

U.S. Municipal Bond Market

The Virus Strikes Back: Our Municipal Credit Outlook in the Face of COVID-19's Fourth Wave

- The fourth wave of COVID-19 infections is here. We considered this a potential development in March when we raised many of our municipal sector outlooks. We are not making changes yet, but could depending on the severity of this fourth wave and what a fifth wave looks like in the fall.
- The municipal credit backdrop has continued to stabilize. Moody's public finance rating upgrades outpaced downgrades again the second quarter of 2021. We believe a near-term floor exists for many general obligation credits and revenue sectors could be questioned if economic activity stalls, but ultimately, we believe the worst is behind us. If the worst from COVID-19 is in fact behind us, municipal credit should remain solid. Uncertainty exists, however. If the fourth or fifth wave of COVID-19 is severe it could pose some headwinds.

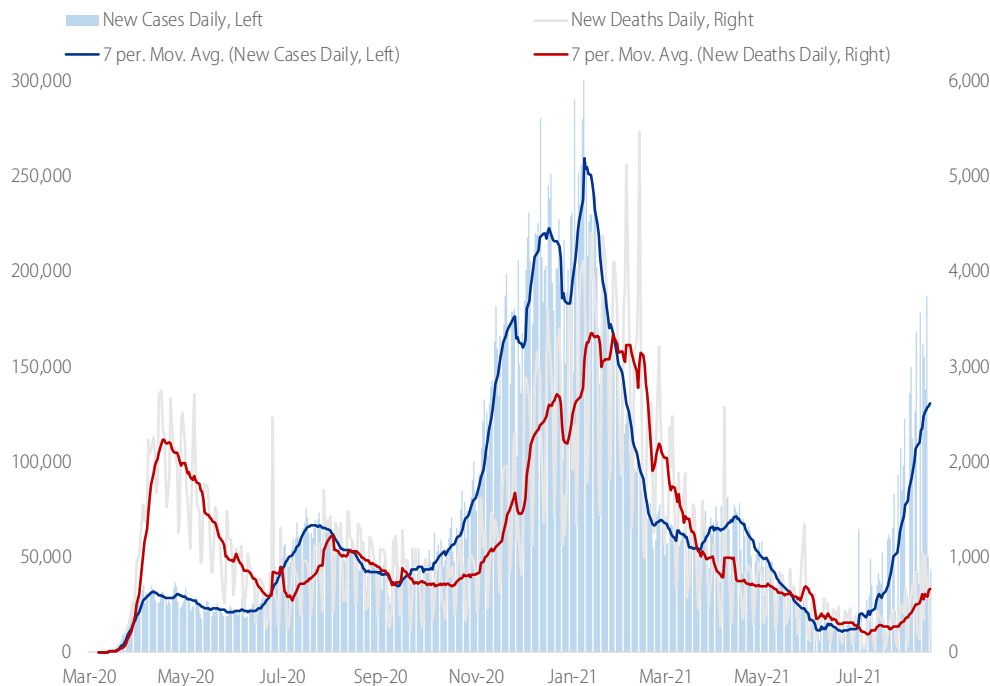
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The Fourth Bullet Point

Going into the second quarter of 2021, investor, consumer, and observer sentiment were understandably constructive, if not downright optimistic. COVID-19 vaccines were widely available after Operation Warp Speed, a partnership between the U.S. Departments of Health and Human Services and Defense, helped accelerate the development and manufacture of COVID-19 vaccines.

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Rising COVID-19 Cases and Deaths in the Delta Fourth Wave



Source: New York Times and HilltopSecurities.

Please see disclosure starting on page 2.

The result was the widespread accessibility of three COVID-19 vaccines from Johnson & Johnson, Moderna, and Pfizer beginning in the summer of 2021 to those over the age of 12.

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After the Democrats took both Georgia run-off seats in January, lawmakers in Washington moved quickly to execute [their legislative agenda](#). A sixth round of COVID-19 relief totaling \$1.9 trillion was passed by the Democrats through budget reconciliation and signed into law by President Joe Biden on March 11, 2021. It was referred to as the [American Rescue Plan Act of 2021 \(Rescue Plan\)](#). The Rescue Plan, among other spending items, included \$650 billion for public finance sectors ([see page 5 of this report for details](#)).

The passage of this legislation was a significant boost to state and local governments and other public finance credits; so much so near the end of the first quarter of 2021 that we wrote about the potential for a [“golden age” for U.S. public finance](#), and that [We Expect a Multi-Year, But Potentially Temporary, Upswing of U.S. Municipal Credit](#). In the last bullet point we included in report’s summary, we included a point of caution: **“It may be necessary to reevaluate our outlook assignments if a significant fourth wave of new COVID-19 cases, hospitalizations, and deaths develops.”**

The Fourth Wave

The fourth wave of COVID-19 infection is here. We have addressed this development in the following HilltopSecurities commentary this month: [Consumer Sentiment Dives to Decade Low](#) (Aug. 13), [The Seriousness of the Delta Surge](#) (Aug. 10) and [Jobs Coming Back, Yet Spread of Delta Variant Challenges State and Local Jobs Recovery](#) (Aug. 6).

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Vaccines have been available for months, but only 51% of eligible Americans are fully vaccinated, according to New York Times data. The daily average number of cases has risen 47% over the last two weeks, totaling 140,893. The last time daily cases reached this mark was in February 2021. Hospitalizations are up 56% in the last two weeks and the daily average is 85,118. The number of deaths is 97% higher over the last two weeks with a daily average of 809. There have been a few individual days where deaths eclipsed 1,000. We have not seen a string of days with 2,000 or 3,000+ deaths like we saw in the worst of the third wave of January 2021, but the trajectory is steep and rising. It is encouraging that the current rate of increase is not as steep as even the beginning of this week. Hopefully, this indicates that activity is beginning to level off.

Currently, the fourth wave is being dominated by the Delta variant. This is a very different and worse virus than initial variants in that it is more contagious and more impactful to children. This is even more disturbing when considering the vaccination age limit of 12. This week (Aug. 18), the Centers for Disease Control and Prevention [announced booster shots will be available in the fall](#) for those who originally received the two-shot Moderna and Pfizer vaccines.

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Mask Mandates

One way some lawmakers are trying to suppress the spread of the Delta variant is by reinstating mask requirements. Several cities and schools have re-required them in recent weeks. We have written about the mask mandate conflicts in [Growing Support for Masking in Schools, Legal Battles May Ensure](#) (Aug. 5) and [Florida Governor Threatens School Funding if Mask Mandates Remain](#) (Aug. 2). This is becoming an issue in other states as well.

We do not yet think it is time to make changes, but we are watching to see how the dynamic from the fourth wave develops and have made a few important notes sector by sector in the below table.

Reevaluating Municipal Sector Outlooks

We are reevaluating the outlooks we assigned to our municipal sectors in March 2021. We do not yet think it is time to make changes, but we are watching to see how the dynamic from the fourth wave develops and have made a few important notes sector by sector in the accompanying table.

No Changes to HilltopSecurities' Municipal Sector Credit Outlooks Yet

Sector	Hilltop Credit Outlook	Recent Action (March 2021)	Key Sector Trends (Updated to Reflect Delta Variant Themes)
State Government	Stable	Raised two notches	Revenues did not plummet as some forecast last year and they are unlikely to this year. Income tax receipts were more resilient than expected, and should continue to be. \$200 billion-plus of federal aid is flowing directly to states. We do not see evident cracks in state credit at this time.
Local Government	Stable	Raised two notches	AV growth has been surprisingly strong through COVID, \$150 billion plus will flow directly to local govts. We do not see evident cracks in local govt credit at this time.
School Districts	Stable	Raised two notches	AV growth has been surprisingly strong through COVID, \$129 billion plus will flow directly to schools. Schools ability to manage infection will not just have a local impact, but will have a larger economic impact too. The U.S. economic comeback could be at risk if primary and secondary schools are forced to move to a virtual format, even if this happens to just large regions or large schools.
Airports	Stable	Raised two notches	Enplanements have not been impacted from the Delta variant yet. It would have taken years for enplanements to ramp up to pre-COVID levels.
Health Care	Negative	None	Health care could be the sector most negatively impacted by the fourth Delta-wave. Elective procedures have been put on hold again in hospitals in the south. This will impact profits and labor costs will increase. We will have to see how big of an impact this has regionally and nationally and if this continues into the end of 2021 with a 5th wave to close out the year.
Higher Education	Private: Negative Public: Cautious	Raised Pub Sect Outlook	College campuses in the north, midwest, northeast, and far west U.S. could be among the safest locations from COVID-19 infection because many of them are requiring students, faculty and staff to be vaccinated. How campuses and inter-colligate sports are able to manage the spread of infection will go along way in determining if students can stay in-person in the Fall (2021) and Spring (2022).
Housing	Positive	Raised	Strong relative value in this sector. State Housing Finance Agencies (HFA) were less impacted than other sectors. We expect housing demand to continue & credit of HFA programs to remain strong.
Public Power (Elec.)	Stable	None	Recovery to 2019 usage levels could take years but federal support has provided a base, we expect infrastructure focused stimulus could provide a boost to the sector, if it occurs.
Tobacco	Negative	None	MSA numbers were slightly higher in 2020 YOY, we continue to expect more downside risk in this sector going forward, near term federal funds could offer some positive retail sales numbers.

Continued below

Toll Facilities	Stable	Raised two notches	Vehicle miles traveled fell to 2004 levels, and we were already seeing usage increase before Delta variant emerged. We are looking closely to see what happens here.
Water and Sewer	Stable	None	Essentiality remains important driver, one of the approved uses of the Rescue Act funds is for water and sewer infrastructure, additional relief could come from potential infrastructure stimulus.

Source: HilltopSecurities.

Municipal Credit Quality in Last Half of 2021

What is the direction for municipal credit quality in the second half of 2021 considering the rise of the Delta variant?

Let's review the first half of 2021. The municipal credit backdrop has continued to stabilize in the second quarter compared to 2020. Moody's public finance upgrades outpaced downgrades again in the second quarter of 2021 122 to 35, per data released on Aug. 13. This is the second consecutive quarter upgrades have outpaced downgrades. This is likely to continue for the rest of 2021. We think that overall municipal credit is strong going into the last half of 2021. The amount of federal relief thrust into public finance is offering a near-term floor to many general obligation credits. A problem for fiscally-challenged credits is that the one-time federal money may make their balance sheets look strong now, but structural imbalances will return without multi-year structural changes to budget plans. This is an issue to be aware of going forward.

There is some uncertainty going into the last half of the year, despite the positive backdrop. We want to monitor the fourth wave of COVID-19's severity (as noted above) and if there is potential for a fifth wave toward the end of 2021. The vaccination rate is an important factor. It rose only slightly to 51% from 50% over the last few weeks. This is not as positive of a change as we would have liked to see. Whether schools stay in-person in the fall and spring will have a direct relationship to the continuation of the U.S. economic recovery, and we think this is an underappreciated connection. If schools go virtual again, it will make it even more difficult for business to return to its new normal.

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Recent HilltopSecurities Municipal Commentary

- [What Could “Irreparable Harm” Look Like if Lawmakers Fail to Extend or Suspend the Debt Ceiling Limit?](#), Aug. 12, 2021
- [Jobs Coming Back, Yet Spread of Delta Variant Challenges State and Local Jobs Recovery](#), Aug. 6, 2021
- [Growing Support for Masking in Schools, Legal Battles May Ensnare](#), Aug. 5, 2021
- [Florida Governor Threatens School Funding if Mask Mandates Remain](#), Aug. 2, 2021
- [Lawmakers May Exploit the Debt Ceiling Limit Again](#), July 22, 2021
- [Fitch Ratings Questions U.S. Governance, Identifies a Breakdown in Political Norms](#), July 16, 2021
- [Our Revised 2021 Municipal Issuance Forecast: \\$460 Billion](#), July 15, 2021

Readers may view all of the HilltopSecurities Municipal Commentary [here](#).

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