NORTHERN TRUST
ASSET MANAGEMENT

2024 U.S. MUNICIPAL BOND SECTOR OUTLOOK: STABILITY AND RESILIENCY

A BASE OF FUNDAMENTAL SUPPORT

We see a soft landing to low-but-positive growth as the most likely scenario for the U.S. economy in 2024, with support from durable consumer spending and sliding inflation. This stronger-than-expected economic environment creates a stable outlook for municipal bond issuers across most sectors (Exhibit 1). While recession remains a risk, we think issuers' resiliency to economic downturns has improved, backed by near-record-high cash reserves. We expect the stable outlook for issuers and strong resiliency to provide a sturdy base of fundamental credit support to the municipal bond market this year.

STATE AND LOCAL GOVERNMENTS: SLOW TAX REVENUE GROWTH

Outlook

We expect continued stability for state governments, local governments and school districts in 2024, although the outlook deteriorated slightly from last year. Total tax revenues (Exhibit 2 on next page) shrunk through the first three quarters of 2023 as economic growth decelerated and poor investment returns in 2022 lowered revenue from income taxes.

What it is

We analyze the trends that influence the credit quality of municipal bond issuers, including state governments, colleges and hospitals.

Why it matters

These trends form the fundamental foundation of investment decisions about municipal bond issuers.

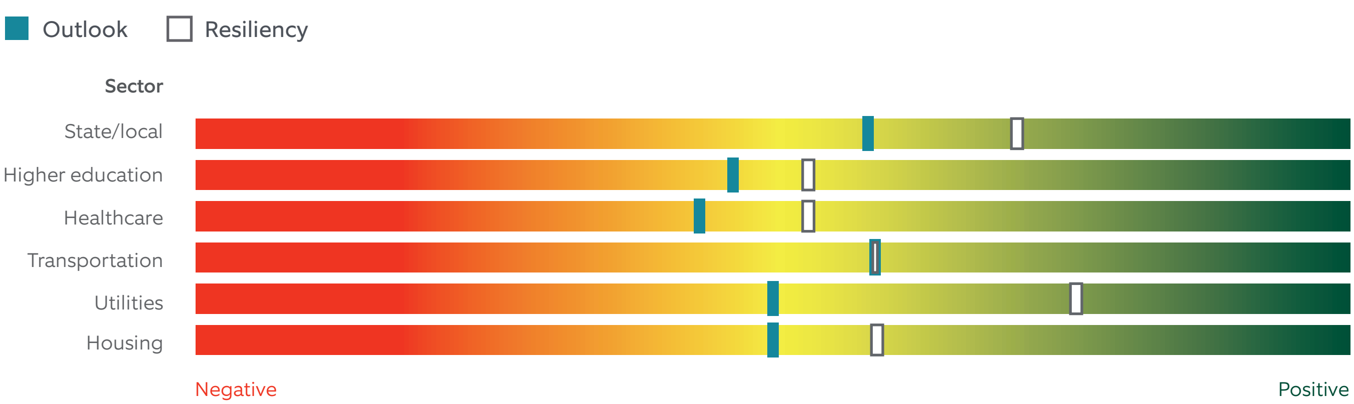
Where it's going

For most market sectors, our research indicates stable outlooks and — in case of an economic downturn — solid resiliency.

EXHIBIT 1: OUTLOOKS ANCHORED NEAR STABLE, BACKED BY STRONG RESILIENCY

Outlooks for higher education and healthcare are the weakest while state/local governments and transportation have the strongest outlooks. We see resilience against economic downturns for all sectors.

NTAM 2024 Credit Outlooks and Resiliency Assessments by Sector



Source: Northern Trust Asset Management

States such as California that have progressive income tax structures and rely on capital gains tax revenue felt this pain more, which may lead to budget cuts in the first half of 2024. However, sales and property tax revenues continue to grow.

In 2024, we expect tax revenues to grow slowly along with the economy (Exhibit 2). The 2023 run-up in equity markets may support tax revenues in 2024, particularly for states that collect an income tax. Property tax collections continue to be strong, bolstering local governments, as assessments are gradually incorporating the rise in property values during the pandemic. Sales tax growth has slowed in recent quarters along with the decline in economic growth. We expect sales tax trends to also follow the economy in 2024.

Record cash reserves likely will buttress the credit ratings of state and local governments as tax revenue growth may slow this year.

Resiliency

Reserves remain near record highs, which likely will reduce the need for budget cuts in the next cycle. State and local governments have tools to manage budget stress if revenues come in lower than expected, which include raising new revenues, reducing or delaying spending, refinancing debt, borrowing, or using reserves. We think record reserves will keep credit quality consistent despite slowing revenue growth. Several weaker states such as Illinois, New Jersey and Connecticut have improved resiliency because of higher reserves and pension funding. We are further factoring the ability of governments to cover the costs of rebuilding after increasingly frequent disasters such as hurricanes, floods and wildfires. We expect the election cycle to dominate the news as the year progresses, yet the results of the election would likely not impact credit until 2025.

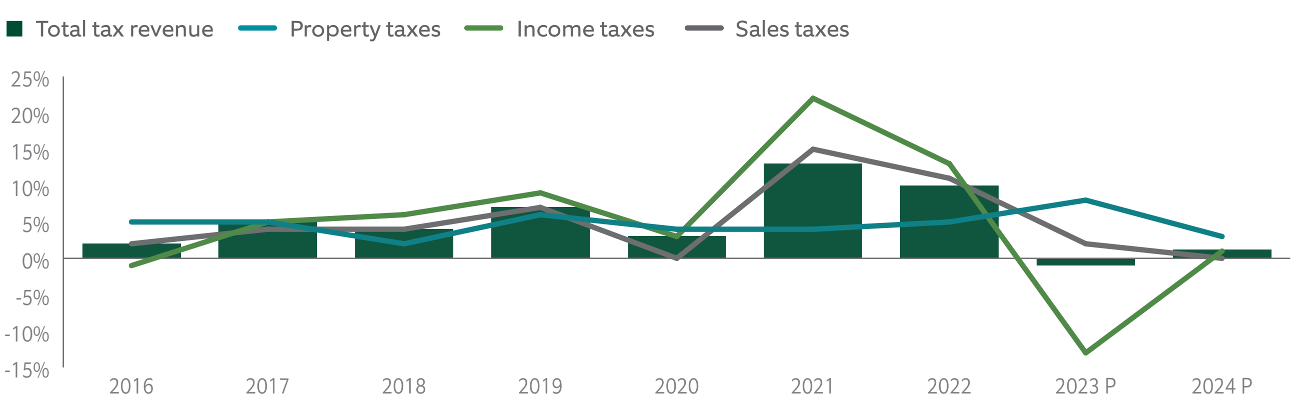
High Yield Outlook

A slowing economy could exacerbate risks to stressed governments who issue high yield municipal bonds. Government credit quality in Puerto Rico, a large part of the high yield market, has stabilized as a federal oversight board controls finances and federal disaster aid from hurricanes continues to prop up the economy.

EXHIBIT 2: LESS VOLATILE TAX REVENUE

After the pandemic spurred volatility in tax revenues for state and local governments, we expect revenues to normalize with a slight improvement this year.

State and Local Government Tax Revenue Change from Previous Year



Source: Northern Trust Asset Management, U.S. Census Bureau. Data as of September 2023. "P" means the data for 2023 and 2024 are projected.

HIGHER EDUCATION: ENROLLMENT STRUGGLE

Outlook

We have a slightly negative outlook on higher education as total enrollments (Exhibit 3) remain well below pre-pandemic levels. The sector continues to bifurcate. Selective private schools with recognizable brands are thriving, with increasingly rich balance sheets and growing revenues. Flagship public schools are also strengthening, as they attract high-paying out-of-state students and philanthropic support. The trend is the opposite at less-selective private universities and non-flagship public colleges, where shifting consumer tastes and a reduced pool of prospective students limits pricing power.

Total revenues for higher education grew 3% in 2023, less than half of the growth in expenses. We expect this trend to possibly force closures and consolidations in parts of the country oversupplied with universities such as the Northeast and Midwest. Because of this, we are increasingly selective in choosing higher education bonds with credit ratings below AA. We are also watching political developments, as higher education has found itself in the crosshairs of some policymakers.

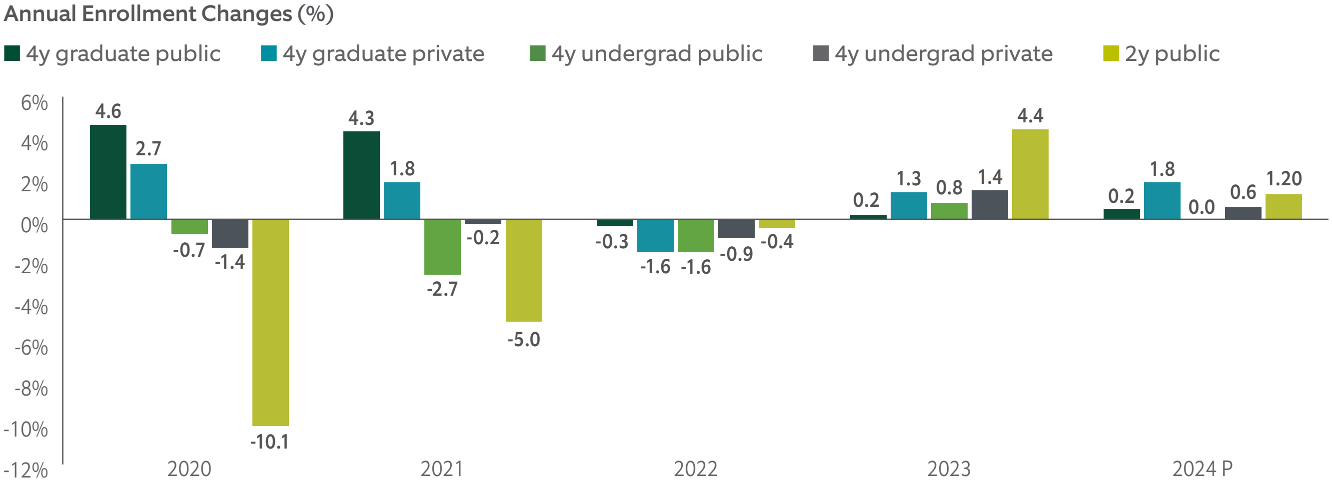
We project tuition revenue for universities to grow below inflation in 2024 and federal pandemic aid will also end. Tuition discount rates are at all-time highs, limiting capacity to increase prices further. After significant investment losses in 2022, we expect equity market gains in 2023 to help maintain strong balance sheets for 2024 and provide support to institutions with large endowments. We expect many institutions to issue debt to address aging facilities after deferring capital plans during the pandemic.

Colleges are struggling to grow enrollment and increase tuition above inflation, contributing to a slightly negative outlook.

EXHIBIT 3: FLAT ENROLLMENT

While enrollment may rise slightly in 2024, selective private schools and flagship public schools likely will gain more students at the expense of smaller regional schools where enrollment is falling.

Annual Enrollment Changes (%)



Source: Northern Trust Asset Management, National Student Clearinghouse Research Center, data as of September 2023. "P" means the enrollment is projected for fall of 2024.

Resiliency

We expect tuition growth to fall short of inflation, damaging resiliency for universities. Tuition discounts have reached all-time highs, and shifts in higher education demand present longer term concerns. Balance sheet improvements offset some of these factors.

High Yield Outlook

We expect credit of lower rated issuers to deteriorate because of pressures on enrollment and elevated expense growth. We think smaller institutions in regions with stagnant population trends that are highly reliant on tuition revenue are the most vulnerable.

While we expect labor costs to decline from the pandemic-related surge, hospital profit margins remain low, contributing to a negative outlook in the healthcare sector.

HEALTHCARE: OPERATING PERFORMANCE IN RECOVERY

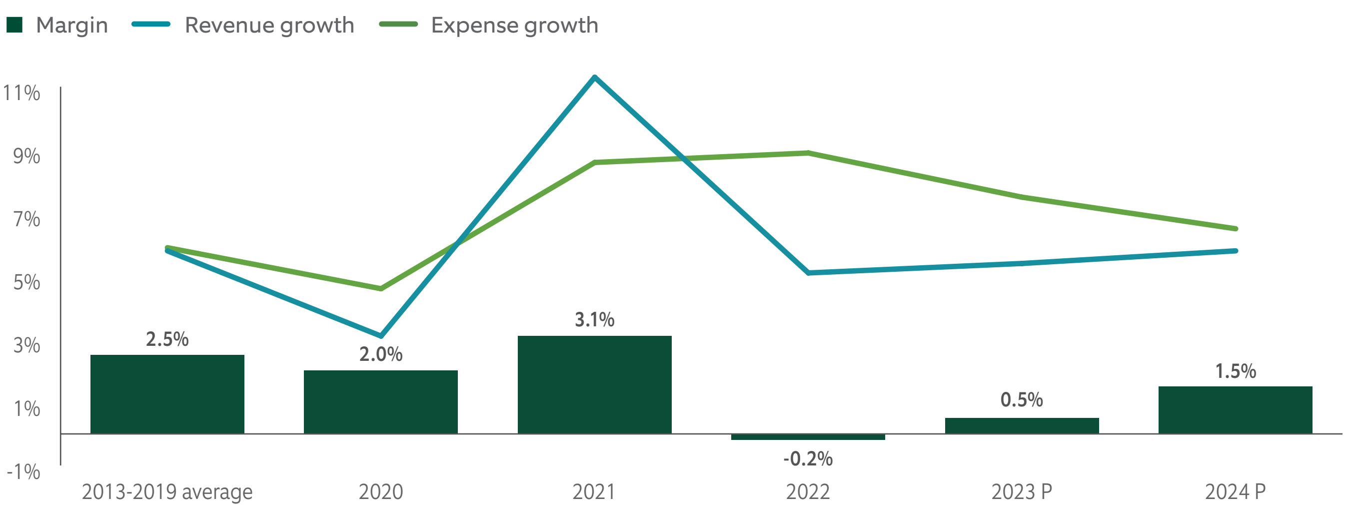
Outlook

The outlook for the healthcare sector is improving, but we maintain a slightly negative outlook. Operating performance has begun to stabilize as labor costs, which previously surged from shortages in particular with nurses, have peaked. We expect labor costs to decline in 2024, but they likely will settle at levels higher than before the pandemic. In terms of revenues, hospitals have negotiated better reimbursement rates from commercial insurers, which may support higher revenues as long as patient levels remain stable. However, the aging U.S. population means more patients are paying with Medicare, which reimburse hospitals at significantly lower rates than commercial insurers.

EXHIBIT 4: HOSPITAL MARGINS IMPROVING BUT REMAIN BELOW AVERAGE

Expense growth, which previously surged largely because of a nursing shortage, is starting to wane while revenue growth likely will increase as hospitals have negotiated higher reimbursement rates from insurers. As a result, we expect higher margins in 2024, though still below average.

Annual Revenue/Expense Growth and Profit Margins



Source: Northern Trust Asset Management, Merritt Research Services, Moody's. Data as of December 2023. "P" means revenue, expenses and margins are projected.

In the end, we expect easing labor costs and higher reimbursements from insurers to produce better results in 2024 from 2023 (Exhibit 4). However, we still expect margins to remain lower than pre-pandemic levels, making us a bit more cautious and selective in our investments.

Airport demand has surged as air travel has risen to eclipse pre-pandemic levels, supporting a stable outlook.

Resiliency

Hospitals historically have learned to adapt well to financial pressures and we think they will need to use that ability to rebuild margins and solve for potential changes in regulations if the political landscape shifts. While cash-on-hand has fallen from the spike during the pandemic, we think hospitals still maintain a sufficient amount of liquidity to manage through stress. We favor larger hospital systems with geographic diversity and strong balance sheets, which better equip them to handle these challenges compared to smaller peers.

High Yield Outlook

We see continued stress for senior living facilities, among the most common high yield issuers in the healthcare sector. Occupancy has risen, but we expect it to remain below pre-pandemic levels through 2024. Some facilities have struggled to fill up additional space that they have built under expansion plans. Similar to hospitals, facilities that have skilled nursing likely will continue to struggle with higher labor costs because of the nursing shortage.

TRANSPORTATION: AIRPORTS, TOLL ROADS AND MASS TRANSIT

Outlook

Airport demand has surged as air travel has risen to eclipse pre-pandemic levels, supporting a stable outlook. Air travel may fall slightly in 2024 (Exhibit 5) as it settles into more normal levels after the recovery from pandemic. An economic slowdown may lighten demand for leisure and business travel, but we think airlines have capacity to lower prices to entice customers to still travel. Bond issuance by airports in 2023 fell to 35% below the five-year average, which suggests that airports have postponed spending on infrastructure and other capital projects. We believe they will need to address some of those projects in 2024, which may cost more than anticipated because of inflation. Still, we think airport balance sheets can absorb more debt to fund capital spending, aided by lower debt issuance in 2023.

Toll roads, particularly those that are mature, historically have been stable because of strong debt service coverage, good liquidity and modest leverage. They tend to weather economic downturns better than airports, as total driving miles is less sensitive to economic changes than air miles. This is reflected by the sharp drop in air miles in 2020 (exhibit 5) and a cumulative decline of 7% for air miles in the 2008/2009 recession compared to only a 2% drop for vehicle miles. In 2023, we project vehicle miles traveled to rise for the third straight year, though they remain slightly below the 2019 peak likely because more people are working from home. The median toll road had nearly 700 days of cash on hand as of November 2023, which is up 18% over the five year period. Meanwhile, the debt service coverage ratio, or cash flow divided by interest payments, exceeded 1.86 in 2023.

The mass transit outlook remains negative as work-from-home trends have slowed the recovery in ridership since the pandemic. We see little chance of recovery to pre-pandemic levels in the foreseeable future. Federal funding aid also is winding down, which will likely force cuts or additional tax support to fill in the financial gap. Yet mass transit bonds are typically secured by sales tax revenues rather than farebox income. So we believe economic trends which drive tax revenues are more important to bondholders than ridership trends. For example, in 2023, New York's state government closed a budget gap for New York's Metropolitan Transportation Authority by providing additional tax revenue. In 2024, we believe other mass transit providers will require similar assistance or reduce transit services.

Utilities play a critical role in communities and they can pass on increased costs to customers, making them an excellent defensive holding if the economy weakens.

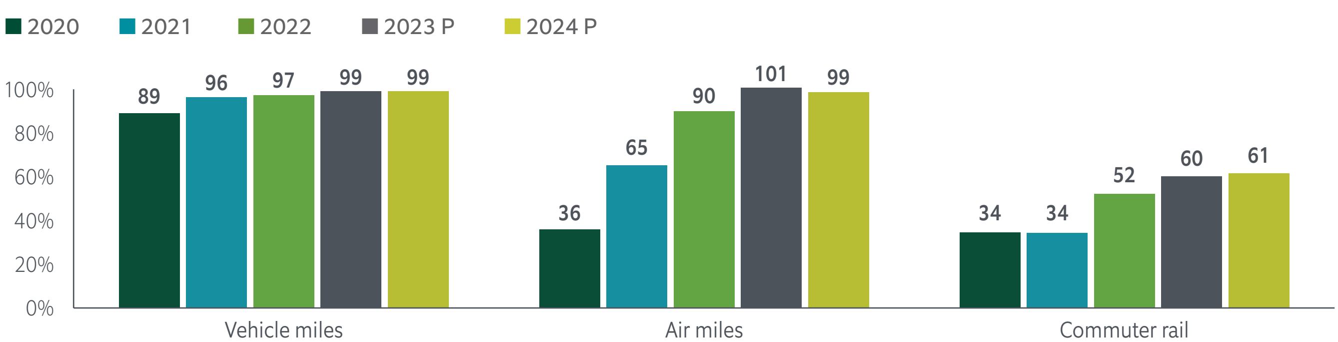
Resiliency

Airports and toll roads have strong liquidity that we believe boosts resiliency in 2024. This should provide a cushion if volumes decline more than expected or if capital projects increase over budget. Generally, toll roads have lower capital costs than airports while they benefit from the inelastic nature of demand for highways and annual toll increases. Both sectors have remained resilient over previous recessions because of their critical roles in the nation's infrastructure.

EXHIBIT 5: ROAD AND AIR TRANSIT RECOVERS FROM THE PANDEMIC

The outlooks for tolls roads and airports are benefiting from a nearly full recovery in road and air transit. We don't expect commuter ridership to reach pre-pandemic levels for the foreseeable future as working from home has become more permanent, damaging the outlook for mass transit.

Vehicle Miles, Air Miles and Rail Ridership vs. Pre-Pandemic (% of 2019 total)



Source: Northern Trust Asset Management, Federal Highway Administration, Department of Transportation, American Public Transportation Agency, vehicle data as of September 2023, airline data as of August 2023 and commuter rail data as of March 2023. "P" means data is projected for 2023 and 2024.

UTILITIES: STEADY RESIDENTIAL DEMAND AND SOLID FINANCIAL POSITION

Outlook

Water, sewer and electric utilities are well positioned in 2024 because of steady residential demand, strong federal infrastructure spending and solid financial health. Risks include aging infrastructure, climate change and more stringent regulations. However, the essentiality of the sector along with the ability to pass on increased costs to customers makes utilities an excellent defensive holding if the economy weakens.

We project financial metrics to remain strong in 2024 as average debt service coverage is around 2 with nearly 1.5 years of cash to cover operating expenses. Electric utilities face higher costs to continue transitioning toward renewable power sources, but we expect federal aid from the Infrastructure Investment and Jobs Act will help offset these expenses. Cybersecurity is a key longer term risk.

Resiliency

Utilities exhibit strong resiliency and lower sensitivity to economic cycles. The often-monopolistic position, low price sensitivity and independent rate setting authority provide strength and stability to the sector.

HOUSING: STABLE AND RESILIENT

Outlook

We have a stable outlook on state Housing Finance Agencies (HFAs) given their strong balance sheet and debt service coverage metrics. Increasingly unaffordable housing and limited supply may constrain HFAs in 2024. Yet HFAs have the ability to offer mortgage rates below the conventional market for single-family loans. Strong demand for rental housing likely also will support the volume of loans for multi-family housing including apartments. Loan delinquencies are similar to pre-pandemic levels, but a weakening economy could push them moderately higher. HFA margins are likely to increase as higher interest rates are bolstering investment earnings.

Resiliency

Recently, most HFAs have strengthened their loan portfolios by increasing government-insured loans, which make them more resilient against delinquencies than during 2008 housing crisis. Additionally, the median asset-to-debt ratio, or the value of the housing assets divided by debt, was 1.48 as of 2022. This is above what we consider a healthy ratio of 1.2 and can offset increases in stress-case loan losses providing strong resiliency to the sector.

High Yield Outlook

Speculative land deals have proven to be more resilient than anticipated. Despite a sharp rise in mortgage rates, demand has remained relatively robust driven by increasing family incomes. We continue to prefer single family residential developments over retail or office due to their diversified ownership and lack of challenges stemming from work from home.

State Housing Finance Agencies' strong balance sheets and ability to pay their interest costs support a stable outlook.

A DECENT SETUP FOR 2024

Our broad analysis of municipal credit fundamentals assumes slowing U.S. economic growth this year that won't turn into a recession. We recognize the risk case of a moderate recession, but even in that case we still believe most sectors, with just a few exceptions, are well-prepared with sufficient cash reserves, healthy balance sheets and the financial tools to navigate a downturn. In 2024, we expect to monitor risks and opportunities related to labor costs, interest rates, and inflation's impact on capital spending plans and operating costs. Further, we will look for rising expenses related to weather disasters along with the potential impact from federal election results.

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