Community Finance Brief

Beyond the Binary in 2024: Volatility with Quiet Gains

CSG

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Brace for an unpredictable year in community finance, where a confluence of global turmoil, mandatory tech advancements, legislative implementation, and potential political upheaval together collide with an already fragile insurance market. While the presidential election may be a noisy stalemate, this chaos presents a hidden opportunity for agents of change to make real progress. Think infrastructure upgrades, strategic bond issuances, and innovative solutions to climate-induced risks. The bottom line: 2024 won't be a year of dramatic change, but it will be a year of laying the groundwork for a more resilient and sustainable future:

RATES & PRESIDENTIAL POLITICS

Historically, the one thing that would be certain during times of global uncertainty is the flight-to-safety bid that means people buy U.S. Treasury bonds as a retreat from chaos, which means the bid for municipal bonds also improves. The problem with this historical certainty is that Fitch downgraded Treasuries earlier this year and we have what looks to be an absolutely chaotic presidential election pending. It is hard to make the case of a bid-to-safety into an asset class that has that going for it.

The labor market, inflation etc.. all do look to be on stabler footing but **CSG** sees presidential polling headlines as dominating market movements more than anything else in 2024 and that will likely make for volatility within the new ranges that have been set over the last month. In the first quarter of 2024, Speaker Johnson, with the tacit support of team Trump, will shut down the government. The gamble that people will point the finger at President Biden and not the Congress (or at least not candidate Trump) will play out poorly and some half-measure will be reached in the early Spring.

Quick Takes

The last time a non-incumbent Republican nominee won the popular vote for president was in 1988.
– *Federal Election Commission*

The last and only time a former president ran for a second, non-consecutive term and won was in 1892 (Grover Cleveland, a.k.a 'The Comeback Kid')
– White House Historical Society

There are 42 states that have enacted some sort of tax and expenditure limitations legislation on local governments in the last year
– *National League of Cities*

Tax changes in the 2023 budget year as well as governors proposed 2024 budgets exceed the tax cuts enacted after the Great Recession
– Center on Budget and Policy Priorities

Thirty-nine states are on track to further increase the size of their rainy day fund balances in fiscal 2023.
– *National Associate of State Budget Offices*

Anyway you slice it, broader rate momentum will be headline dependent and less to do with traditional fundamentals and technicals.

ON FUNDAMENTALS & TECHNICALS

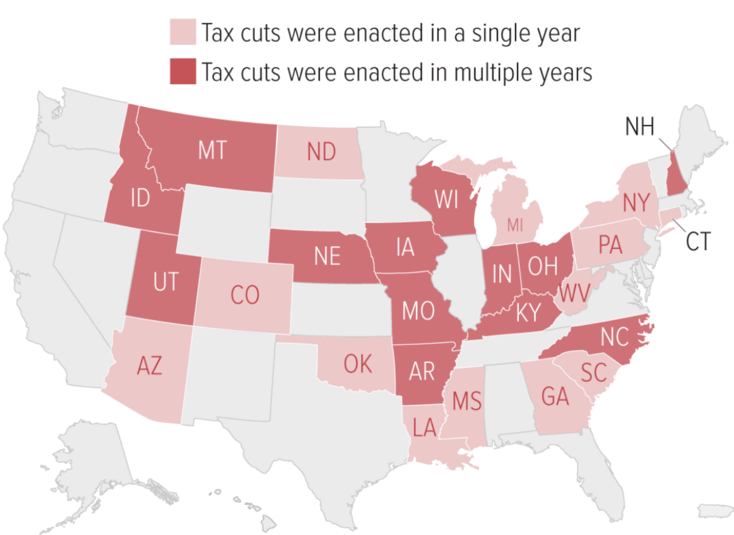
Unaddressed infrastructure, cyber security, social/ environmental challenges and pensions are the standard points. Election years historically see more issuance in the first three quarters as issuers lock in certainty before November.

On taxes, we would add to the mix that 2017's tax cuts sunset in 2025, which could start to be priced into the market depending on how the presidential race is shaping up. Covid-related funds are getting tapped out as well and that is going to be a negative vector on certain local government, urban names.

According to the [Center on Budget and Policy Priorities](), from 2021 through 2023, 26 states cut their personal income tax rates and/or corporate income tax rates, 13 of them multiple times (**see figure, below**). The scope of cuts are now larger than those seen in the wake of the Great Recession. That is a

States Have Passed Wave of Costly Income Tax Cuts

Enacted cuts to personal or corporate income tax rates, 2021-2023



Source: CBPP analysis of state legislation

"In the face of growing climate risk, private insurance companies have reassessed," states **Alice C. Hill** of the *Council of Foreign Relations*. "Some insurers have sought to raise premiums, reducing insurance affordability for homeowners. Other insurance companies have simply declined to offer insurance. The two largest homeowners insurance companies in the United States, State Far and Allstate, announced earlier this year that they would take a break from issuing new policies in California. When property insurance becomes unavailable or too costly, some homeowners choose to go without. That means they bear the entire loser should disaster strike, unless government or philanthropic aid materializes.

big figure to think about and deserves pause. To counter that, the National Association of State Budget Officers reports the highest aggregate of state rainy day funds in history.

MARKET STRUCTURE

There was a moment this October when, on a trading floor, someone commented ib something to the effect of "I've never seen a sell-off like this where I am not seeing an uptick in institutional bids-wanteds." The data on that day shows the bids-wanteds on Bloomberg were average, but the market tanked under a deluge of motivated sellers. If you looked at sellers of odd-lots and below the $1 million market in general, it was well above average.

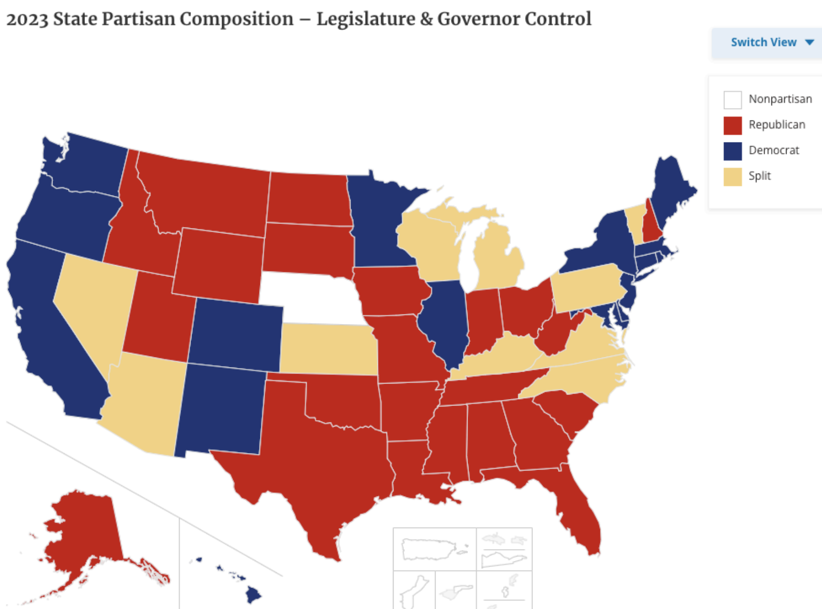
In October the market saw a massive transfer of risk from mutual funds to ETFs/SMA accounts taking advantage of the historical anomalies that occurred during that time (ratios etc..). Enter November, with less calendar and a drop in the bids-wanteds and peak ratios and the month saw the best performance on record. The so-called herd that is municipal rate direction, has become more concentrated and unidirectional. That this market cannot be properly and/or efficiently hedged plays into this vector.

This is an important and basically non-reported aspect of the market structure of the municipal bond market right now. The growth of separately-managed accounts, exchange-traded funds and essentially a larger decentralization, or less concentration, of securities in a few big hands, has implications for volatility in the secondary marketplace, which also impacts borrowing rates for communities.

These asset management vehicles are growing for a variety of reasons, but the biggest driver is cheaper access to investments via the ETF and technology in general, has democratized access to the asset class (yay!) but this becomes problematic when one considers the unique way in which municipal bonds are issued (serial maturities) and traded (over the counter). We are in a time when the behind-the-times process of tagging and labeling securities makes for a slow and cumbersome trading process (T+?) mixed with a new dynamic of distribution of ownership (and pitifully low broker/dealer holdings) will make for increased volatility in 2024.

"State legislatures have gotten more aggressive in their use of preemption in recent years," states a 2018 *National League of Cities* report. "Explanations for this increase include lobbying efforts by special interests, spatial sorting of political preferences between urban and rural areas, and sing party dominance in most state governments. This last point is particularly important as preemption efforts often concern a political divisive issue, they rely on single party dominance to pass through state legislatures."

STATE PREEMPTION ISSUES WILL MULTIPLY



There are 39 states in the union wherein one party has control of both the legislature and the governorship, according to the National Conference of State Legislatures **(see figure, left**). The largest shift has been with Republican control at the state level in the last 30-years as in 1993 Republicans held 12 states and in 2023 they held 23.

As discussed earlier this month, the 'blue dot in a red state' issue has financial implications that are playing out in real time across the county. While it has a history of creating stress on local government bond credits, it also has broader implications as far as social issues and the politics of ESG. The *Washington Post* had a great article recently on the issue of state versus local policies when it comes to a variety of social issues like abortion or LGBTQ+ but it did not cover the ESG topic, which any observer of, or participant in, the municipal bond market and public finance in general, would say is a big issue headed into 2024.

The history of ESG and how environmental and social issues became intertwined into state and eventually federal politics when President Biden exercised his first veto earlier this year to counter an anti-ESG approach to federal public pensions, is fairly simple. The divisions in this country over social and environmental issues have proven easy to leverage for political (oh, Vivek) and financial gain. With that said, the so-called anti-ESG or or anti-woke Wall Street movement remains vital as there are large segments of the U.S. population who have economic, educational and broader social points of views that, as part of the electorate, demand to be listened to. Fourteen states have now passed some sort of anti-ESG law in the last 2-years, per **CSG** review.

Looking ahead, ESG will continue to be a wedge issue regardless of the costs incurred but we do not expect that to deter the overall volume of ESG-ish issuance. With this year's green/blue/sustainable issuance looking to outpace last year despite the ESG headwinds, 2024 will start to see more federal legislation-related issuance per the Jobs and IRA, which will prove easy for third-party labels to improve their bottom lines. We don't subscribe to the pay-for-green model but issuance in that vein will see an uptick in 2024.

With the wedge issue growing and the divides increasing between pro- and anti-ESG states, local governments will be forced to go along with state rules. This will only enhance the blue city in a red state dynamic, and this could pose fiscal challenges to some local governments that rely on state aid.

From a trading perspective, it could mean a modest discount in pricing for the 'anti' states as rating agencies appear to be incorporating climate issues into their metrics. This will be a 2024 pause as we expect in future years a modest de-politicization on climate as costs grow. A middle ground approach will evolve that doesn't use the the letter E, S or G but will essentially better prepare communities for a hotter future but that isn't ready to happen quite yet next year.

Policy	# of States with Preemption
Minimum Wage	28
Paid Leave	23
Anti-Discrimination	3
Ride Sharing	41
Home Sharing	5
Municipal Broadband	20
Tax and Expenditure Limitations	42

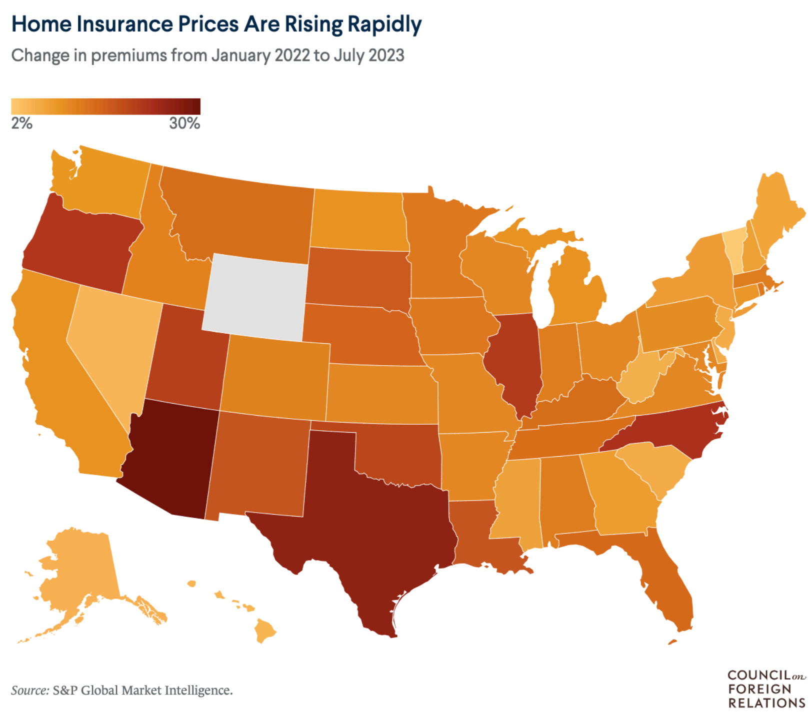
CURRENT INSURANCE MODEL IS FAILING AS FORM OF RISK TRANSFER

Speaking of a hotter future, **CSG** sees 2024 as the year of insurance reckoning as the industry's status quo approach flaws become undeniably evident and the pieces for real needed change start to be put in place. Much has been written about the increasing cost of property insurance and its impact on state and local budgets, its outsized impact on communities of color, and how most state and local governments are not budgeting for climate change appropriately. And that does not even get into the cost of upgrading public infrastructure that will be needed to have the revenue of the business model get up to speed with actuarial modeling these companies use.

Even with the dire situation, change won't quite happen in 2024 because this requires real executive branch overhaul in coordination with Congress. Instead, the same piecemeal approach will take place, cans will be kicked down the road but, we expect the issue to be elevated significantly as the cost of natural disasters and their frequency makes it clear that people in this country cannot afford to live in certain places (**see figure, page 6**), live the way they currently do and within the infrastructure that currently exists.

CSG expects a series of events during the summer that will put the spotlight on this issue. If 2023 was the headline risk year for this topic, this coming year will be the "I told you so" year and from here, real discussions on different ways to address these issues will occur and 'parametric insurance' will become a (financial) household term.

The toll on state and local credit will not yet be reflected in market prices unless said event is occurs in an area that is already in financial distress. So, if it's Florida, with the fundamentals and technicals being what they are in that state right now, do not expect markets to price that risk appropriately. Even in a state with shortfalls like California, strong market technicals will continue to buoy that state and spreads will remain tight to benchmarks.



NEW FRONTIERS IN TECH

While the tech headlines will be about artificial intelligence, what will change the muni marketplace, and it will really change certain structural components of the marketplace, will be the roll out of the Financial Data Transparency Act.

FDTA hits two major pain points in the muni industry that keep it in the stone age of financial markets: disclosure and inadvertently security tagging. While disclosure does make headlines from time-to-time, the way in which information is disclosed, as in, how it is physically put into form and why, is not cocktail party fodder. Official statements, arguably the single most important thing a bond issuer creates, it about to be turned upside down. It will be more standard, it will be more organized, and it will be machine readable - IF, the Act gets put into motion as policy makers envision it.

The historical problem with the public finance market is that most policy makers at the federal level know little of the marketplace and so how the Act gets put into place will be up to the SEC and trade association lobbyists. This coming year will decide who wins and how in the FDTA battle behind the scenes. It is an opportunity to enact real, comprehensive change for good - fingers crossed.

LEAD WILL BE A HEAVY BURDEN

The Environmental Protection Agency put out its new lead pipe removal rules and while we don't expect it be an extremely important area to focus on for 2024 (the rules won't likely be final until midyear), how the issue is approached is symbolic of larger items afoot. This will be a federally unfunded mandate and that will become clearer as the year progresses. It will fall on the municipal bond market to fund these enterprises and the current pressure on the water sector won't bode well. This sector is prime for a comprehensive impact security program wherein guideposts of 10% removal on an annual basis is the framework for a variable-rate impact coupon.

LITIGATION WITH ENERGY TRANSITION

The price of renewable energy will take a toll on the U.S. energy market in that the concepts that are the foundation of our monopolist energy distribution system will be challenged in court. A recent case in Hawaii wherein a biomass company is suing Hawaii Electric demonstrates a lot of the issues at hand. You can read more here, but you have a renewable energy company suing the state system for terminating a power purchase agreement.

Essentially, federal and state mandates pushing for more renewable energy sources as we move to carbon neutral will inevitably break down certain monopolies around the country. It doesn't help that Honua Ola would have burned grasses that played a role in the wildfires in Maui. Market participants in the energy sector should be prepared for more legal action that focus on antitrust and environmental issues.

OTHER THOUGHTS:

Historically Black Colleges and Universities will see enrollment increases after the Supreme Court decision on enrollment.

The melding of green and affordable housing will make some real headway as programs to retrofit and weatherize along with grants and tax-incentives per federal and state initiatives kick into gear and there will be an uptick in bonds to support such initiatives.

State bond banks will get some time in the sun as data will start to trickle out that states with this type of financial infrastructure in place are better situated to take advantage of the deluge of federal dollars enacted in the last three years .

Impact will move beyond a label. The Chicago bond that borrowed from Neighborly's playbook to engage the community in an earnest way and make municipal bonds tangible will be seen as a turning point for the marketplace. It is not about a label, or an investor model, it is about state and local governments making the change to embrace impact that will result in real, thoughtful, meaningful change in the way communities raise capital in this country.

On urban areas, the conversation of commercial to whatever it is a mayor decides should be monitored as there will be winners and losers here as long-term commercial leases will be coming up for renewal in this post-pandemic economy.