Investment Insights

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.

The commonwealth's future credit-worthiness will likely be largely influenced by its ability to maintain available reserves without reliance on one-time revenues and the continuation of increased pension funding.

The Invesco Municipal Bond team is positive on Penn Medicine due to its disciplined management team and position as a complex medical care provider in the Mid-Atlantic region. Both are strong indicators that the credit can maintain an investment grade rating.

State Overview

Due to recent revenue outperformance, conservative budgeting, and a concerted effort to build up reserves, we believe the Commonwealth of Pennsylvania is in a solid financial position.

Pennsylvania benefits from a large and diverse economy that has seen consistent growth in the last several years,[1] access to liquidity through the state treasury or issuance of tax-anticipation bonds (TANs),[2] and record levels of reserves.[3]

Detracting credit factors include underfunded pensions and the commonwealth's history of budget impasses. Despite contributing over 100% of the tread water rate* for the last five years,[4] Pennsylvania's pensions continue to be funded under the 80% mark that the US Government Accountability Office deems to be sound for government pensions.[5] The fiscal 2024 budget was enacted over a month late,[6] which we view as a sign of governance weakness. While the budget impasse didn't impact debt payments,[6] it did delay the statutorily required deposit to the commonwealth's rainy-day fund.[3]

Key to maintaining credit quality will be the commonwealth's maintenance of structurally balanced, timely approved budgets, maintenance of reserves sufficient to provide financial flexibility, and continued progress on the commonwealth's pension funding.

Fiscal Year 2024

The commonwealth entered the 2024 fiscal year in a strong financial position after several years of revenue outperformance and subsequent transfers to reserve funds. Fiscal 2023 ended with a general fund** balance of $5.2 billion,[7] or 9% of general fund revenues, up from $23 million at the end of fiscal 2019.[8]

The fiscal 2024 budget was enacted on August 3, 2023, several weeks into the fiscal year, highlighting the commonwealth's history of budget impasses.[9] General fund revenues are 2% above budget through April 2024.[10] This performance is driven by smaller revenue streams such as corporate taxes and inheritance tax revenues while the commonwealth's two largest revenue sources, sales and use tax (SUT) receipts and personal income tax (PIT) receipts, are trending largely in line with budgeted figures.[10]

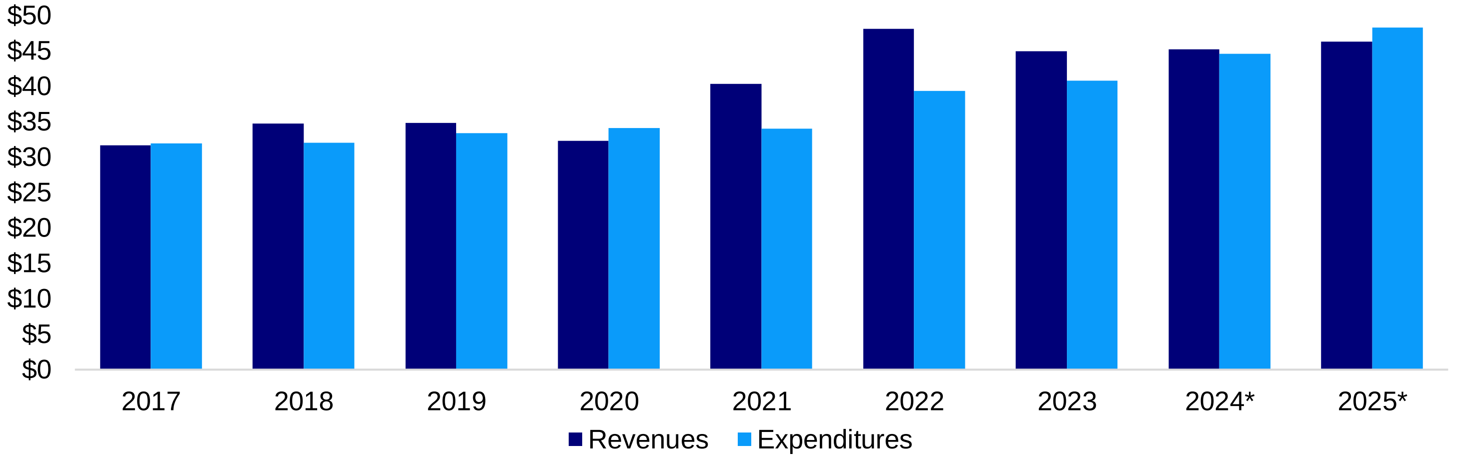
Fiscal 2025 Executive Budget

The executive budget for fiscal 2025 proposes general fund expenditures of $48.3 billion, an 8.7% increase year over year (see Figure 1).[11] Historically, education and health and human services comprised the majority of the general fund budget. This continues to be true in fiscal 2025 with these categories accounting for 40% and 41% of the general fund budget, respectively.[12] Education spending is budgeted to increase 9.9% year over year, largely driven by a $1.1 billion, or 13.6%, increase in basic education funding for school districts, the largest increase in the commonwealth's history.[11] Health and human services spending is expected to increase 6% compared to fiscal 2024 levels.[12]

* 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.

** 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.

Figure 1: General Fund Operations ($Billions)



Source: Pennsylvania Governor's Executive Budget 2024-2025, published February 2024
*Fiscal 2024 and 2025 are estimates based on the fiscal 2025 Executive Budget

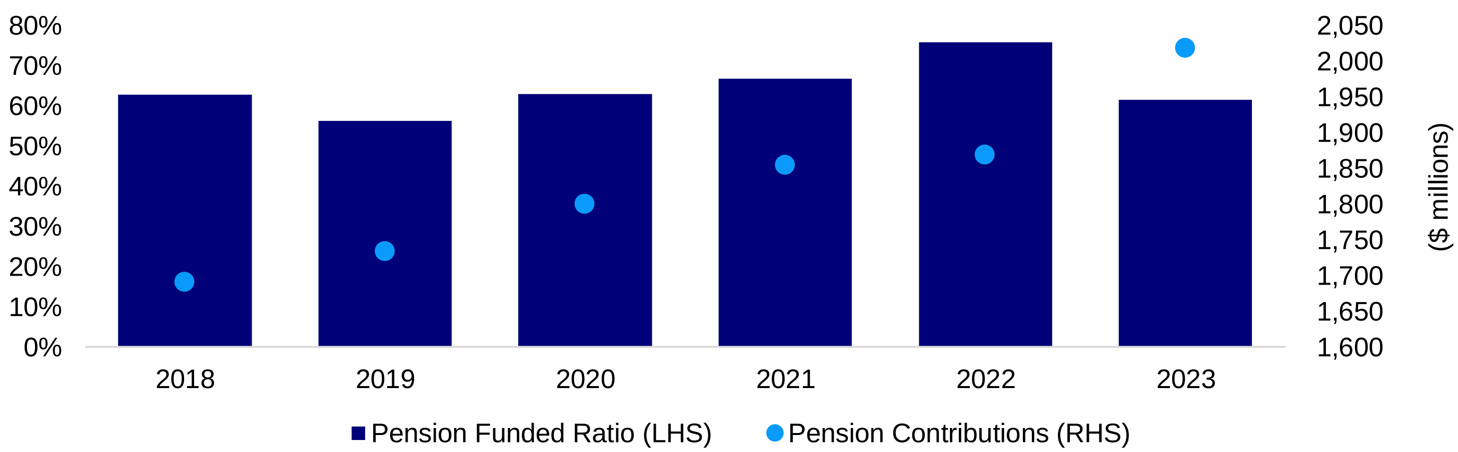
General fund revenue growth of 2% is expected with the two largest sources of revenue, PIT and SUT receipts budgeted for 4.5% and 1.3% growth, respectively.[12] The budget shows a deficit equal to 4% of general fund revenues, which is expected to be closed with the use of reserves.[12]

This is the first time that management has budgeted the use of reserves to balance operations in several years and is a credit risk to monitor. That said, the recent accumulation of reserves should allow Pennsylvania to close the budget gap without significantly reducing financial flexibility. Fiscal 2020 started with a budget stabilization fund balance of $23 million[13] which, as of midway through fiscal 2024, has grown to $6.1 billion, or 13% of fiscal 2023 general fund revenues.[12] This increase was driven from revenue outperformance and an influx of federal funds, both of which have bolstered the commonwealth's budget stabilization fund to record levels. Overall, we're cautiously optimistic that management can find new revenue streams to match revenues to expenditures, however the continued use of reserves to close budget gaps may weaken overall creditworthiness in the longer term.

Liquidity

Pennsylvania benefits from strong access to liquidity. In the past, the state has relied on the state treasurer for liquidity, borrowing $1.5 billion in November 2019.[14] In January 2020, the treasurer increased the line of credit to $2 billion.[14] The commonwealth hasn't sold any cash flow notes since October 2020.[6] Overall, cash and investments have increased from 13% of total governmental revenues in fiscal 2020 to 30% by fiscal year-end 2023.[4]

Figure 2: Pension Overview



Source: CreditScope as of June 2023.

Pension Funding
Pennsylvania's pension has been consistently underfunded, although the commonwealth has been making steady progress to combat weakness, increasing the funded ratio from 56% in fiscal 2019 to 62% in fiscal 2023 (see Figure 2).[4]

Positively, management has demonstrated its commitment to improving its pension funding practices, including contributing the full amount of its actuarially required contribution since fiscal 2019.[4]

Economic Update
Although Pennsylvania is the nation's fifth most populous state with a population of $13 million as of 2023,[15] the commonwealth's population growth has been flat for the last decade.[4] Flat population growth is expected to continue through 2030.[1]

Pennsylvania is highly urbanized with two major metropolitan areas, Philadelphia and Pittsburgh.[16] While the commonwealth is still the second largest natural gas producer in the nation, the growth of this industry has plateaued since 2021.[12]

Although Pennsylvania's economic recovery has lagged that of the nation,[3] there are economic signs of recovery. Nonfarm employment was 2.5% higher from 2022 levels[12] and the commonwealth's unemployment rate as of March 2024 was trending lower than the national rate.[17]

In 2023, Pennsylvania's real gross domestic product (GDP*) growth rate was 2.1%, up from 1.0% in 2022,[1] per the Independent Fiscal Office. Real GDP growth is estimated to average 1.4% through 2025.[1] Wealth indicators for the commonwealth are largely in line with those of the country.[18]

Pennsylvania General Obligation Update

Moody's: Aa3 / Positive as of September 11, 2023
S&P: A+ / Positive as of September 22, 2023
Fitch: AA / Stable as of December 5, 2023

Moody's has maintained an Aa3 since May 2016 but changed their outlook to positive from stable in September 2023. The rationale for the outlook change was improved reserve levels. Their 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 outlook change from stable to positive include the commonwealth's progress toward a structurally balanced budget and increased reserves.

Fitch upgraded the commonwealth's general obligation bonds to AA/Stable from AA-/Positive in December of 2023. Fitch said that increased reserve levels and improved operating performance were major drivers for the rating change.

Spotlight on a Pennsylvania Revenue Bond: University of Pennsylvania Health System

Moody's: Aa3 as of October 27, 2023
S&P: AA as of October 10, 2023

University of Pennsylvania Health System and its academic partner Perelman School of Medicine at the University of Pennsylvania operate together under the brand name Penn Medicine. Penn Medicine's service area is home to 12.2 million people throughout 27 counties in eastern Pennsylvania, southern New Jersey, and Delaware.[19] Penn Medicine's complex tertiary and quaternary services draw patients from not only the Middle Atlantic region, but also from across the United States.

Penn Medicine's flagship facility is the Hospital of the University of Pennsylvania (HUP), which was the nation's first teaching hospital founded in 1874.[19] Today, HUP is an 866 licensed bed quaternary care hospital, and academic medical center located on the campus of the University of Pennsylvania in the West Philadelphia.[19]

Penn Medicine has an experienced senior leadership team that is responsible for developing and executing the organization's strategic objectives. For example, Penn Medicine has grown over the years to include Penn Medicine Chester County Hospital, Penn Medicine Lancaster General Health, Penn Medicine Princeton Health, and other numerous hospital and clinical practices throughout service area.

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. Having characteristics such as a sufficient liquidity cushion, the ability to access financial markets, and an experienced leadership team are likely to help Penn Medicine successfully navigate economic cycles that impact the healthcare sector. The underlying credit qualities at Penn Medicine continue to support a bond rating in the AA category. Our municipal bond team has built a position in Penn Medicine over time by participating in multiple bond offerings.

Pennsylvania general obligation bonds and University of Pennsylvania Health System issues comprised 0.30% and 1.43% of Invesco Pennsylvania Municipal Fund's (OPATX) portfolio as of 3/31/24. Holdings are subject to change without notice and are not buy/sell recommendations.

*GDP measures the monetary value of final goods and services produced in the state annually.

Sources:
1. Pennsylvania Independent Fiscal Office, as of April 2024
2. S&P, as of August 2022
3. Fitch, as of December 2023
4. CreditScope, as of June 2023
5. U.S. Government Accountability Office, July 2008
6. Moody's, as of September 2023
7. Pennsylvania Annual Comprehensive Financial Report, as of June 2023
8. Pennsylvania Annual Comprehensive Financial Report, as of June 2019
9. Associated Press, as of August 2023
10. Pennsylvania Revenue Department, as of April 2024
11. House Appropriations Committee, 2024/25 Budget at a Glance, as of February 2024
12. Pennsylvania Governor's Executive Budget 2024-2025, published February 2024
13. Commonwealth of Pennsylvania General Obligation Bond Offering Statement, June 2019
14. Moody's, as of June 2020
15. United States Census, July 2023
16. Commonwealth of Pennsylvania General Obligation Bond Offering Statement, December 2023
17. Bureau of Labor Statistics, March 2024
18. CreditScope, as of December 2023
19. University of Pennsylvania Health System Offering Statement, March 2021

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 five 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 tax-free 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 (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.

The opinions expressed are those of the author, are based on current market conditions and are subject to change without notice. These opinions may differ from those of other Invesco investment professionals.

*Source: Simfund as of March 31, 2024.