All U.S. Public Finance Sector Outlooks Are Now Negative

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Following mobility restrictions and closure of large segments of the economy due to COVID-19 and the swift onset of recession, all of S&P Global Ratings' sector outlooks in U.S. public finance are now negative. At the start of 2020 all sector outlooks were stable with the exception of higher education, ports, and mass transit. The shift in our outlooks to end the first quarter reflects the expectation of sharp decline in the economy through at least the second quarter and uncertainty about the rate of spread and peak of COVID-19 as well as the timing of economic recovery.

Sector outlooks are an indication of credit trends in the year ahead and may be informed by existing outlook distributions or existing and emerging risks that could influence rating actions. By themselves, we do not expect that these sector outlook revisions will lead to immediate negative rating actions. However, given the confluence of events from COVID-19 and the ensuing recession, we believe that rapid expenditure increases and precipitous revenue declines will generate more negative than positive rating actions across U.S. public finance for the remainder of 2020.

The financial position of governments and not-for-profits was generally healthy at the beginning of the year, which we believe provides flexibility to respond to the evolving situation. However, we see real fiscal challenges ahead across all sectors (see table 1). The rapid onset of the recession with projections of sharp GDP decline, surging unemployment, and decreased consumer spending will pressure credit quality.

All Sector Outlooks Across U.S. Public Finance Turn Negative – Key Macro Factors

Duration
Uncertainty about the rate of spread and peak of COVID-19 could pressure liquidity

Mobility Restrictions
Closure of large segments of the economy has weakened demand and revenues

GDP Decline/Unemployment
Unprecedented decline forecasted for the 2nd quarter will present challenges across public finance

Containment/Mitigation Costs
Many issuers are at the front line of absorbing these unbudgeted costs

Policy Response
The timing of federal stimulus funds and support are uncertain and timing is of the essence

Market Volatility
Market access could continue to be pressured and more costly; prolonged equity market decline hurts revenues and pensions

S&P Global Economics Forecast

On March 17, S&P Global Economics said that the global and U.S. economy had fallen into recession. Since then, their updated economic forecasts have shown a more severe projected decline of key economic indicators (see "It's Game Over For The Record U.S. Run; The Timing Of A Restart Remains Uncertain," published March 27, 2020, on RatingsDirect). Highlights of the most recent baseline forecast update include:

- The restricted mobility across large segments of the country has translated to a projected decline of GDP in the first quarter of 2.1% and 12.7% for the second quarter.
- The updated forecast also projects headline unemployment for the second quarter to be 10.1%, with more than 10 million jobs lost. That is more than the 8.7 million workers who lost their jobs during the Great Recession.
- Overall, consumer spending will trim 2.0 percentage points from first-quarter GDP, with sharp declines in March spending wiping out gains from earlier in the quarter. In the second quarter, consumer spending is likely to fall by 13.2%, with more households quarantined or without paychecks to spend.

These figures represent the baseline forecast but the deep recession forecast is more severe (see table). Overall, the baseline recession will likely be on par with the economic losses seen during the Great Recession, but over a much shorter time. In our deep recession scenario, the possible economic damage would far exceed that of the Great Recession. S&P Global Economics is currently forecasting a U-shaped recovery in the second half of the year but the path and severity of the coronavirus pandemic will dictate when the rebound will start.

U.S. Recessions In History

Peak	Trough	Length (months)	Previous expansion	GDP decline (%)	Stock market decline*	Unemployment rate increase (percentage points)	Federal funds rate decline§
Apr-60	Feb-61	10	24	(1.3)		1.5	(1.30)
Dec-69	Nov-70	11	106	(0.7)	(32.1)	2.4	(3.37)
Nov-73	Mar-75	16	36	(3.1)	(41.2)	3.8	(4.49)
Jan-80	Jul-80	6	58	(2.2)	(13.4)	1.5	(4.79)
Jul-81	Nov-82	16	12	(2.6)	(15.5)	3.6	(9.84)
Jul-90	Mar-91	8	92	(1.4)	(15.6)	1.3	(2.03)
Mar-01	Nov-01	8	120	(0.4)	(20.3)	1.3	(3.89)
Dec-07	Jun-09	18	73	(4.0)	(41.1)	4.5	(4.03)
Baseline							
Mar-20	May-20	3	129	(3.8)	(34)	9.0	(2.25)
Deep recession							
Mar-20	Sep-20	7	129	(5.9)	(41)	12.0	(2.25)
Past cycle average (1960-2010)		11.6	65.1	(2.0)	(25.6)	2.5	(4.22)

*S&P 500 reflects percentage change from the peak before the recession till the trough during the recession. §Discount rate in 1960 and 1970 recessions. Sources: NBER, BEA, BLS, Federal Reserve, and S&P Global estimates for 2020 recession.

Federal Stimulus

The COVID-19 pandemic is evolving swiftly and the information regarding economic and financial dislocation will need to be balanced with various government stimulus programs and timing is of the essence. The Coronavirus Aid, Relief, and Economic Security (CARES) Act was finalized and includes new programs that will provide direct payments to nearly every sector in U.S. public finance. How quickly the funds flow to governments, schools, hospitals, transportation entities, and through the broader economy will determine its effectiveness. The record $2 trillion stimulus will not stop the recession but we expect that it could augment liquidity across public finance, limit recessionary decline, and support economic recovery if stimulus finds are timely.

Market Volatility

Compounding the challenges associated with COVID-19 is the volatility in the equity and capital markets, which has varying implications across the sectors.

Municipal market

From a credit standpoint, a functioning municipal market will be important to all sectors in U.S. public finance. After a two-week period of significant volatility and outflows which sharply increased rates and limited primary market activity, unprecedented actions by the Federal Reserve have contributed to stability at month's end. Access to short- and long-term borrowing will be important to navigate the recession and recovery.

Equity market

Persistent equity market volatility will be another credit risk for those state and local governments that rely on income tax revenue (see "Market Volatility Has Varying Impact On U.S. States' Capital Gains Tax Exposure," March 10). It could also weaken endowments and other investment portfolios across the sector. Given the current market downturn, U.S. public pension plans will likely require higher contributions, which will exacerbate budget pressures across sectors. We also believe pension plans with weak liquidity may need to sell assets at a loss and this will further contribute to decreasing funded ratios and increased contributions (see "Pension Brief: Liquidity Is A Rising Concern For U.S. Public Pensions In Down Markets," March 24).

We expect to see a lot of variation across the country and municipal market sectors in how the COVID-19 pandemic plays out but we think that liquidity will be an important consideration to weathering this situation. The duration of this pandemic, the associated mobility restrictions, and management response will factor into credit stability.

States

Key Takeaways

- States are front-line responders and are absorbing significant unbudgeted costs.
- The closure of large segments of the economy and the "sudden stop" recession will swiftly and negatively affect key revenue streams.
- Active management, the timing of federal stimulus, and access to liquidity will be the credit focus.

The economic impacts of the pandemic are uncertain and will vary by state but are likely to weaken revenue collections in the last two quarters of fiscal 2020 and into fiscal 2021 across the sector. We also note that sharp oil price declines are weighing on revenue collections for oil producing states (see "U.S. Oil-Producing States' Fiscal Preparedness Varies As Prices Collapse," March 11). States that opt to follow the revised federal tax filing date to July 15 will afford taxpayers flexibility during a difficult time but will likely add to budget gaps, pressure liquidity, and make revenue forecasting for fiscal 2021 more challenging. Spending for containment and mitigation will also vary by state but is going to be sizeable. Federal stimulus funds have supported state credit stability in prior recessions but the effectiveness this time will be tied to the size and timing of disbursements given the pace of economic decline and magnitude of unbudgeted spending. While we anticipate the current situation will remain fluid, adequacy of the federal stimulus provisions, active management, and access to liquidity will remain key credit considerations.

States have a long history of managing through volatile economic periods. We have observed many improvements to budget structure, reserve policies and debt management over time. In our view, these enhancements significantly improve the state sector's ability to manage through cycles. Fiscal flexibility varies across the sector and credit direction will depend on the ability and willingness of a state to make fiscal adjustments. Lower rated states are most exposed to credit pressure derived from exogenous shocks given their comparatively weaker credit metrics including lower reserve levels, cyclical revenue streams, and elevated fixed costs (pensions, debt service, other-post employment benefits, etc.).

Local Governments

Key Takeaways

- Many local governments are starting this recession from a position of strength, but swift budget adjustments may be necessary. Reserves provide flexibility and liquidity but may not fully address imbalances.
- For school districts, we are watching for unexpected expenditure pressures and state funding trends given expected state budget gaps.
- Bonds backed by sales, hotel, income and other similar taxes are relatively vulnerable to credit deterioration given the narrow pledge and inherent volatility of the revenue streams.

Changing the sector outlook to negative is a reflection of the fiscal stress local governments will likely face in 2020 and beyond. Given generally healthy reserves and liquidity levels, long term planning and active budget management we see in the majority of local governments, we expect that many will weather the pressures coming their way.

For local governments on the front line of the pandemic, expenditures will immediately spike. We expect some of those COVID-19 related costs to be reimbursed through federal stimulus, but with reimbursement timing uncertain, the possibility of liquidity issues that pressure operations--and sometimes debt service--looms.

COVID-19 related mobility restrictions are having an immediate impact on sales and use tax collections, which will likely be exacerbated by the ensuing recession. Local governments supported by more stable property taxes may see more stability but will still be affected by the recession. Any governments seeing sharp changes on both the revenue and expenditure side will be particularly challenged and liquidity will be even more critical to manage through this unprecedented sharp downturn.

Unlike local governments, most school districts are not expected to have major unbudgeted costs and are nearing the end of the school year, so most should be able to weather the COVID-19 interruption reasonably well over the next several months. However, as the extent of tax revenue losses at the state level become apparent over the next few months, school districts may be starting the 2020-21 school year in a much different position if state shared revenues are cut. Mid-year revenue cuts passed on from the states to school districts--as we saw in the last recession--are often the most difficult gaps to close given a more limited ability for school districts to cut expenditures. Given the generally lower reserves for schools compared to local governments, there is greater chance for a structural imbalance to develop as well as less cushion to address it.

Not-For-Profit Health Care

Key Takeaways

- The major negatives now are the costs of treating COVID-19 patients, lost revenues, and investment market deterioration that has weakened unrestricted reserves.
- Certain credits, especially those with stronger unrestricted reserves and access to liquidity, may be able to manage better through this crisis.
- Duration, location, and severity will be important considerations in determining the broader impact of this pandemic on the sector.

We published a report on our now-negative view of the sector on March 25. See "Not-For-Profit Acute Care Sector Outlook Revised To Negative Reflecting Possible Prolonged COVID-19 Impact."

The acute care hospitals and systems we rate, regardless of location, are beginning to experience operating pressure due to deferred visits and surgeries, and the various costs to ready their organizations for caring for a potential surge of COVID-19 patients. Staffing and supplies remain a major concern for many providers. While this is unfolding at a varying pace across the country, almost all of the hospitals are doing some preparation that will likely affect performance, although the duration, severity, and location of COVID-19 cases remain key unknowns.

In addition to understanding operating and cash flow impacts as a result of this pandemic, we also will continue to monitor liquidity, market access, and unrestricted reserves as the investment and credit markets remain somewhat volatile. Credits with healthy reserve levels and liquidity access should be able to cushion any short-term COVID-19 related challenges.

While we believe many of our rated organizations will be able to manage through this event, we believe certain hospitals and health systems may not be as well positioned to hold their ratings and outlooks due to weaker pre-COVID-19 credit characteristics. We will continue to review all of our credit ratings through our surveillance process, but we may prioritize entities with weaker credit characteristics, in particular low levels of unrestricted reserves and limited access to liquidity., as well as those credits with increased liabilities and cash demands such as pensions and larger capital projects.

Higher Education

Key Takeaways

- In the near term, the biggest financial impact to institutions is the loss of auxiliary revenues.
- We expect weakened operating results, the scope of which will be determined by the duration of COVID-19 and financial impacts from lost auxiliary revenues, cuts in state funding, and declines in fall 2020 enrollments.
- Declining investment performance and endowment market values along with weaker fundraising could negatively affect ratings.
- Institutions with limited liquidity and financial flexibility face greater operating pressure.

Our outlook on the U.S. not-for-profit higher education sector has been negative for three consecutive years now, and we believe that the COVID-19 outbreak and related economic and financial impacts exacerbate pressures already facing colleges and universities. Most colleges and universities have moved courses online, and a vast majority have asked students to vacate residence halls. In the near term, we believe the biggest financial impact to institutions is the loss of auxiliary revenue from housing and dining fees, parking fees, as well as revenues from sports, theater, and other events. For schools with health care systems, lost revenue from elective surgical procedures could be material. We expect most institutions will end up refunding students for housing and dining on a pro-rated basis; several have shared they plan to credit student accounts, with graduating seniors and others having the option to apply for cash refunds. At the same time, additional unbudgeted expenditures for expanded technology support and increased cleaning are required, which costs might be offset in part by reduced operating costs with few students and employees living and working on campuses. The recently passed CARES Act will provide some budgetary relief to higher education institutions-- 50% must be used for direct emergency aid for students and the remaining funds can be used to defray some COVID-19 expenses. Despite this aid, we expect to see stressed operating budgets, the scope of which will ultimately be determined by the magnitude of lost auxiliary revenues, the duration of this pandemic, and fall 2020 enrollment figures..

With student recruitment and campus visits on hold, and international enrollments projected to be down considerably in the fall, total demand for colleges and universities in fall 2020 is a major source of concern. Reduced enrollment, particularly out-of-state and non-domestic enrollment, could have material financial implications for institutions. Compounding the issue, the pressures of the current recessionary environment on affordability, investment performance and endowment market values, and fundraising capabilities, could create more credit stress overall. For public institutions, the impacts from slower economic growth will vary greatly by state, but for some, it will mean significant reductions in state funding. We think that schools with limited flexibility--whether that be in programming, financial operations, liquidity and resources, or student draw--will face weakened credit profiles, and expect that this unprecedented crisis could be the tipping point for more school closures, in particular among smaller, more regional colleges and universities.

Off Balance Sheet/Privatized Student Housing

Key Takeaways

- On March 25, we revised our outlook to negative on all U.S. higher education privatized (off balance sheet, or OBS) student housing project ratings in the wake of the COVID-19 pandemic and the uncertainties surrounding the ultimate economic fallout (see "U.S. Higher Education Privatized Student Housing Projects Outlook Revised To Negative On Potential COVID-19 Impact").
- The negative outlook on all of these ratings reflects expected challenges facing the industry due to a sudden and potentially prolonged decline in student housing occupancy and associated loss of rental revenue, as most colleges and universities have moved to remote learning and the majority of students have moved out of residence halls.

Charter Schools

Key Takeaways

- The sector outlook revision to negative reflects the potential for reduced state funding or unbudgeted expenditures for expanded technology support. Given how heavily charter schools rely on per-pupil state funding, the biggest financial impact to these schools will be reductions in funding or funding delays. Both will be monitored on a state-by-state basis.
- Compared to traditional public schools, most charter schools have limited revenue diversity and less financial flexibility.
- In our opinion, schools at the lower end of the rating scale remain more vulnerable to revenue, debt service coverage, and covenant pressure than our higher-rated schools, which tend to have some fundraising capabilities and greater liquidity. Schools with limited liquidity and financial flexibility face greater risk.

Community Colleges

Key Takeaways

- Our negative outlook on the not-for-profit community college sector reflects operating risks stemming from the - pandemic that has created significant uncertainty for the broader higher education industry.
- These entities may face sustained operating and liquidity pressure if they incur material unexpected costs related to the shift to online programming or refunds of tuition or fees. State funding declines are also possible.
- Community colleges typically lack meaningful endowments, have limited fundraising capabilities, and lack robust liquidity to weather a long period of significant stress.

Independent Schools

Key Takeaways

- Our negative sector outlook reflects the pressures of the current recessionary environment on affordability, investment performance, and endowment market values, and fundraising capabilities.
- Extended school closures could weaken student demand and result in lower auxiliary revenues, particularly if campuses remain closed through the summer or if boarding schools--which constitute about half of our rated universe--refund room and board costs.
- In our opinion, schools at the lower end of the rating scale remain more vulnerable to demand, affordability, and revenue diversity pressure than our higher-rated schools, which tend to have highly selective admission profiles and substantial endowment funds to provide flexibility.

Not-For-Profit/501(c)(3)

Key Takeaways

- Our non-profit sector includes a broad range of credits ranging from cultural and research organizations to foundations, membership organizations, and service organizations. Our negative outlook on this sector reflects the pressures on financial operations as a result of facility closures and cancelled performances and events and uncertainty about the resumption of normal operations. Declining investment performance and endowment market values along with weaker fundraising results also serve as credit factors that could negatively affect ratings during this economic slowdown.
- While almost all of our ratings for the sector are currently investment grade, we believe there will be greater pressure on those organizations with limited revenue and expense flexibility, lack of liquidity or balance sheet cushion, and weak fundraising capabilities.

Housing

Key Takeaways

- The sudden contraction of the economy and potential policy responses relating to mortgage forbearance, eviction, and foreclosure could stress the housing sector, particularly HFAs and stand-alone multifamily properties
- Senior properties in particular may face pressure on net operating income due to extended vacancies and higher expenses from the pandemic
- Liquidity--both internal resources and access to external facilities--will be key to navigating any interruption or decrease in revenues for HFAs, CDFIs, and multifamily property owners

The negative sector outlook is based on the seismic shift in the economy along with announced efforts to keep renters and homeowners in their residences through eviction and foreclosure moratoriums, which will add significant stress to the municipal housing sector over the next several quarters. Given the potential for increased delinquencies from unemployment, delayed or suspended rental payment relief, and mortgage forbearance, housing finance agency (HFA) programs and stand-alone affordable multifamily developments could experience negative pressure.

Liquidity will be the key factor for both HFAs and community development financial institutions (CDFIs) to address emerging risks in their respective activities. The majority of our rated HFAs and CDFIs have strong asset quality, carry large balance sheets, have liquid reserves and access to external liquidity. However, several of these organizations' liquid assets may prove constrained, leading to downward rating pressure, particularly if these additional burdens extend beyond three to four months without access to additional relief. Without the announced, but not yet implemented Government National Mortgage Association relief, we believe HFAs that service loans may be under stress to advance mortgage payments for the expected heightened levels of borrowers who will enter forbearance.

We also see potential financial stress in stand-alone affordable rental properties, as significant revenue declines due to eviction moratoriums, an uptick in operating expenses and extended vacancies will pressure ratings, particularly for those properties already operating with slim margins and limited operating reserves. In addition, because seniors have been the most vulnerable to the coronavirus, senior properties, particularly those with assisted living and memory care facilities, may see slower lease-ups and unforeseen operating costs. For public housing authorities (PHAs), tenant rental revenues may decline, but we don't expect near term rating changes as this revenue source accounts for only an average of 15% of revenues; furthermore, the CARES legislation contains a number of provisions to help PHAs compensate for reductions in revenue and continue their operations.

We expect any negative rating actions to be driven by the duration and severity of the macroeconomic downturn. At the same time, some of our rated credits may avoid significant financial hardship and rating deterioration due to strong balance sheets, robust liquidity positions, and proactive management, bolstered by any relevant federal government support. In our opinion, the magnitude and timing of federal stimulus could be pivotal to future credit direction for the sector.

Public Utilities

Key Takeaways

- Shuttering businesses to limit the spread of coronavirus deprives utilities of commercial and industrial sales revenues.
- Utilities' bad debt expense could rise with unemployment.
- Illness or quarantine that pares a utility's workforce could degrade service and revenues.
- Local governments might pressure utilities to provide greater financial support as municipal revenue streams decline along with economic activity.

We view this sector--municipal water, sewer, electric, and gas utilities--as increasingly vulnerable to the potential economic effects of the pandemic. Although we expect that the essential nature of these utility services will support significant demand for these services, we nevertheless believe that the widespread shuttering of commercial establishments and factories will remove a component of sales, exposing utilities' cash flows and liquidity to potentially meaningful declines if shutdowns persist. For individual utilities, the effects will vary depending on service area characteristics such as customer base composition, customers' income levels, and other economic factors. Many utilities, whether voluntarily or by fiat, are implementing moratoriums on shutting off customers' service for nonpayment. Although these compassionate measures will ensure that customers that are facing layoffs due to economic contraction retain access to vital services, suspending cutoffs has the potential to pressure cash flows and liquidity. Moreover, experience indicates that when utilities suspend cutoffs there is often a cohort of customers that piggyback on those that are truly in need by also withholding payments, further pressuring financial performance. Utilities are around-the-clock operations, and if illness or quarantine pare a utility's workforce and operations degrade, revenues could follow. Lastly, if local governments' revenue streams decline with the downturn, government units might pressure their related utilities to increase transfer payments to support municipal operations.

Transportation

Key Takeaways

- On March 26, we revised the outlooks on nearly all issue and issuer credit ratings in the transportation sectors--airports, ports, toll facilities, transit, and parking--to negative. This means issuers face at least a one-in-three likelihood of a negative rating action over the intermediate term for investment-grade credits (generally up to two years) and over the short term for speculative-grade credits (generally up to one year). This followed the updated overall view of the sector published on March 16 ("U.S. Transportation Infrastructure Sector Outlook Update: Now Negative For All Sectors").
- We believe the dramatic contraction of the global and U.S. economies and virtual collapse of travel and mobility across the transportation subsectors is a demand shock without precedent, with no definitive indication at this time regarding its duration and severity as well as the follow-on effects of an economic recession.
- The CARES legislation includes direct financial aid to airport operators ($10 billion) and transit authorities ($25 billion) which we view favorably as it will augment liquidity and assist with near-term operational funding requirements including debt service.
- We will be focusing on near-term (next six months) liquidity, refinancing and remarketing risks faced by issuers--particularly those with weaker credit metrics--along with analyzing intermediate (six-12 months) funding and budgetary risks of those credits most affected by volume declines. We will also be gauging the shape of the recovery at the macro level and what it could look like for specific issuers in the context of our view of anticipated volume levels and economic forecasts.

Long-Term Pools

Key Takeaways

- Our negative outlook on this sector is based primarily on our negative overall view of the U.S. public finance sector since the majority of the underlying cash flows that are either pledged for repayment of bonds or guaranteed by the programs originate from U.S. public finance asset classes.
- While these programs benefit from additional overcollateralization and diversity, we believe that ratings on programs that are either currently experiencing exceptionally low loan delinquencies of 0% from underlying loan repayments or operating with a relatively small number of borrowers could be particularly susceptible to downward rating action.

This report does not constitute a rating action.

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