APPLETON PARTNERS, INC.

2025 Appleton Partners Municipal Sector Outlooks

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2025 MUNICIPAL SECTOR OUTLOOK

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SECTOR OUTLOOK

STATE GOVERNMENTS

Outlook: Stable (maintain)

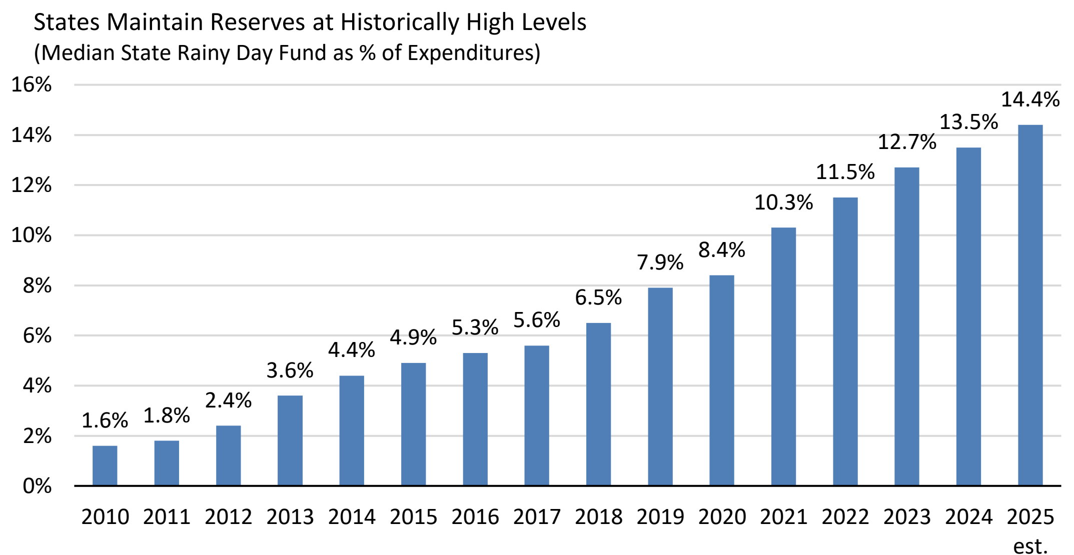
Sector Overview & Outlook:

We are maintaining our "stable" outlook for the State sector as both revenues and expenses normalize from elevated levels coming out of the pandemic. A still solid employment environment, a healthy housing market, and consumer wealth supported by strong 2024 investment performance point to a resilient economy in early 2025. While we expect 2025 GDP growth to be slower, yet still positive, should there be a downside surprise, most states are in a healthy fiscal position. This offers a cushion against potentially softer revenue collections.

The absence of a "hard landing," or any "landing" for that matter, in 2024 resulted in surprisingly positive revenue growth for States. Median state tax revenue was up a modest +1.3% in FY24 (National Association of State Budget Officers, Fall 2024 Survey), although this outpaced earlier estimates by 150 basis points. Expenditures were in line with estimates, resulting in overall budget outperformance. Surpluses, while not particularly large, can be used to boost reserves, provide supplemental retirement funding, and/or pay for capital expenditures.

We anticipate stable fiscal conditions for most States in 2025, an expectation based on slightly positive-to-flat revenues, along with easing inflationary pressures on expenditures. Favorably, budget officers are once again taking a conservative approach in FY25, projecting only +0.3% median revenue growth, according to NASBO. We believe there is potential for revenues to exceed those projections, particularly in States where high income residents enjoy outsize benefits from 2024 investment returns.

Should the national economy stumble, States are in relatively good shape to weather a downturn. Revenue outperformance means few have needed to tap reserves, leaving these funds at historically high levels. Median rainy-day balances compared to expenses are expected to reach 14.4% at the end of FY25, compared to 13.5% in 2024 and a prior 10-year average of 8.7%.



Source: Bank of America

A still healthy economy, robust reserves, and increased budgetary flexibility all support stable credit conditions for States in 2025. Potential federal policy changes – immigration, tax, energy, etc. – could have varying ramifications, but the impact and timing of those changes remain to be seen. Beyond 2025, cuts in federal spending, particularly Medicaid, could present more material challenges, particularly in States with generous expanded coverage. Time will tell, although in aggregate, the State sector remains a relatively stable area for tax-exempt investors.

SECTOR OUTLOOK

LOCAL GOVERNMENTS

Outlook: Stable (maintain)

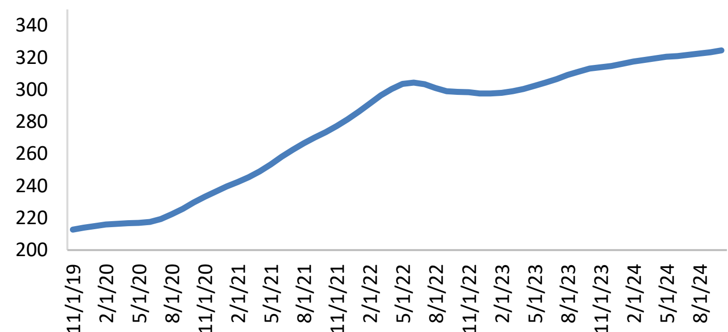
Sector Overview & Outlook:

Our "stable" outlook for Local Governments is driven by an expectation of healthy revenues and lower fixed costs, which is helping to offset growing operating expenses, most notably labor. While currently "stable," there is a possibility that increased caution will be necessary during 2H25, as a number of high-profile cities and school districts have begun to warn about future deficits.

We include cities, counties, towns, and school districts in the Local Government sector, and, generally speaking, the two largest revenue sources are property taxes and state funding. Our expectation is that both will remain healthy in 2025.

- Property Taxes are directly correlated with housing prices. Higher mortgage rates have not yet dented housing values in most areas of the country, given limited inventory. According to the U.S. Census Bureau, 40% of households do not have a mortgage, well above <33% reported in 2010. For those with a mortgage, 56% have a rate below 4% (Federal Housing Finance Agency). The incentive to move is low in today's rate environment, a dynamic that is keeping a lid on supply and a floor on pricing.
- State Funding – Our "Stable" outlook for States indicates that, as of now, there is little need to make cuts to local funding. Programs supported by States include K-12 education, healthcare, and transportation.
- Commercial Real Estate (CRE) – While property devaluation pressure remains an issue, particularly office space, worries of a "doom loop" appear to be receding. Reliance on CRE varies across urban centers, although even the most exposed are likely to weather the downturn well. Valuation declines are stretched over multiple years, allowing for phased-in budget adjustments. Media attention focused on commercial property weakness tends to overlook the fact that residential properties dominate most city tax bases. Revenue diversity also allows cities to offset or mitigate lower CRE derived property taxes. We are evaluating data as it becomes available but do not currently view CRE exposure as an overly troublesome 2025 risk.

Despite Elevated Mortgage Rates, the Housing Market Remains Strong
S&P CoreLogic Case-Shiller U.S. National Home Price Index



Source: S&P CoreLogic Case-Shiller U.S. National Home Price Index

Local Governments are also benefiting from improvements in pension funding, which allows annual costs to remain stable. The Equitable Institute indicates that the aggregate funded ratio for State and local pension plans was estimated to reach 81% at the end of 2024, up from 75.6% in 2023, in large part due to strong recent investment returns. A single year of investment performance may not be indicative of a trend, but it can alleviate pension funding pressure for municipalities.

Labor costs will be a 2025 focus for our Research team as it typically represents a local government's largest expense item. While long-term benefit funding will likely be stable, wage increases are likely to exceed revenue growth. Generous multi-year labor contracts granted in recent years when inflation was running >5.0% are causing some municipalities to warn about upcoming budget gaps. Large cities such as San Francisco, Los Angeles, and Chicago have reported increasing out-year deficits. The extent of these and other gaps varies significantly, with Chicago (a name not approved at Appleton) facing particular challenges. The Local Government sector remains stable in our view, although careful issuer evaluation is warranted. We favor Local Governments that serve vibrant economies, operate in states with healthy funding conditions, and have proactively managed long-term liabilities such as debt and pensions.

Sector Outlook

Healthcare

Outlook: **Stable (maintain)**

Sector Overview & Outlook:

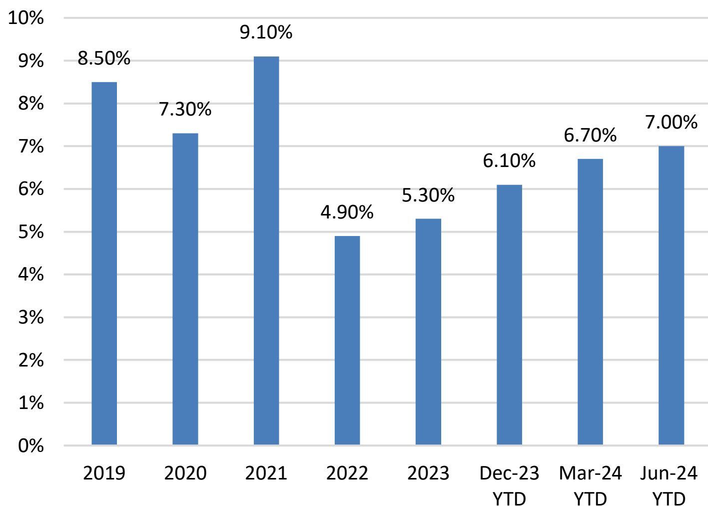
The Healthcare sector is slowly finding its stride after years of having to adapt to a challenging operating environment in the wake of the pandemic. The largest factors thwarting operating margins in recent years were staffing shortages, supply inflation, and wage growth. While these factors are still present for most hospitals, health systems have been adjusting their operations to meet these realities, and we are now seeing margin improvement. Per Moody's, the median operating cash flow margin is now approaching 7%, a sustainable level that allows systems to invest in their infrastructure while strengthening their balance sheets.

Persistent inflation remains a concern for healthcare credits although, contrary to recent years, many systems are starting to see their expense control efforts bear fruition by focusing on improving hospital efficiencies and utilizing advancements in technology to improve productivity across a myriad of departments. In general, large health systems have greater leverage in this regard as they benefit from economies of scale. Many health systems have gained control of contract labor costs, which has helped alleviate wage pressure and reduced employee turnover.

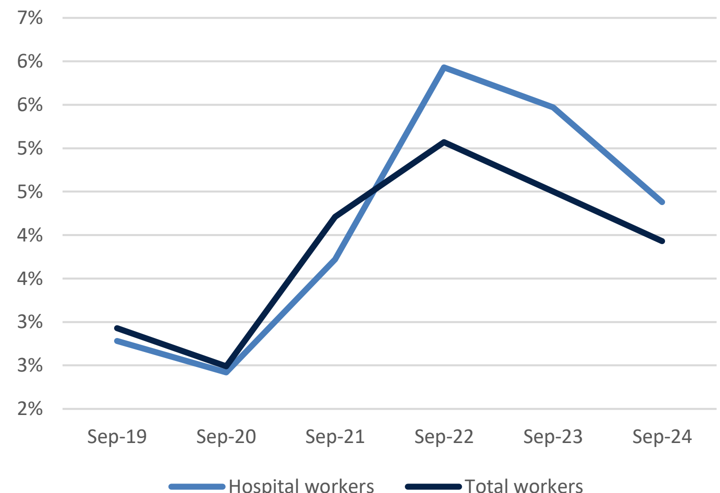
On the revenue side, many systems have been able to negotiate higher commercial insurance reimbursement rates, a development that, paired with increased adoption of state-directed payment programs, has enhanced funding. Volume growth continues at a stable pace, though outpatient services have seen a significant patient draw and have grown at a faster rate than inpatient services. This has an outsized benefit to large health systems as they have a greater ability to put resources and funding into constructing and expanding outpatient facilities that can drive revenue growth. Inpatient margin improvement has often been focused on increasing efficiency through reduced length of stay and by alleviating capacity constraints.

Hospital management teams have faced challenging times as they have been forced to evaluate many facets of operations since the onset of the pandemic. While median operating margins remain below pre-pandemic levels, we expect systems with experienced management teams and sufficient capital to invest in productivity enhancement will be able to improve operating efficiency. Increased deployment of AI tools and IT infrastructure should accelerate efficiency momentum and generate steady margin increases over the next few years.

We are looking for issuer specific opportunities in large multistate systems with financial flexibility and seasoned management teams, as we feel they are generally much better equipped to make critical operational decisions. This is important in sustaining the performance needed to excel in today's environment.



Source: Moody's



Source: S&P, U.S. Bureau of Labor Statistics

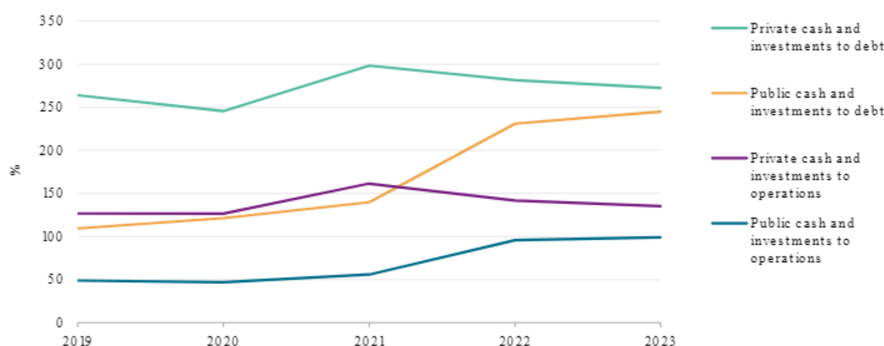
SECTOR OUTLOOK

HIGHER EDUCATION

Outlook: Stable (maintain)

Sector Overview & Outlook:
We are maintaining a "stable" outlook for the higher education sector. This past year was challenging in the aftermath of the affirmative action decision, controversial protests, FAFSA delays, and the impending "demographic cliff." We foresee plenty of headline risk in 2025, although, in our view, credit quality should improve for the top half of higher education institutions.

The higher education market has become increasingly bifurcated by quality. Top schools have seen their acceptance rates grind lower and have rapidly grown their endowments. On the other side of the spectrum, a growing number of smaller, more liberal arts and regional schools have either closed or are facing pressure to find a merger partner. During the 2023-2024 academic year, 19 non-profit higher education institutions closed, merged, or lost Title IV eligibility, and this trend has continued throughout 2024 (Source: Inside Higher Ed). The level of closings is rising, and we expect to see more consolidation in the years ahead. With a "demographic cliff" in mind, less prestigious, smaller liberal arts schools in the Northeast and Midwest will likely face continued struggles.



The Trump Administration is expected to introduce volatility to the higher education sector in 2025. International student demand should wane as it did during the initial three years of Trump's first term. The extent to which research dollars will be reduced or redirected also remains to be seen.

More positively, State support continues to backstop public institutions, as funding increased in 42 out of 50 states in fiscal 2024 (Source: Fitch). As displayed in the accompanying chart, public institutions have also closed their cash and investments to debt gap over the last couple of years. For the most part, the ire of the new Administration has been directed at private institutions, with public institutions less likely to be affected by any forthcoming changes.

According to Moody's November 2024 Higher Education survey, enrollment was expected to increase modestly in Fall 2024, with public schools (+1.9%) outpacing private schools (+0.7%). Looking at the overall sector more broadly, net tuition revenue is expected to increase by 2.9% in FY25, although most of this growth risks being offset by inflationary cost pressures (Source: Moody's).

We maintain a preference for higher education institutions that maintain a strong competitive position, are relatively large, benefit from revenue diversity, and exhibit solid financial profiles that offer greater fiscal stability. Given the factors discussed above, we favor public institutions over private entities in 2025 but note that some select private universities remain viable investment opportunities.

SECTOR OUTLOOK

AIRPORTS

Outlook: **Stable (maintain)**

Sector Overview & Outlook:

Passenger activity growth was sustained in 2024 as TSA passenger volumes were up almost 5% YoY. However, growth has slowed considerably over the last four years, with the rate of increase returning to more typical pre-pandemic levels.

The YoY growth rate also noticeably slowed over the course of 2024, with November volume below the prior year's pace.

TSA Throughput (YTD as of 11/30)	
2024	825,847,864
2023	788,112,467
2022	693,939,952
2021	525,911,397
2020	311,989,697
2019	775,014,545

Source: U.S. Transportation Security Administration

While we expect passenger volume to increase in 2025, the trend of slowing growth rates is likely to continue. Our expectation is for low single digits in 2025 due to two principal factors:

- The macro environment should be less supportive, with economic growth rates lagging and a somewhat weaker consumer reducing discretionary spending.
- The impact of this will be felt most acutely by the middle-to-lower-income consumer, a dynamic that most heavily impacts airports with a higher reliance on budget airline traffic.
- Airlines are expected to reduce or slow the growth in available seats to stabilize prices and increase margins.
- A reduction in available seats would have the ancillary effect of reducing non-airline revenue for highly impacted airports, as fewer passengers lead to lower parking, rental car, and concession revenue.

The airport sector also faces significant capital costs due to maintenance demands and terminal expansion projects aimed at increasing capacity and meeting the needs of larger aircraft. The costs of these capital projects are increasing along with construction inflation, with the Airport Council International North America estimating airport capital needs of $151B, an increase from $115B in 2021. While these expenses will not all be debt-financed, Moody's is projecting debt issuance from their rated universe of $68B through 2029, an increase of $8B in just the last year. Fiscal flexibility is also constrained as most of these plans cannot easily be altered once they are started given the nature of the contracts and the use of federal grant money that has specific time limits.

However, most airports enter this period in a very strong financial position. Liquidity averages over 700 days of cash on hand, and leverage profiles are generally strong. Many use and lease agreements between the airports and the signatory airlines allow airports to pass increasing debt service costs to the airlines, a contractual arrangement that is helping airport systems maintain their strong credit profiles while funding capital plans.

We prefer large hub airports as well as select smaller regional airports that benefit from a dominant market position and have a more consistent passenger demand profile. The strength of management teams is also a factor we evaluate given the need to address growing capital requirements and an uneven demand profile.

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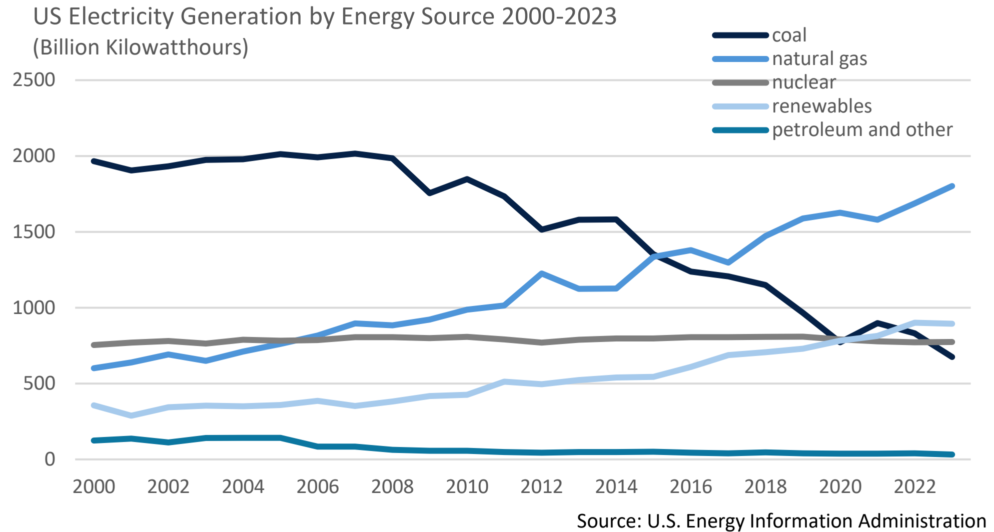
SECTOR OUTLOOK

PUBLIC POWER

Outlook: Stable (maintain)

Sector Overview & Outlook:

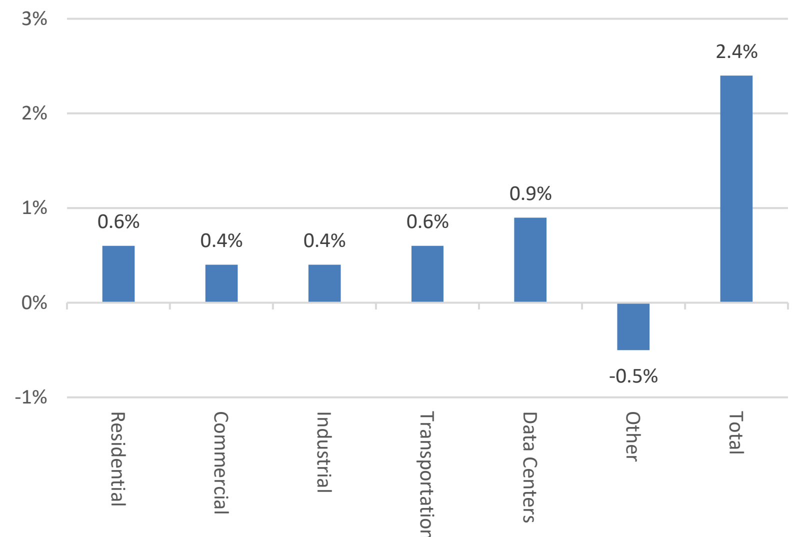
We are maintaining a "stable" outlook for the Public Power sector in 2025. Relatively stable natural gas prices made 2024 a less eventful year than the last few, helping utility bond issuers maintain their credit standing. Henry Hub natural gas prices remained range bound between $1.5 - $3.2 million BTU (Source: EIA). By contrast, prices had risen as high as $8.8 per million BTU in 2022.



Source: U.S. Energy Information Administration

Natural gas continues to gain ground in terms of U.S. electricity generation, whereas coal's downward trend has not been altered. Nuclear, renewables, and petroleum have all been stable over the last few years. Given its dominant position in electricity generation, the public power sector has become increasingly levered to natural gas prices. The U.S. is currently producing the most natural gas in its history, and the Trump Administration welcomes more natural gas production (Source: EIA). The supply effect on prices may be offset, though, by rising tensions in oil-rich areas of the world. It is very difficult to forecast the path of natural gas prices in 2025, a risk factor that could impact the public power credit landscape.

Another important element of public power credit lies in data centers. As artificial intelligence rises to the forefront, data center development is imperative. After many years of stagnant demand growth (0% CAGR from 2007-2022), data center expansion has re-ignited capacity needs in the public power sector. Increased efficiency has constrained public power growth historically, although recent estimates of +2.4% CAGR through 2030 are noteworthy, and the assumption there is that about a third of that growth will be data center-driven (Source: Goldman Sachs). Although data centers represented only 3% of U.S. power usage in 2022, their share is expected to increase to 8% by 2030 (Source: EIA). Public power utilities will need to continue to invest in power infrastructure to keep up with growing demand.



Source: Goldman Sachs Research, EIA

In this environment, our investment thesis from last year has not fundamentally changed. We continue to prefer public power issuers with large and reliable service areas, comfortable debt service coverage levels, and ample liquidity. More capital investment will be required to keep pace with increased demand, and we are looking for issuers with the ability to pass along increased costs through rate adjustments. Rate flexibility, liquidity, and reasonable leverage are paramount for public power utilities as the sector moves into a new era.

SECTOR OUTLOOK

TOLL ROADS

Outlook: Stable (maintain)

Sector Overview & Outlook:

Toll Roads realized traffic growth through the past year but at a slower pace, with total vehicle miles traveled increasing <1% YoY through September 2024. This very modestly surpassed the pre-pandemic peak.

Total Vehicle Miles Traveled - 9-Months Ended:	
9/30/24	2,470,095
9/30/23	2,450,583
9/30/22	2,398,760
9/30/21	2,340,750
9/30/20	2,157,274
9/30/19	2,455,727
9/30/18	2,428,100

Federal Reserve Economic Data, Federal Reserve Bank of St. Louis

Toll revenue growth is outpacing traffic growth though, due largely to CPI-linked toll increases. All systems we cover reverted back to formulaic toll schedules after choosing lower than allowable increases during recent periods of surging inflation. Healthy revenue growth has allowed credit metrics to further improve, with average days cash approaching 1,200 days and enough available liquidity to cover over three years of cash operating expenses. Median debt service coverage is also nearing 2.5x.

While we expect to see traffic and revenue growth in FY25, several factors will present revenue and credit challenges going forward.

- A weaker macroeconomic backdrop is expected to hinder commercial and passenger traffic growth, as FY25 GDP expansion is likely to slow, and unemployment may tick up.
- Toll systems will need to maintain funding for large capital plans aimed at deferred maintenance and expansion plans. Project costs are generally running higher than originally budgeted, largely a product of the last few year's inflation. To fund these plans, management teams will need to spend down currently very strong liquidity and issue additional debt.
- While toll rate increases are expected to fund most capital spending requirements, increases will be lower than those of the last few years due to slowing inflation and affordability concerns. Weaker economic expansion rates may end up hindering customers' willingness and ability to pay higher tolls.
- The level of federal infrastructure funding coming from the Trump Administration is an open question. A decline in funding is a real possibility that would introduce a need for either additional debt or further reductions in liquidity.

Our base case calls for overall traffic growth of <1% and a 2% increase in toll revenue, the latter of which should be largely in line with inflation, given CPI-linked toll increases. These revenues will allow the leverage profile of most sector issuers to remain sound even as more debt is issued to fund large ongoing capital programs. Liquidity is expected to weaken yet remain more than adequate to support sound credit profiles among most credits.

While our "stable" sector outlook remains in place, we continue to prefer large toll systems that cover broad, economically vibrant service areas that are integral to growing populations. We also look for systems that are supported by strong, seasoned management teams that maintain adequate liquidity and leverage profiles.

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SECTOR OUTLOOK

WATER & SEWER

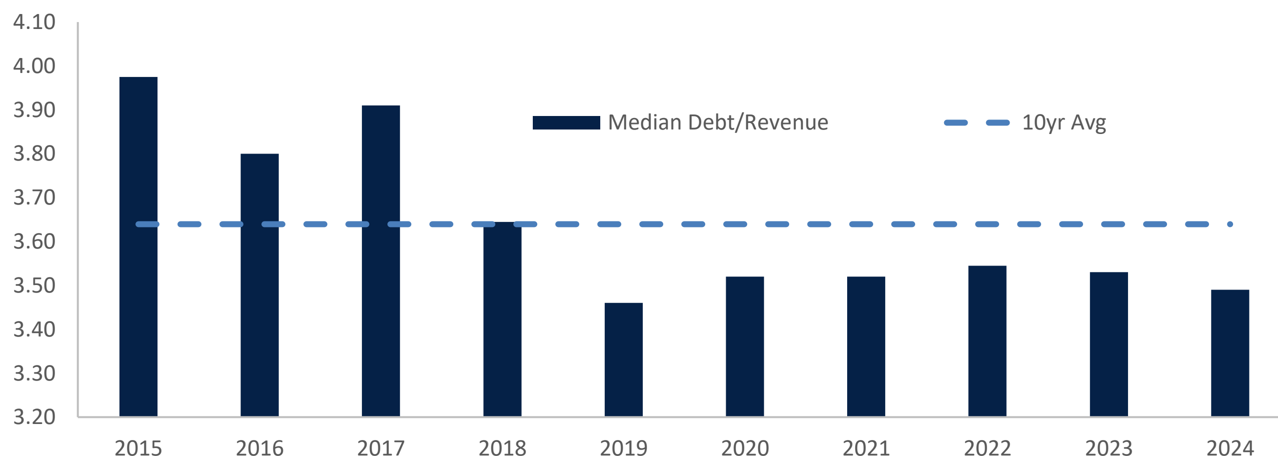
Outlook: Stable (maintain)

Sector Overview & Outlook:
Essentiality of service, autonomous rate-setting authority, and strong customer support for necessary capital investments all support the defensive nature of the Water & Sewer sector. We are maintaining a "Stable" sector outlook based on an expectation that these factors will allow for 2025 revenue growth and healthy operating margins.

The need for reliable and safe water and wastewater services generally allows municipal utilities to push through price increases that cover growth in operating expenses and necessary infrastructure investment. This customer reliance tends to be consistent through economic cycles. Outside of a handful of utilities servicing economically depressed markets, economic conditions in 2025 should support most revenue needs.

While other sectors worry about potential Trump Administration policy changes, deregulation could be a positively affect Water & Sewer sector. The EPA finalized regulations in 2024 that limited per- and polyfluoroalkyl substances (PFAS) and shortened the timeline to replace lead lines to 10 years from 30 years. Any elimination or watering-down of recent mandated programs would mitigate capital needs and reduce the need to increase borrowing. Of course, the reprieve could be only short-term, and some entities may voluntarily choose to go forward with planned investments in the interests of customer health.

Drought conditions have dramatically reduced, although this is always a lurking risk. Regardless of potential deregulation, utilities in areas prone to drought will be forced to invest in resource diversity, storage, and recycling capabilities. Leverage for these utilities will increase, necessitating rate hikes. The risk is clearly greatest in the Western and Southwestern U.S.



Source: Merritt Research Services, Issuer Financial Statements

Our research process seeks out Water & Sewer utilities that serve healthy economies, proactively invest in infrastructure maintenance, and have the ability and willingness to implement affordable rate increases that support their long-term credit profile.

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SECTOR OUTLOOK

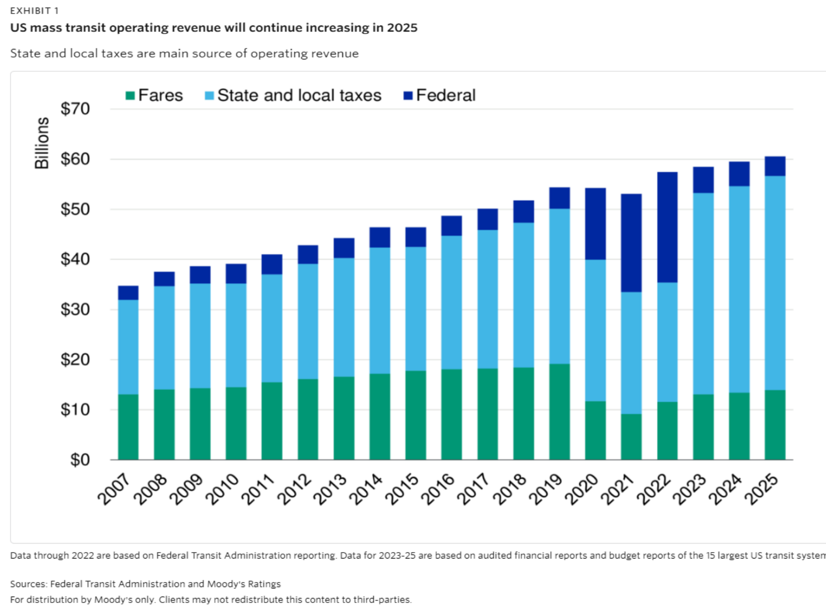
MASS TRANSIT

Outlook: **Stable (upgrade from Cautious)**

Sector Overview & Outlook:

While the Mass Transit sector faces sustained ridership challenges brought on by the pandemic, many have adjusted to ridership levels that have settled below prior norms. Over the last four years, Federal funds have served to bridge revenue gaps created by lagging ridership volume, helping systems avoid a significant fiscal cliff. Given an expectation that these funds would be depleted in 2024, transit systems have tirelessly worked to replace revenue sources, primarily through State and local tax dollars. Moody's reported that increases in State and local tax revenue have offset lost fare revenue on a nearly dollar-for-dollar basis. This has created revenue stability and is the primary catalyst in our update to "Stable," up from last year's "Cautious."

Most systems rely heavily on tax revenues drawn from the economies they serve, a funding source that is considered to be relatively stable. Economic expansion and strong consumer spending have both been positives, although we are projecting only about 2% growth in 2025. Proposed new taxes and fees represent a source that certain systems may tap into in 2025 and beyond, a source of funding that would be directed in part to new transit initiatives.



Reliance on State aid is likely to become increasingly necessary, a concern somewhat mitigated by the critical role transit systems play in local and regional economies. While we value the sector's essentiality and recognize the importance of State and Federal aid, this revenue source can be volatile given the need for annual appropriation and the ability of States to reduce funding during weak economic periods. Revenue is also vulnerable to fluctuations resulting from service reductions, operational challenges, or other system changes. Sustaining financial flexibility and operational excellence has become increasingly challenging for most mass transit systems in an age of reduced ridership.

Our Credit Research team favors Mass Transit systems that are economically essential, enjoy strong voter support, have debt secured by dedicated tax revenues, and benefit from healthy local economic conditions. We are inclined to invest in issuers with relative revenue stability, ample debt coverage, and those that segregate revenue to fund debt service before operations.

SECTOR OUTLOOK

PORTS

Outlook: **Stable (maintain)**

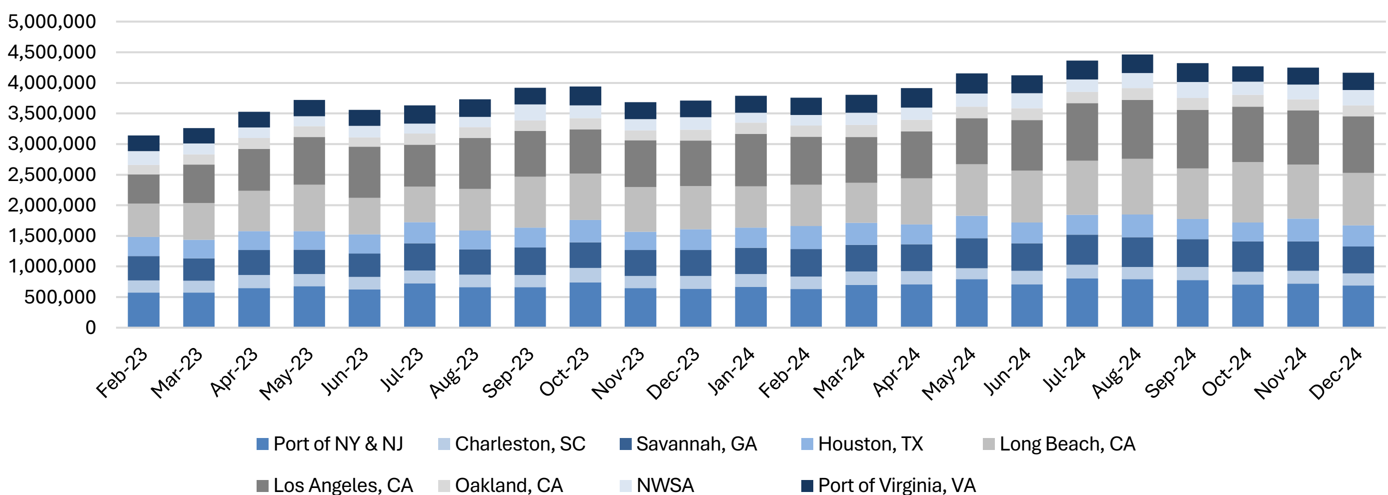
Sector Overview & Outlook:

Our outlook for the Port sector remains stable as cargo volume is expected to increase at a modest rate of 2% in 2025. We view this marginally positive growth as favorable despite slowing relative to 2024. Slower growth is largely the result of tepid GDP expansion, modest consumer spending, and an inventory buildup caused by retailers accelerating shipments to avoid potential tariffs and disruptions from a potential East Coast strike, which has since been resolved.

President Trump has already imposed or threatened several new tariffs on trading partners. The ultimate extent of the impact will depend on the actual size and scale of tariffs after what promises to be an extended negotiation process. If significant tariffs are sustained, a sharp decline in cargo volume would likely result as retailers adjust shipments. Operator ports generate revenue based on cargo volume and would, therefore, be at the greatest risk.

In the second half of 2024, retailers increased shipments ahead of potential strike activity at East and Gulf Coast Ports. Members of the International Longshoremen's Association and employers were amid labor negotiations regarding salary increases and job security, although the two sides were able to reach an agreement in early January 2025, avoiding a second strike. While avoiding further strike activity is a positive, retailers had prepared by accelerating shipments in the second half of 2024 to build up inventory levels. Similarly to the impact of tariffs, operator ports will be most impacted as management subsequently adjusts to the buildup in inventory levels. While volume growth will soften, experienced management is well-equipped to deal with the volatility.

Despite temporary headwinds, Ports benefit from economic essentiality, as the transport and delivery of goods throughout the nation is critical to commerce. Most issuers also possess strong reserves accumulated through robust recent operations along with prudent management teams. Our credit process seeks Port issuers based in economically vibrant markets that boast dominant market positions, advanced infrastructure, and stable financial profiles. We also favor "landlord" ports that derive a large portion of revenue from long-term leases, as this allows for more stable financial operations.



Source: U.S. Department of Transportation

ONE POST OFFICE SQ. BOSTON, MA 02109 TEL. 617.338.0700 WWW.APPLETONPARTNERS.COM

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