APPLETON PARTNERS, INC.

MUNICIPAL CREDIT OBSERVATIONS

AUGUST 19, 2020

As Labor Day approaches, the financial markets are nearly five months out from the depths of March. Market conditions across nearly all major asset classes have improved dramatically, aided by Federal policy support and a more positive forward outlook, yet COVID-19's path and its economic ramifications remain highly uncertain. In May we wrote about municipal credit quality and how Appleton was seeking to separate risk from opportunity. Our stance remains the same – a diligent research process is key and we believe our longstanding preference for high quality and well-established issuers will serve well in the current environment. With that being said, trepidation lingers as state and local entities struggle to manage budgetary challenges, and the prospects for additional Federal aid are caught up in election year political negotiations. Against this backdrop, let's look at the state of municipal credit.

Strained Budgets and Cloudy Forecasts

Fiscal challenges abound as economic restrictions have led to a flood of job losses and business closures that have compromised state and local government sales, income and other taxes. Today's environment is marked by many unknowns and 3rd party forecasts of total state and local revenue declines through FY 2021 vary widely as depicted in the accompanying chart. On an annualized basis, the average projected budget gap is roughly 10%, a sizeable yet not insurmountable hit.

Total State & Local Revenue Shortfall	Combined FY20-FY21 ($ billion)
Low Estimate	$234.8
Average Estimate	$384.9
High Estimate	$765.0

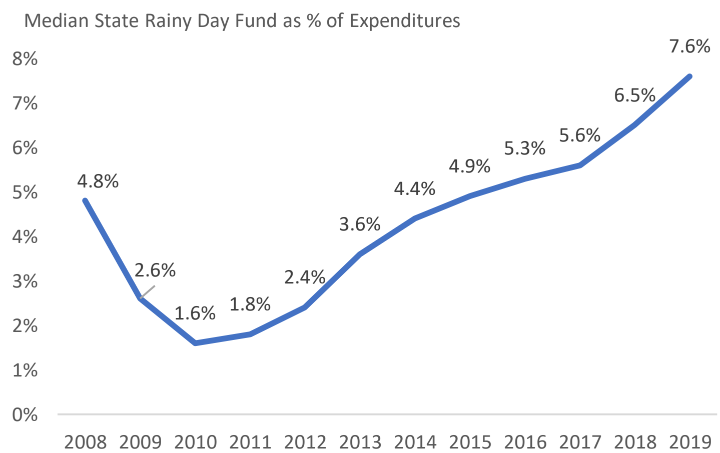
Source: Tax Foundation, Cleveland Federal Reserve, Barclays, JP Morgan, Center on Budget and Policy Priorities, Moody's Analytics, National League of Cities, National Association of Counties

At the state level, an extension of income tax filing and payment deadlines from April 15th to July 15th exacerbated this spring's negative budget headlines. State tax revenues had dropped 49.4%.

YoY in April, although as deferred personal income tax payments began being collected comparisons have steadily improved. May's average YoY shortfall was reduced to -20.9% and recent data released by The Urban Institute indicates that the June revenue decline was -12.8% YoY. Revenue trends should continue to modestly improve as economic activity returns despite further expected COVID-19 flareups and reopening setbacks. Nonetheless, difficult budget decisions will still be necessary.

Fortified Balance Sheets Are Helping to Weather the Storm

It bears reemphasizing that most state and local governments entered this crisis from a position of strength. Nine years of economic expansion produced steady growth in tax collections. State "rainy-day" funds collectively increased to $72 billion and median balances relative to annual expenditures reached 7.6% in 2019. These reserves offer a cushion that is now being drawn upon in these tough times.



Source: National Association of State Budget Officers, Fall 2019 survey

Municipal deleveraging has also been evident. Net state tax-supported debt increased by only 4.7% from 2010 to 2019, while average debt expense relative to total budgets stood at a modest 3.8% at the close of FY 2019. At the local government level this figure was higher, but still a manageable 8.9%. The implication is that disciplined fiscal management, an attribute we carefully assess when evaluating issuer credit quality, is benefiting fiscally stronger state and local governments when they need it most.

The Value of Fiscal Flexibility

State and local governments generally have a much greater ability than corporations to realign revenues and expenses during challenging times. During the Great Recession of 2008-2009, 33 states enacted tax measures that helped offset revenue shortfalls. These included increases in tax rates, expansion of taxable items, and elimination of tax credits, deductions and exemptions. On the other side of the equation, 42 states cut spending in 2009 and 2010. While such decisions are often unpopular, state and local governments possess many fiscal tools that can help balance budgets. While today's budget issues are acute, in any economic environment we carefully assess a municipality's fiscal flexibility based on factors such as revenue diversity and sustainability, balance sheet strength, and management experience.

Municipal Credit Observations

Not All Revenue Is Created Equal

Stark revenue distinctions must be understood to properly evaluate credit risk. Given the nature of the current downturn, anything associated with leisure – hotel taxes, car rental fees, food and beverage taxes – has experienced significant revenue declines. The extent to which these tax sources return is highly dependent on economic momentum.

Conversely, property taxes, a more resilient revenue source accounting for about 80% of local government inflows, increased 3% during Q2 on a YoY basis according to the Bureau of Economic Analysis. Maintaining current payment status is a high priority for most businesses and homeowners, while declines in home value assessments are typically implemented with a 1 to 2-year lag.

Personal income taxes are also less vulnerable than leisure and travel related revenues and recently collected deferred receipts have provided a much needed liquidity boost. California provides a weekly update on collections, data we view as a rough proxy for other states that levy income taxes. The Legislative Analyst Office indicates that 2020 income tax collections from April through June trailed the same months of the prior year by $26 billion. Collection of deferred income taxes during the first 17 days of July rapidly shrunk that gap to only $2 billion, or 9% YoY.

Pennsylvania has reported a similar story. Personal income tax collections had been running 40.9% below 2019 on a YoY basis at the end of May, a shortfall that declined to 5.7% as of the end of July.

	April	May	June	July
Personal Income Taxes	1,111	947	1,016	2,313
Previous Year	2,520	966	1,204	1,023
YOY%	-55.9%	-1.9%	-15.5%	126.1%
Cumulative PITs	1,111	2,059	3,075	5,388
Cumulative YOY%		-40.9%	-34.4%	-5.7%

Source: Pennsylvania Independent Fiscal Office

Municipal Defaults Have Been Highly Concentrated

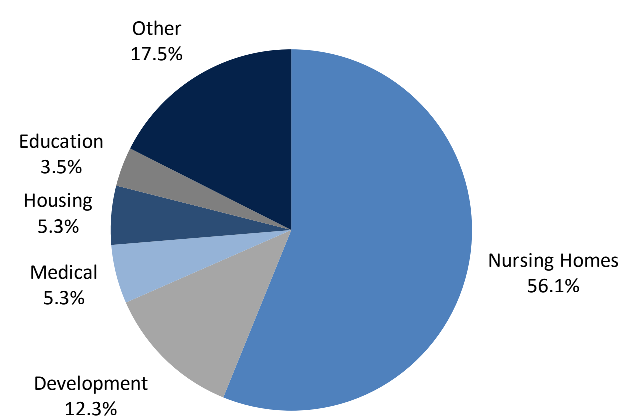
At Appleton, our investment process has always emphasized quality and separating undue credit risk from value lies at the heart of our research efforts. This focus on fundamental analysis is paramount, particularly during pressured economic cycles. Similar to past recessions, we expect defaults to increase in the municipal market, but remain concentrated in non-traditional, riskier sectors, far from the areas of the market in which we invest.

The first half of 2020 has already resulted in 56 municipal credit defaults, greater than 8 of the last 10 full calendar years. Senior living has been most severely impacted, accounting for more than half of YTD municipal defaults. Hotels and convention centers also face acute pressure due to a lack of business and leisure travel.

Smaller tax-exempt issuers are also generally at greater risk during economic downturns, one of the reasons we have long favored larger municipalities with strong balance sheets, sustainable revenue streams and established market access. These higher quality credits have many more options available to them when fiscal adjustments become necessary.

Broadly speaking, while we expect the municipal default rate to be elevated for some time, it should stay low relative to the size of the overall market. JP Morgan estimates that the default rate could tick up to 0.46% to 0.60% over the next few years, as compared to a Moody's reported annual average of 0.16% since 1970.

Municipal Market Defaults: % of 1H 2020 Cases



Source: JP Morgan

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Maintain Credit Vigilance

Our Credit Research team has been actively stress-testing Appleton's municipal holdings by developing proprietary scenario analysis models that are regularly updated as new issuer specific information becomes available. This process has reaffirmed our conviction in the tax-exempt credits we own in client portfolios. For example:

- Our Toll Road holdings have enough cash reserves on average to cover 2 years of operating expenses even when assuming no new revenue.
- Airport bonds may be the most impacted sector with enplanements falling by more than 90% from late March through May. Liquidity is critical and analysis of our Airport holdings revealed that reserves met an average of 22 months of debt and operating expenditures.
- In the Sales Tax-Backed Bond sector, all our holdings should be able to withstand a 40% decline in revenues for an entire year and still cover maximum annual debt service.
- Healthcare is another particularly vulnerable sector and our exposure is limited to large multi-state systems and dominant regional players. Approved credits have an average operating revenue base of $8.5 billion and liquid reserves of $4.9 billion.

Avoid Reliance on Federal Support

The Federal response to COVID-19 has been timely, vast and effective, with municipalities one of the beneficiaries. The CARES Act delivered $150 billion to state and local governments to help respond to COVID-19. Healthcare, education and transportation entities also benefited from sizable CARES Act grants. More recently, the Municipal Liquidity Facility, a $500 billion program that allows municipalities to borrow directly from the Fed on a short-term basis, was introduced. Although its use will likely be very limited, the implicit liquidity backstop has bolstered market confidence. The possibility of additional aid to state and local governments is currently in limbo and while we hope it is forthcoming, our credit research process relies solely on the fundamentals of each underlying obligor. Credit approval of a municipal bond issuer does not factor in Federal or other external support.

There's No Substitute for Quality

There is risk in the municipal market, although we believe that high-quality credits with strong balance sheets, healthy revenue streams, service essentiality and established market access will fare well. These times are unique, but in any condition, we fall back on fundamentals. Security selection is critical, and we feel that a comprehensive, quality focused research process can differentiate credits able to withstand turbulent times from those with legitimate credit vulnerabilities.

Accessibility and communication are important in any environment, although these attributes are especially valuable during uncertain and volatile times. Appleton Partners is committed to sharing our market and portfolio management perspectives as developments unfold. We hope these briefs are helpful and also invite you to reach out to us directly and/or visit www.appletonpartners.com/Insights for additional commentary and insights.