State of the state: Pennsylvania

State overview

We believe the Commonwealth of Pennsylvania is on an upwards trajectory despite some headwinds. Pennsylvania benefits from a large and diverse economy that has seen consistent growth in the last several years, as well as access to liquidity through the State Treasury or issuance of tax-anticipation bonds (TANs). Additionally, the fiscal 2023 enacted budget fully funds the actuarially determined contributions for the state public pension plans, showing management’s commitment to addressing its weak pension funded ratio.

We believe there are two major factors that most heavily weigh on the commonwealth’s direction of ratings. First, despite increasing contributions over the last several years, Pennsylvania’s pensions have continued to be funded under the 80% mark that the U.S. Government Accountability Office deems to be sound for government pensions. Second, though reserve levels have seen recent improvements, they are largely due to one-time transfers of federal aid related to the pandemic or non-recurring revenues.

Key to maintaining credit quality will be the commonwealth’s maintenance of structurally balanced budgets and reserve levels once one-time revenues from federal funding are largely exhausted at the end of fiscal 2023 and continued progress on the commonwealth’s pension funding.

Fiscal year 2023 update

Per Pennsylvania’s executive fiscal 2024 budget, the available financials for fiscal 2023 show appropriations of $41.1 billion, a 4.5% increase over fiscal 2022. The majority of expenditures were appropriated to education and human services, representing a collective 82% of total expenditures. Spending includes $1.4 billion in allocated federal stimulus funds, the last significant tranche of the $7.3 billion in American Rescue Plan Act funds the commonwealth received. Pennsylvania continued its trend of increasing reserves by transferring $2.1 billion, or 4% of fiscal year 2022’s general fund revenues, into its rainy day fund at the start of fiscal 2023. This transfer brought the rainy day fund balance to $4.96 billion, or 42.3 days of spending. This value is higher than the 50-state median of 34.4 days cash on hand for fiscal year 2021.

Better-than-expected revenue collections continued into fiscal 2023, with year-to-date revenue collections coming in 6.5% above estimates as of the end of February 2023. 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 General Fund revenues, respectively. In fiscal 2023, PIT and SUT receipts have exceeded Department of Revenue estimates though the end of February 2023 by 9% each.

Based on the fiscal year 2024 executive budget, fiscal 2023 is expected to end with another surplus, increasing the ending general fund balance from $5.5 billion in fiscal 2022 to $7.9 billion in fiscal 2023.

*The general fund is the major operating fund of the state. It receives all state income not earmarked for a particular program or activity and not specified by law to be deposited in another fund.
Fiscal 2024 executive budget

The executive fiscal 2024 budget includes general fund appropriations of $44.4 billion, an 8% increase over fiscal 2023. Education and human services lead expenditures, accounting for 84% of the budget. Fiscal 2024 general fund revenues are budgeted to decrease 2% year-over-year to $4.3 billion as the extreme revenue growth of fiscal years 2021 and 2022 taper off. Per the House of Appropriations, the gap between projected fiscal 2024 general fund expenditures and revenues will be closed by using available general fund balance equal to roughly 2% of available fiscal year 2022 general fund revenues. Unlike in the previous two fiscal years, the executive budget doesn’t include a transfer of general fund balance to the rainy day fund.

Liquidity

In our opinion, Pennsylvania benefits from strong access to liquidity. In the past, the commonwealth has relied on the state treasurer for liquidity, borrowing $1.5 billion in November 2019. In January 2020, the treasurer increased the line of credit to $2 billion. In years since that credit line increase, Pennsylvania has built up its level of cash and investments, increasing from 13% of total governmental revenues in fiscal 2020 to 28% by fiscal year-end 2022.

Pension Funding

The state’s pension has been consistently underfunded, although Pennsylvania has been making steady progress to combat this in recent years. The state’s funded ratio ended fiscal 2022 at a level of 76%, up markedly from the funded ratio of 56% at the end of fiscal year 2019.
Additionally, Pennsylvania has made 100% of its required pension contributions since 2019. The commonwealth has also contributed over 100% of its pension tread water rate since fiscal 2018, demonstrating state government's commitment to improving its pension funding practices. The commonwealth's net pension liability decreased in fiscal 2022 by 20% to $12.5 billion whereas pension contributions remained essentially flat.

Per the House Appropriations Committee, the fiscal 2023 budget fully funds the actuarially determined contribution for the Public School Employees’ Retirement System (PSERS) and the State Employees’ Retirement System (SERS) for the eighth and seventh consecutive years, respectively.

**Economic update**

Although Pennsylvania is the nation’s 5th most populous state with a population of 12.9 million as of June 30, 2022, the commonwealth’s population growth has been stagnant from 2010 through 2021. This flat population growth is expected to continue through 2030. Pennsylvania has two major metropolitan areas, Philadelphia and Pittsburgh. While natural gas remains a major component of the state’s economic profile, the service sector, including healthcare, has seen recent growth. Additionally, some large tech firms, including Google and eBay have moved to the state in recent years, drawn by talent of students from many of the commonwealth's universities. As of December 2022, education and health services comprised the majority of the state’s non-farm employment with 21% of non-farm employees, followed by the trade, transportation and utilities industry at 20%. From June through December of 2022, the trade, transportation and utilities industry grew 5%, while education and health services grew 3%.

In fiscal 2021, the growth rate of Pennsylvania’s real gross domestic product (GDP)** was 4.4%, which fell to 1.5% in 2022 and is expected to average 1.0% through 2026. Historically, Pennsylvania’s economic growth has lagged that of the nation in times of economic expansion, but there are encouraging economic signs for the state. As of January 2023, the unemployment rate was 4.3% compared to 4.5% in January 2021, and wealth indicators for the commonwealth are mostly in line with those of the country.

**Pennsylvania General Obligation Update**

Moody's Rating: Aa3 / Stable as of August 26, 2022
S&P Rating: A+ / Stable as of August 22, 2022
Fitch Rating: AA / Positive as of August 29, 2022

Moody's has maintained an Aa3 rating with a stable outlook for Pennsylvania since May 2016. This rating is based on credit positives such as improving pension funding metrics, better-than-expected revenue performance and stable access to liquidity. Credit negatives cited are higher than average leverage and below average economic performance.

S&P has maintained an A+ rating for the state since 2017. Reasons cited for the rating include stronger than anticipated economic performance resulting in surpluses and increases in reserves. Concerns mentioned in the latest report include the challenges Pennsylvania will face to balance future budgets without one-time federal aid funding as well as challenges for the commonwealth stemming from pension underfunding.

Fitch has assigned an AA- rating since July 2019. The outlook was revised from stable to positive in April of 2022, citing the commonwealth’s operating surplus and subsequent increase in reserves. However, Fitch also notes the state’s history of implementing one-time budget measures, structurally imbalanced budgets and slower economic growth compared to the nation.

**Spotlight on a Pennsylvania Revenue Bond: University of Pennsylvania Health System (Penn Medicine)**

Moody’s: Aa3 as of March 12, 2021
S&P: AA as of May 4, 2022

Penn Medicine is a nationally recognized healthcare leader that integrates an esteemed school of medicine with an innovative health system. Penn Medicine keeps a clear focus on three key pillars: patient care, education, and research. The success of these pillars requires a strong relationship between Perelman School of Medicine at University of Pennsylvania and the Health System. Penn Medicine’s flagship facility is The Hospital of the University of Pennsylvania, which is an 866-licensed-bed quaternary care hospital and academic medical center located on the campus of the University of Pennsylvania in Philadelphia. Penn Medicine’s other components include Clinical Practices of the University of Pennsylvania, Penn Presbyterian Medical Center, Pennsylvania Hospital, The Chester County Hospital and Health System Lancaster General Hospital, Princeton Healthcare System, Clinical Care Associates, and Wissahickon Hospice.

Penn Medicine’s regional service area consists of twenty-seven counties throughout eastern Pennsylvania, southern New Jersey, and Delaware. Geographic distribution of inpatient discharges for the health system consists of 75% from Pennsylvania and 20% from New Jersey. The tertiary and quaternary** services of the health system attract patients from the Middle Atlantic region and across the United States. Penn Medicine competes not only with local healthcare providers, but also with tertiary providers in New York City and Baltimore as well as other academic medical centers throughout the United States.

*Tread water rate refers to the amount of annual pension contribution required to hold the funded rate at current levels, all else being equal. A rate of more than 100% will increase the funded rate, whereas a rate of less than 100% will decrease the funded rate.
**GDP measures the monetary value of final goods and services produced in the state annually.
†Tertiary and quaternary health care are highly specialized levels of care, extended over long periods of time, and usually only available at regional or national levels.
Despite the ongoing uncertainty and economic challenges associated with the COVID-19 and inflation within the healthcare industry, the underlying credit qualities at Penn Medicine remain strong and have continued to support a bond rating in the AA category by both Moody’s and S&P. This organization has a deep and experienced senior leadership team that continues to execute on the organization’s key pillars.

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. Penn Medicine has continued to support a strong balance sheet with ample liquidity and proper 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 tough economic environment and support an investment grade rating.

Pennsylvania general obligation bonds and University of Pennsylvania Health System issues comprised 0.40% and 1.37% of Invesco Pennsylvania Municipal Fund’s (OPATX) portfolio as of 12/31/2022. Holdings are subject to change without notice and are not buy/sell recommendations.

2. S&P, dated August 22, 2022
5. Pennsylvania Governor’s Executive Budget 2023-2024, published March 2, 2023
7. Moody’s, dated August 26, 2022
8. Pennsylvania Independent Fiscal Office, Monthly Revenue Update as of February 2023, dated March 1, 2023
9. House Appropriations Committee, 2023/24 Executive Budget Briefing, dated March 7, 2023
10. Moody’s, dated June 30, 2020
11. CreditScope as of June 30, 2022
13. Pennsylvania Independent Fiscal Office, Demographic Outlook, dated October 5, 2022
16. Pennsylvania Independent Fiscal Office, Economic and Budget Outlook, dated January 24, 2023
17. Fitch, dated August 29, 2022
19. Moody’s, dated March 12, 2021; S&P, dated May 24, 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 5 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.

Before investing, investors should carefully read the prospectus and/or summary prospectus and carefully consider the investment objectives, risk, charges and expenses. For this and more complete information about the funds, investors should ask their financial professional for a prospectus/summary prospectus or visit invesco.com/fundprospectus.

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This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions, there can be no assurance that actual results will not differ materially from expectations.

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 (Prerefund / 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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