ENERGY & THE MUNICIPAL MARKET

MARCH 11, 2020

Supply Shock Prompts An Oil Price Plunge

A collapse in Russia and OPEC's supply limitation alliance, coupled with growing Coronavirus economic ramifications, caused West Texas Crude Oil prices to fall below $34 per barrel as trading opened on March 11th, down almost 40% over the past three weeks. Although credit stress should lie predominantly in the corporate markets, we comment here on municipal implications.

Municipal Bonds Are Not Corporates

Municipal spreads have remained tight amid increasingly volatile markets, suggesting the overall credit impact in the tax-exempt market is expected to be manageable. This is consistent with the recent past relative to corporates, as 10Yr Muni BBB-AAA spreads have historically been less volatile than 10Yr BBB Corp-UST spreads.

Energy Prices and Credit Quality

Municipals are generally less vulnerable than most corporate bonds to economic shocks, although there are tangible tax-exempt credit risks that also demand research scrutiny. Appleton's credit team looks at energy-related exposure among tax-exempt issuers as a multi-dimensional risk factor.

We evaluate state and local governments' budget exposure, reserve levels, and management practices. For revenue bonds, we assess project-related cash flows and each issuer's ability to adjust rates and other charges. Analyzing these and other variables can help differentiate credit strength from what we see as undue risk.

Significant declines in energy prices will impact state and municipal budgets in the "energy patch", forcing fiscal adjustments. Accordingly, our research process cautiously models downside scenarios. Before purchasing bonds that introduce energy exposure, we demand a margin of safety.

Where Do We See Potential Vulnerability?

The chart below details FY 2020 crude oil price assumptions for top oil producing states. These estimates influence projected energy related tax revenues, as well as economic inputs such as income, corporate and sales taxes.

The reason we feel some states are better prepared than others to withstand bearish energy markets transcends budgeted projections. Our assessment of fiscal position, economic reliance on energy, and diversity of revenue sources suggest that Alaska, Louisiana and Oklahoma will be most affected should oil prices stay near today's levels for an extended period. That would likely require difficult budget decisions within the next few months. States such as Colorado and Texas are less vulnerable given greater economic diversity and/or significant reserves.

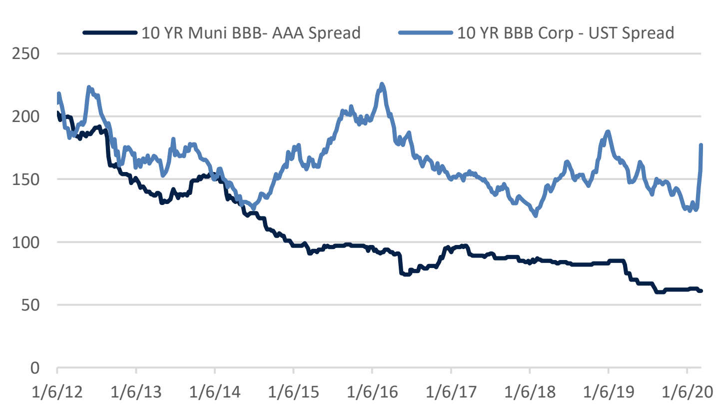
While an energy bear market would pressure certain credit ratings, we are not forecasting widespread municipal credit problems, and feel larger, well-established issuers are largely on solid ground. However, valuations are relatively rich and we feel that prudent credit analysis and security selection will prove valuable in terms of long-term portfolio total return.

Drilling More Deeply

State GOs are hardly alone in terms of potential energy-related economic impact. Local municipalities within energy states can have very different exposure. For example, Dallas is much less vulnerable than Houston given the former's minimal reliance on the energy sector. Looking carefully at local utility enterprises and bonds backed by dedicated taxes is also important.

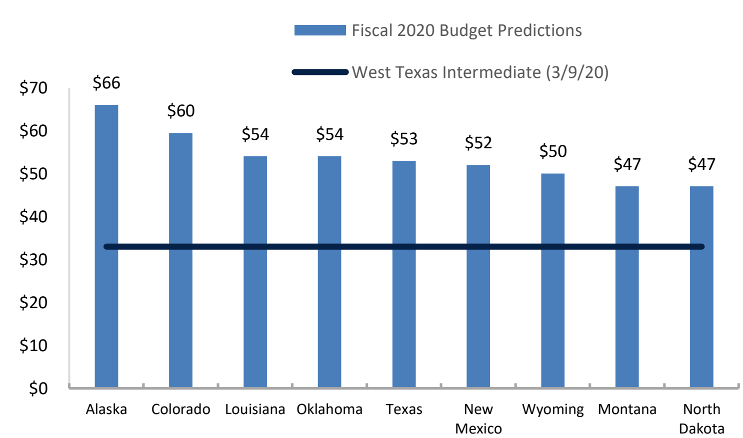
Where energy prices go from here remains to be seen as there are many economic and geopolitical unknowns. That's why proprietary research, a high quality credit profile, and ongoing due diligence have always been integral to our investment process.

Option-Adjusted Spread Movements:
January 6, 2012 - March 9, 2020



Source: Refinitiv Municipal Market Data

Budget Estimates for Crude Oil Prices
Select Energy States May Need Mid-Year Budget Assumptions



Source: Barclays Research