APPLETON PARTNERS, INC.

DIFFERENTIATING CREDIT VIGILANCE FROM COMPLACENCY

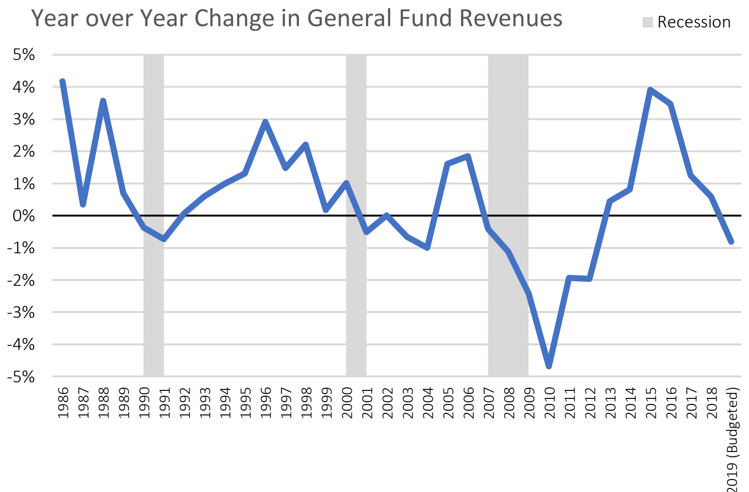
"ONLY WHEN THE TIDE GOES OUT DO YOU DISCOVER WHO'S BEEN SWIMMING NAKED" - WARREN BUFFET

This frequently cited quip from one of the great investors of our time is highly applicable to today's markets. All too often favorable capital market conditions have generated a degree of investor and analyst complacency. With municipal credit spreads at near record lows, the margin for safety has been diminished. Strong technical factors and a steady economic expansion have essentially lifted all boats, a condition that may be masking future credit concerns.

ARE LOCAL CREDIT CONDITIONS DETERIORATING?

In the face of growing economic uncertainty, local finance officers foresee darker clouds on the horizon. Municipalities responding to the National League of Cities' annual Fall survey reported fiscal 2018 revenues increasing by a modest 0.6% in real terms. This lags growth of 1.25% (2017) and 3.47% (2016) the prior two years. Given this decelerating trend, it comes as no surprise that these same municipalities have budgeted for declines in revenue in fiscal 2019 (-0.81%) and are casting a wary eye towards 2020, with nearly two out of three predicting a recession as soon as next year.

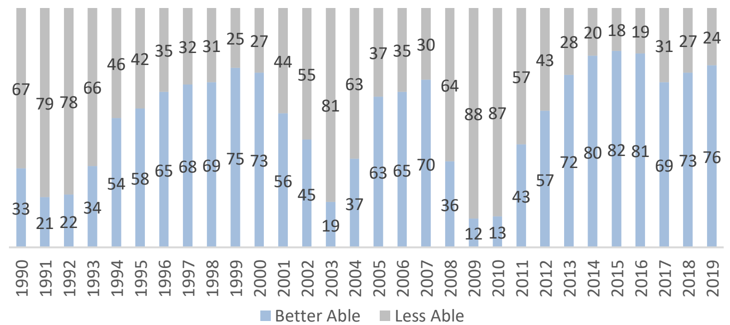
We applaud management prudency, and conservative assumptions are an appropriate means of preserving fiscal flexibility. Although revenue expectations are hardly a perfect predictor of future economic conditions, the accompanying chart reveals that a multi-year deceleration of revenue collections has often preceded recessions.



Source: National League of Cities, "City Fiscal Conditions 2019"

AN ENCOURAGING SIGN

Are credit conditions deteriorating? Broadly speaking, we do not feel this is currently the case. Three out of four local government officials reported their city was in better financial shape than the previous year, the eighth consecutive year of this positive trend. While this tends to be a lagging indicator – if revenues drop officers will respond negatively in surveys the following year – the confidence likely reflects stronger balance sheets and rebuilt reserves after a long period of strong tax revenue collections. This would indicate an ability, at least in the short-term, to respond to declines in revenues with expenditure adjustments, increases in revenues, or withdrawals from reserves.



Source: National League of Cities, "City Fiscal Conditions 2019"

SECTOR TRENDS AND INDIVIDUAL CREDITS

As active managers, credit decision-making is instrumental in our ability to add long-term value. While the fiscal health of most municipalities is much improved, differentiating those well-positioned to withstand potentially weaker economic conditions from more vulnerable entities is imperative.

While there is no crystal ball in projecting future credit developments, we find that zeroing in on reserve balances and debt burden, two key elements of financial flexibility, offers visibility into issuer credit strength.

Reserve balances reflect a municipality's "cushion," or ability to offset a degree of revenue declines without significantly reducing essential services or making other painful cuts. For the most part, reserves have been rebuilt, with median fund balances at the end of 2018 equal to 22.2% of expenditures, up from 19.6% in 2014.

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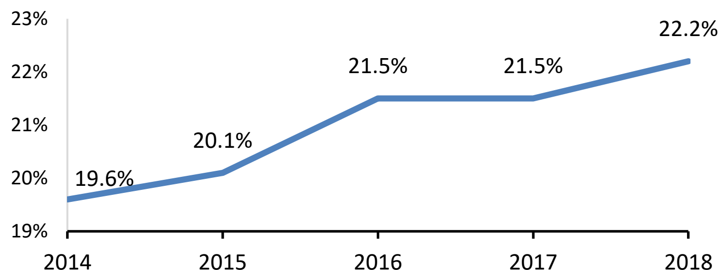


Source: Investortools, Merritt Research Services, Large Cities (>$100mm in debt outstanding)

However, reserve improvement has been far from uniform. While the "strongest" cities (top 10%) saw reserves remain steady-to-slightly improved, the "weakest" cities (bottom 10%) experienced declines. Notably, this weakening has occurred during a period of economic expansion, heightening the risk of more severe financial deterioration should revenue trends eventually worsen.

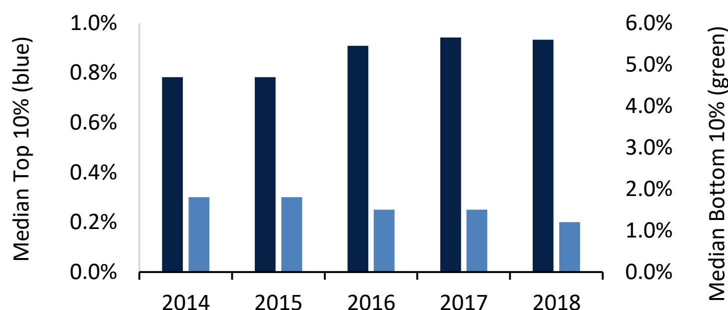
Available Reserves as % of Expenditures

	2014	2015	2016	2017	2018
Median	19.6%	20.1%	21.5%	21.5%	22.2%
Median Top 10%	66.2%	66.9%	64.7%	65.4%	69.3%
Median Bottom 10%	4.4%	4.7%	3.2%	4.6%	3.1%
Difference Top v. Bottom	61.9%	62.2%	61.5%	60.8%	66.2%

Source: Investortools, Merritt Research Services, Large Cities (>$100mm in debt outstanding)

Debt is necessary to finance government infrastructure, but too much leverage results in an excessive portion of the annual budget being allocated to debt service rather than other needs and priorities. Overall, expanding tax bases and a focus on austerity has kept leverage in check for most cities, with median debt outstanding staying relatively constant since 2014 at 1.5% of full tax base value. Yet, as with reserve levels, digging a bit deeper reveals significant divergence in leverage between the strongest and weakest cities.

The median for the top 10% of cities in terms of debt to full value declined from 0.3% in 2014 to 0.2% in 2018. On the other hand, the bottom 10% of cities measured by leverage saw their ratios increase by nearly 100 basis points over that same period.



Source: Investortools, Merritt Research Services, Large Cities (>$100mm in debt outstanding)

STEWARDSHIP MATTERS

Reserves and debt burden are only two factors among many we analyze as part of our proprietary research process. The strength and diversity of an issuer's economy and revenue streams are also of great importance. However, these can be impacted by external factors outside of management's control (such as recession). Therefore, we look for prudent, effective fiscal oversight and an efficient political decision-making process. These attributes contribute to financial flexibility and suggest greater potential credit stability over the course of an economic cycle. The reverse holds true as well. The lack of such attributes has often been associated with weakening public sector credit.

No one has perfect foresight, which is why we independently assess each bond issuer's ability to deal with potential downturns, searching for a comfortable margin of safety. Even while the tide is still high.

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