluctuate following the pandemic, while they also grapple with staffing issues including a shortage of nurses.

EXHIBIT 4: A PROFIT PENDULUM

Hospital profit margins dropped in 2022 following a pandemic-induced spike. Margins may rise in 2023, but likely still short of pre-pandemic levels as staffing expenses rise.

Hospital Operating Margin (%)

Source: Northern Trust Asset Management, Merritt Research Services, data as of December 2022. Data for 2022 and 2023 are estimated.

TRANSPORTATION

Outlook

The credit outlook is slightly positive as passengers are returning to travel (see Exhibit 5) while the pandemic has waned. Airport and toll road traffic volumes improved markedly in 2022 with some regions exceeding pre-pandemic levels. Mass transit improved as well, but volume remains well below pre-pandemic levels.

In 2023, we expect more moderate growth for all three sectors. With the possible slowing economy, we think higher unemployment and less discretionary spending will slow the pace of growth in business and leisure air-travel demand. We believe healthy cash balances among air-travel issuers will provide a cushion should volumes unexpectedly decline. For toll roads, revenue remained stable in 2022 despite higher gas prices, though a slowing economy would likely dampen toll road volume in 2023. We expect commuter rail ridership recovery to continue in 2023 with increased return-to-work, but remain significantly behind pre-pandemic levels. A continued increase in employees returning to the workplace may offset any decline in ridership because of higher unemployment.

Resiliency

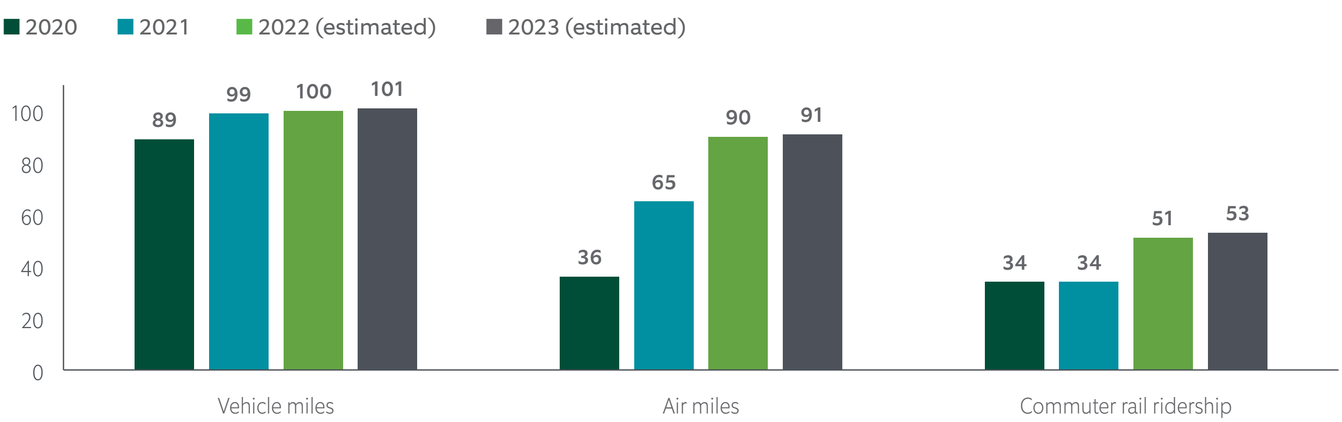
We think robust cash reserves and more federal support bolster sector resiliency. Airlines and airports both may benefit from cohesive working relationships that often strengthened through the pandemic.

We believe healthy cash balances among air-travel bond issuers will provide a cushion should air travel unexpectedly decline.

EXHIBIT 5: A RETURN TO WORK AND TRAVEL

As the overhang from the pandemic has lightened, people are returning to air, car and train travel in increasing numbers.

Vehicle Miles, Air Miles and Rail Ridership vs. Pre-Pandemic (% of 2019 total)



Source: Northern Trust Asset Management, Federal Highway Administration, Department of Transportation, American Public Transportation Agency. Vehicle and airline data are as of August 2022 and commuter rail data are as of June 2022. Data beyond June 2022 are estimated.

ESSENTIAL UTILITIES

Outlook

We have a stable credit outlook supported by strong sector resiliency. Utilities are enjoying steady residential demand, healthy cash balances and strong federal infrastructure spending despite spending pressure from aging infrastructure and more stringent regulations. We think the move toward renewable energy sources will continue. However, the rapid pace is likely to slow despite federal incentives as providers contend with higher costs. We expect utilities to balance their desire to introduce cleaner energy sources with maintaining adequate capacity to serve customers. Climate and cyber-security challenges present key longer term risks.

Resiliency

Essential utilities historically have exhibited strong resiliency and lower sensitivity to economic cycles. The often monopolistic position, low price sensitivity and independent rate-setting authority provide strength and stability to the sector.

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HOUSING

Outlook

We hold a stable credit outlook. We expect State Housing Finance Agency (HFAs) programs to absorb potential loan losses if the economy weakens, but declining housing affordability and limited housing supply may constrain the sector. Higher mortgage rates, elevated home prices and inflation likely will slow down sales and loan origination. However, HFAs' ability to offer mortgage loans with lower interest rates than conventional mortgages and strong demand for affordable rental housing will probably benefit HFAs. Loan delinquencies have fallen to near pre-pandemic levels, though we expect a moderate increase in 2023 with a slowing economy. We project improved margins as HFAs hold substantial short-term investments with higher yields to bolster investment earnings. HFAs also have healthy levels of over-collateralization to absorb any losses.

Most State Housing Finance Agencies (HFAs) maintain strong financial positions and high cash balances, which we believe provide resiliency against delinquencies.

Resiliency

Most HFAs have strengthened their portfolios by adding mortgage-backed securities and government insurance, which we think will make them more resilient against delinquencies than during the 2008 housing crisis. Additionally, they maintain strong financial positions and high cash balances.

High Yield Outlook

Sharp increases in mortgage rates coupled with concerns about affordability increase the risks of dampened demand for speculative land districts that require sales of new homes. Retail, office and commercial development districts likely will be further stressed as occupancy still remains in flux since the worst of the pandemic.

CONCLUSION: SHIFT TO A STABLE OUTLOOK

Our municipal bond credit quality outlooks for sectors have generally shifted closer to stable for 2023 from a more positive stance in 2022, given our most likely economic scenario calls for slowing growth and persistent inflation. However, with the pullback in outlooks, we believe the majority of sectors remain well-positioned to withstand a moderate slowdown in growth as they have built up strong resiliency over the past few years.

LEARN MORE

Visit our website to learn more about municipal bond investing at Northern Trust Asset Management.

How helpful was this paper?

DEFINITIONS

Outlook: The outlook for each municipal sector reflects our opinion on whether key macroeconomic and sector-specific factors will be predominantly supportive or challenging for the sector's fiscal health in the next 12 to 18 months. Individual outlooks reflect our base case expectation — modest general economic growth in the short term — as well as unique sector-specific factors and trends. The outlook does not reflect an issuer's ability to navigate these macro factors, nor does it suggest credit trajectory or rating movement for any individual issuer. The sector outlook considers all issuers in the sector, but is also weighted by market presence. For example, the state of California (the largest issuer in the market) will affect the state outlook more than Nebraska (one of the smallest issuers in the market).

Resiliency: Resiliency reflects a sector's relative ability to withstand a material economic downturn within the outlook's timeframe. This view specifically considers historical and projected revenue volatility, elasticity of market demand, flexibility of operating costs, fixed cost burden and current reserve position relative to projected need.

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