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Investment Insights | Fixed Income

State of the state: Pennsylvania

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Overview

- Pennsylvania benefits from a large and diverse economy that has seen consistent growth in the last several years.
- Going forward, the commonwealth's creditworthiness will likely be largely influenced by its ability to maintain available reserves without reliance of one-time revenues and the continuation of increased pension funding.
- The investment team likes Thomas Jefferson University's health system (Jefferson Health) due to its sufficient liquidity cushion, ability to access financial markets, and strong leadership team.

State overview

Despite some challenges facing the Commonwealth of Pennsylvania, the investment team believes it should maintain its current investment grade ratings. Pennsylvania benefits from a large and diverse economy that has seen consistent growth in the last several years,[1] as well as access to liquidity through the State Treasury or issuance of tax-anticipation bonds (TANs).[2] Another positive for the state is the government's commitment to addressing its weak pension funding ratio, as demonstrated by the fiscal 2023 enacted budget fully funding the actuarially determined contributions for Pennsylvania's public pension plans.[3]

We believe there are two major factors that most heavily weigh on the commonwealth's direction of ratings. Despite increasing contributions over the last several years, Pennsylvania's pensions have continued to be funded below the 80% mark that the US Government Accountability Office deems to be sound for public pensions.[4] Secondly, a history of imbalanced budgets remedied with one-time revenues has resulted in persistently narrow reserves.[5] While reserve levels have recently improved, these advances are largely due to one-time transfers of federal aid related to the COVID-19 pandemic.[3]

Pennsylvania general obligation update

Moody's: Aa3/Stable Outlook[6]

- Moody's has maintained an Aa3 rating with a stable outlook since May 2016. This rating is based on credit positives including a large and diverse tax base, stable access to liquidity and improving pension payment practices. Credit negatives cited are higher than average leverage, slim budget reserves and below average economic performance.

S&P: A+/Stable Outlook[2]

- S&P has maintained an A+ rating for the state since 2017. In August 2021, the outlook was revised from negative to stable. Reasons cited for the outlook change included the influx of federal aid, stronger-than-expected revenue collections, and deposits into the state's Budget Stabilization Fund. S&P noted concerns regarding the challenges Pennsylvania will face in balancing future budgets without one-time federal aid funding.

Fitch: AA-/Positive Outlook[7]

- Fitch has assigned an AA- rating since July 2019. The outlook was revised from stable to positive in April of 2022, due to Pennsylvania's operating surplus and subsequent increase in reserves. Despite seeing economic growth prior to the COVID-19 pandemic, Fitch noted concerns relating to the state's history of implementing one-time budget measures and structurally imbalanced budgets.

Fiscal Year 2022 Financial Update

As in fiscal 2021, Pennsylvania's operational performance was better than expected. According to the Department of Revenues, General Fund* revenues exceeded estimates by $5.6 billion, or 13%.[8] The outperformance was primarily driven by the two largest sources of General Fund revenues, personal income tax (PIT) receipts and sales and use tax (SUT) receipts. These revenue sources represented 38% and 29% of fiscal 2022 total operating revenues, respectively and exceeded estimates by 15% and 9%, respectively.[8] Corporate tax receipts, which represent the third largest revenue source at 15% of fiscal 2022 total General Fund revenues, exceeded estimates by 29%.[8]

Unaudited financial reports for fiscal 2022 reveal appropriations of $37.5 billion, which were a 10% increase over the prior fiscal year.[9] The majority of expenditures were appropriated to education and human services, which comprised 82% of total expenditures.[9]

Like many states, the Commonwealth of Pennsylvania ended fiscal 2022 with record reserve levels.[10] Per the State Treasurer's office, the General Fund balance increased by $3.7 billion from fiscal year end 2021 to fiscal year end 2022, an increase of 26%.[10]

In addition to General Fund balance increases, Pennsylvania saw an increase in its Budget Stabilization Fund (BSF).[11] Based on the surplus accumulated in fiscal 2021, the enacted fiscal 2022 budget included a transfer of $2.6 billion to the BSF, increasing the fund balance to 27 days cash on hand.[11]

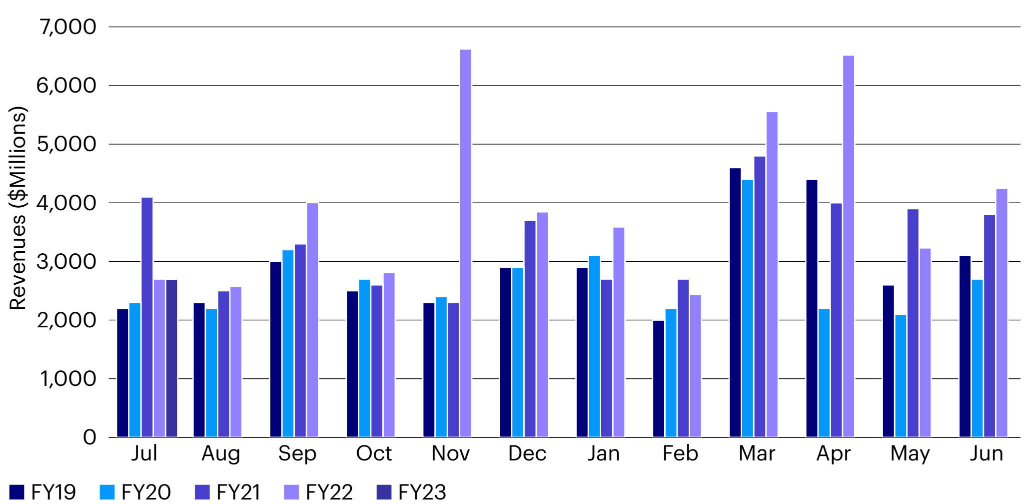
Fiscal Year 2023 Enacted Budget

The Commonwealth of Pennsylvania's fiscal 2023 budget includes a transfer of $2.1 billion from the General Fund to the Budget Stabilization Fund (BSF), commonly referred to as the rainy day fund.[3] This is the second consecutive year of sizable transfers into the BSF, bringing the total rainy day fund balance to $4.96 billion or 42.3 days of operating expenses.[3] This is in contrast to the fiscal year end 2021 level of 2.2 days cash on hand,[12] and is higher than the 2021 50-state median of 34.4 days cash on hand.[3]

The enacted fiscal 2023 budget includes General Fund appropriations of $43.7 billion, a 17% increase over fiscal 2022.[9] Education and human services lead expenditures, accounting for 84% of the budget.[9]

According to both the Secretary of Revenue and Secretary of the Budget, projected General Fund revenues for fiscal year 2023 total $43.6 billion, a decrease of $4.6 billion, or 9% compared to the prior fiscal year.[3] The main driver of this revenue decrease is the lack of non-recurring $3.8 billion American Rescue Plan Act (ARPA) funds that were included in fiscal 2022's revenues.[3] Taking these ARPA funds into account, fiscal 2023 ongoing revenues are only expected to decline 2% for the year.[3] Of the $7.29 billion ARPA funds allocated to Pennsylvania, $2.16 billion remains to be appropriated in future years.[3]

Monthly General Fund Revenues



FY refers to Fiscal Year.
Source: Pennsylvania Department of Revenue as of July 2022.

*The General Fund is the primary state fund from which the ongoing expenses of state government are paid.

Liquidity

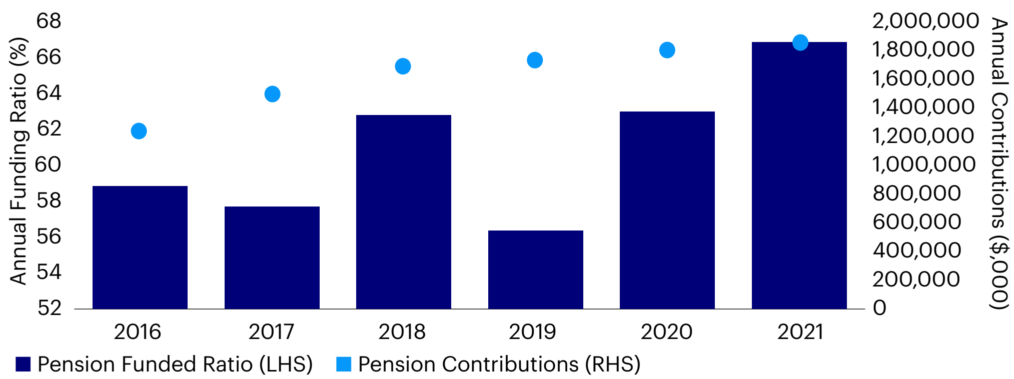
In our opinion, Pennsylvania benefits from access to liquidity. In the past, the commonwealth has relied on the state treasurer for liquidity, borrowing $1.5 billion in November 2019.[13] In January 2020, the treasurer increased the line of credit to $2 billion.[13] At the end of fiscal 2021, the commonwealth saw an increase in total governmental cash and investments of roughly $13 billion, $7.2 billion of which came from ARPA funds.[14]

Pension funding

Like many states, Pennsylvania is facing a rise in its pension liability.[15] The state's pension has been consistently underfunded, ending fiscal 2020 with a funded ratio of 63%.[15] While pension contributions have increased yearly since 2014, Pennsylvania failed to meet the required contribution in fiscal 2018.[15] However, beginning in fiscal 2019, the state has made 100% of its required pension contributions each year.[15] Furthermore, the executive fiscal 2023 budget fully funds the actuarially determined amount for the state's pensions.[3]

Pennsylvania's pension liability increased to $15.6 billion as of fiscal year end 2021, a 2% increase from the previous year.[15] Meanwhile, pension contributions increased 4% over the same period.[15] The commonwealth's efforts to shore up pension funding appears to be paying off, with the pension funding ratio increasing from 56% in fiscal 2019 to 67% in fiscal 2021.[15]

Pension Overview



Source: CreditScope, as of June 30, 2022.

Economic update

Although Pennsylvania is the nation's fifth-most populous state with a population of 12.9 million as of 2021, the commonwealth's population growth has been flat from 2010 through 2021.[15] This zero-growth trend is expected to continue through 2030.[16]

Going into the pandemic, Pennsylvania's real GDP growth rate was 1.7%, dropping to -4.5% in 2020.[16] However, 2021 saw the state's GDP bounce back at a growth rate of 4.4%, and the Independent Fiscal Office projects GDP growth will remain stable at roughly 2% per annum through 2025.[16]

Pennsylvania has two major metropolitan areas, Philadelphia and Pittsburgh,[17] and is the second-largest natural gas producer in the nation.[18] Additionally, some large tech firms, including Google and eBay, have moved to the state, drawn by the talent of students from many of its universities.[17] As of June 2022, education and health services comprise the majority of the state's non-farm employment with 21% of non-farm employees, followed by the trade, transportation, & utilities industry at 19%.[19] These industries saw a drop in employment of 4% each from January 2020 to January 2021.[20] However, from January 2021 through June 2022, the trade, transportation, & utilities industry grew 5%, while education and health services growth was flat.[19]

Pennsylvania's unemployment rate peaked in April 2020 at 15.5%, driven by the shutdowns associated with the COVID-19 pandemic.[19] Unemployment steadily decreased until June 2022, when the jobless rate ticked up to 4.6% from 4.0% the prior month.[19] While this figure is higher than the national unemployment rate of 3.8% for the same period,[19] Pennsylvania's economic growth has historically lagged that of the nation in times of economic expansion.[9] Wealth indicators for the commonwealth are mostly in line with those of the country as a whole.[15]

Sources:
1. PA Offering Statement, Appendix B "Selected Data on the Commonwealth of Pennsylvania," as of September 16, 2020.
2. S&P report, dated August 4, 2021.
3. House Appropriations Committee, 2022/23 Budget in Depth, July 20, 2022.
4. U.S. Government Accountability Office, State and Local Government Pension Plans: Current Structure and Funded Status, July 10, 2008.
5. S&P report, dated April 15, 2021.
6. Moody's report, dated April 14, 2022.
7. Fitch report, dated April 22, 2022.
8. Pennsylvania Revenue Department, July 1, 2022.
9. Pennsylvania Governor's Executive Budget 2022-2023, published February 8, 2022.
10. Pennsylvania Treasury Transparency Portal, as of June 30, 2022.
11. House Appropriations Committee, 2021/22 Budget in Depth, July 1, 2022.
12. Pennsylvania Treasury Transparency Portal, as of June 30, 2021.
13. Moody's report, dated June 30, 2020.
14. Commonwealth of Pennsylvania Annual Comprehensive Financial Report for the Fiscal Year Ended June 30, 2021, dated December 10, 2021.
15. CreditScope, as of June 30, 2021
16. PA Independent Fiscal Office, Economic and Budget Outlook 2021 - 2026, dated November 15, 2021.
17. Pennsylvania Offering Statement, dated June 16, 2021.
18. PA Independent Fiscal Office, Q4 2022 Natural Gas Production Report, dated February 22, 2022.
19. U.S. Bureau of Labor Statistics, as of June 30, 2022.
20. U.S. Bureau of Labor Statistics, as of June 4, 2021.

Spotlight on a Pennsylvania Revenue Bond
Issuer: Thomas Jefferson University (aka Jefferson Health)

Moody's: A2 (1/17/2022)
S&P: A (1/11/2022)

Thomas Jefferson University was founded as a medical college in 1824 and opened its first free-standing hospital called Thomas Jefferson University Hospital in 1887.[1] Today, Thomas Jefferson University contains 7,229 full-time equivalent students with two campuses offering graduate, undergraduate, and certificate programs in numerous health professions.[2] However, over 80% of operating revenue for Thomas Jefferson University consists of net patient service revenue that is generated from its fourteen acute care hospital locations and outpatient facilities under the name Jefferson Health.[3] Despite the ongoing uncertainty and economic challenges associated with the COVID-19 pandemic, the underlying credit qualities at Thomas Jefferson University remain strong and have continued to support a bond rating in the A category by Moody's and S&P.[4]

Thomas Jefferson University's health system, Jefferson Health, is a nationally ranked academic medical system. This organization has a deep and experienced senior leadership team responsible for developing and executing the organization's strategic objectives. For example, Jefferson Health has experienced significant growth in recent years through several strategic acquisitions and is now among the market leaders throughout the Philadelphia-Camden-Wilmington metropolitan statistical area. Also, the organization recently acquired the Health Partners Insurance Plan to further diversify operating revenue and help provide additional growth opportunities.

Monitoring the financial performance of credits is a primary focus for the Invesco municipal research team as borrowers continue to manage the operating and economic challenges related to the pandemic. Thomas Jefferson University has continued to maintain a strong balance sheet with ample liquidity and appropriate financial leverage in relation to its rating category. Having characteristics such as; a sufficient liquidity cushion, the ability to access financial markets, and a strong leadership team are likely to help this organization successfully navigate through this difficult economic environment and maintain an investment grade rating.

Sources:
1. Thomas Jefferson University Official Statement, Series 2022B, dated January 27, 2022.
2. Thomas Jefferson University Annual Continuing Disclosure 2021-2022 Academic Year, dated October 28, 2021.
3. Thomas Jefferson University Consolidated Financial Statements, as of June 30, 2021, dated October 28, 2021.
4. Moody's Report dated January 17, 2022 and S&P report dated January 11, 2022.

Invesco Municipal Bond team

The Invesco Fixed Income Municipal Bond team's investment philosophy is based on the belief that creating long-term value through comprehensive, forward-looking research is the key to providing clients with diversified portfolios that aim to maximize risk-adjusted returns.

Proprietary credit research and risk management are the foundations of our investment process, supported by a deep and experienced team of investment professionals with expertise that spans the entire municipal investment universe. We maintain an integrated, team-based investment process that combines the strength of our fundamental credit research analysts with the market knowledge and investment experience of our portfolio managers.

Our position among the top 10 municipal investment managers by assets in the US* enables us to access preferred market opportunities and gain valuable market insight. Our team has established relationships with more than 120 national and regional municipal debt dealers in the US. We believe these established relationships, as well as our size, allow us to achieve fluid execution in daily transactions. Our ability to aggregate trades across multiple portfolios also enables us to obtain lower institutional pricing, which can contribute to portfolio performance.

About risk

Municipal securities are subject to the risk that legislative or economic conditions could affect an issuer's ability to make payments of principal and/or interest.

Junk bonds involve greater risk of default or price changes due to changes in the issuer's credit quality.

The values of junk bonds fluctuate more than those of high quality bonds and can decline significantly over short time periods.

All fixed income securities are subject to two types of risk: credit risk and interest rate risk. Credit risk refers to the possibility that the issuer of a security will be unable to make interest payments and/ or repay the principal on its debt. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa.

Municipal bonds are issued by state and local government agencies to finance public projects and services. They typically pay interest that is a tax in their state of issuance. Because of their tax benefits, municipal bonds usually offer lower pre-tax yields than similar taxable bonds. The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

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Past performance does not guarantee future results.

A credit rating is an assessment provided by a nationally recognized statistical rating organization (NRSRO) of the creditworthiness of an issuer with respect to debt obligations, including specific securities, money market instruments or other debts. Ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest); ratings are subject to change without notice. If securities are rated differently by the rating agencies, the higher rating is applied. Not Rated indicates the debtor was not rated and should not be interpreted as indicating low quality. A negative in Cash indicates fund activity that has accrued or is pending settlement. Pre-Refunded / Escrowed to Maturity (Prerefunded / ETM) bonds are issues backed by an escrow account, invested in US Treasuries, which is used to pay bondholders. Other includes bonds rated below single B and bonds currently not paying a coupon. For more information on the rating methodology, please visit www.standardandpoors.com and select 'Understanding Ratings' under Rating Resources on the homepage; www.moodys.com and select 'Rating Methodologies' under Research and Ratings on the homepage; www.fitchratings.com and select 'Ratings Definitions' on the homepage.

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*Source: Simfund as of 6/30/2022.

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