Investment Insights

State of the state: New Jersey

State overview

New Jersey has continued to demonstrate near-term positive momentum following the COVID-19 pandemic. Revenue growth has been strong in recent years on steady increases in gross income taxes, sales taxes, and a new pass-through business alternative income tax that was initiated in fiscal 2021. This trend has helped to sustain fund balances that remain well above what New Jersey has reported historically, in addition to pandemic-related government stimulus and a large COVID-19 Emergency General Obligation bond issuance that also contributed to these healthy reserves. As a credit positive, the state has used this opportunity to begin proactively addressing its large liability burden, making the full actuarial contribution to the state’s pension plans two years in a row. New Jersey’s trend of building an improved general fund balance, coupled with an enhanced financial flexibility have garnered positive outlooks from all three public rating agencies. New Jersey also benefits from a large economy with high wealth levels, as illustrated by an average personal income that is 118% of the national average.\(^1\) Its proximity to the New York City metro area further provides for access to a diverse set of employment opportunities, but with a cost of living that is lower than residing in Manhattan itself. For these reasons, the investment team believes debt issued by the state of New Jersey has continued to offer opportunity for municipal investors.

Despite the recent progress, New Jersey faces longer-term challenges stemming from its exposure to debt and retirement liabilities that are among the largest in the country. Now that the bulk of one-time COVID-19 federal stimulus packages have largely come to an end, these challenges have the potential to become more pronounced as reserve balances are consumed. Therefore, the state’s credit trajectory will hinge on its demonstrated ability to achieve a balanced budget solely with tax collections and other recurring revenues, while ensuring policies are in place to sustain its debt management program moving forward. Absent these controls and policy measures, New Jersey could face the politically unpopular decision to either cut appropriations or incur additional deficit financing. Either outcome would be a negative for the credit, especially following a period where the governor has expanded the budget to cover increased levels of educational spending and pension contributions. Additionally, New Jersey’s already-high tax rates restrict the state’s ability to further increase revenues absent a continued rebound in post-pandemic economic activity. Ultimately, the direction of future credit ratings will largely depend on New Jersey’s ability to address these fiscal concerns in a timely and sustainable fashion.

Fiscal update: Revenues

As shown in Figure 1, New Jersey revenues rely heavily on gross income and sales taxes. Combined, these two income streams account for 67% of budgeted revenues.\(^2\)

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*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.*
As the economy continues to recover post-pandemic, so too does the state’s financial health. Through January of 2023, gross income tax revenues were 5% higher than the same period in fiscal year 2022, while sales taxes increased by 6%. Overall full-year revenues based on the state’s original fiscal 2023 budget were initially expected to decline by 3%, however, that figure is likely to be adjusted upward when the Office of Legislative Services releases its revised year-end estimate this March. Thus, the overall revenue trend for fiscal 2023 appears to be stable at this time.

### Fiscal update: Expenses

New Jersey’s budget has continued to expand in several areas, particularly in education which remains the largest component of the proposed budget for fiscal 2023. Total spending for education was $12.6 billion, or approximately 37% of total 2023 budgeted appropriations (see Figure 3). Other expense drivers that are significant include human services and employee benefits, the ramp-up of which is the result of the state’s increased pension contributions in recent years.
Strong revenue growth has also led to less reliance on reserves to cover expenses. According to the state’s latest budgetary estimate, the reduction in New Jersey’s fund balance in FY 2023 is only expected to be approximately $579 million, which would leave the state with nearly $6.8 billion in reserves at year-end. While the decrease does represent a decline of 8% over the prior fiscal 2022 period, it is far less than the 32% decline originally anticipated as part of the Governor’s initially proposed 2023 budget. Thus, in absolute dollars this relative outperformance has continued to provide New Jersey with adequate near-term liquidity as compared to historical levels and still amounts to over 13% of annual expenses. (See Figure 5).

2022 budget estimates and 2023 governor’s budget

After significantly expanding the governor’s budget in fiscal 2021 to account for increased pension contributions, we believe total appropriations for fiscal 2023 (approximately $50.7 billion) should begin to stabilize. (See Figure 4). It is our view that through its recent debt defeasance and prevention program, the state should also begin to realize recurring benefits in the form of lower interest and debt service costs in the coming years. So far, New Jersey has appropriated $8.9 billion to this fund, of which $2.3 billion has been used to pay off bonds primarily for its School Facilities Construction Program. As part of the debt prevention component, a portion of this funding has also been used for school construction and restoration projects, thus allowing the state to refrain from new borrowings at least over the near term.

New Jersey pension funding

New Jersey’s retirement obligations are a significant hurdle and account for a far greater portion of the state’s long-term liabilities than its outstanding bonds. According to Moody’s investor service, the pension liability alone represents about half of the state’s total long-term liabilities, increasing to over 80% when including post-employment benefit costs (OPEB). Funding ratios remain low at approximately 33% for the seven-pension system in aggregate, however as noted the state has been making progress in addressing this liability in the form of contributing its full annual pension payment in fiscal 2022 and 2023. These payments represent the first full contributions to the plans in 25 years. As fund balances are consumed and slowly decline moving forward, however, the state’s ability to sustain this practice of full funding will be a credit risk to monitor. The plans’ assets also remain vulnerable to swings in market performance. For example, after a strong 2021, the negative returns experienced in both equity and fixed income markets during 2022 have pulled back a large portion of those prior gains.

Figure 6: New Jersey Pension Funding: 2017 - 2022

<table>
<thead>
<tr>
<th>FY 2017</th>
<th>FY 2018</th>
<th>FY 2019</th>
<th>FY 2020</th>
<th>FY 2021</th>
<th>FY 2022</th>
</tr>
</thead>
<tbody>
<tr>
<td>Valuation Date</td>
<td>July 1, 2016</td>
<td>July 1, 2017</td>
<td>July 1, 2018</td>
<td>July 1, 2019</td>
<td>July 1, 2020</td>
</tr>
<tr>
<td>Assets</td>
<td>75,348</td>
<td>79,313</td>
<td>81,433</td>
<td>82,293</td>
<td>79,867</td>
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<tr>
<td>Liabilities</td>
<td>243,591</td>
<td>221,601</td>
<td>209,560</td>
<td>207,123</td>
<td>208,173</td>
</tr>
<tr>
<td>% Funded</td>
<td>30.9%</td>
<td>35.8%</td>
<td>38.9%</td>
<td>39.7%</td>
<td>38.4%</td>
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</tbody>
</table>


Economic update

A major factor supporting New Jersey is the state’s significant wealth characteristics, as reflected in the state’s per capita personal income (PCPI) that is 118% of national levels. (See Figure 7) This level, which is among the highest in the nation, is supported by the state’s proximity to the New York City metro area as a major employment center. While New Jersey’s tax structure is high, especially for earners making above $1 million per year, housing remains more affordable than comparable New York City options.

Figure 7: Per Capita Personal Income: 2016 - 2021

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</thead>
<tbody>
<tr>
<td>NJ Per Capita Personal Income</td>
<td>62,213</td>
<td>64,410</td>
<td>67,142</td>
<td>69,626</td>
<td>73,460</td>
<td>74,805</td>
</tr>
<tr>
<td>US Per Capita Personal Income</td>
<td>49,812</td>
<td>51,811</td>
<td>54,098</td>
<td>56,047</td>
<td>59,510</td>
<td>63,444</td>
</tr>
<tr>
<td>NJ/US Per Capita Personal Income</td>
<td>125%</td>
<td>124%</td>
<td>124%</td>
<td>124%</td>
<td>123%</td>
<td>118%</td>
</tr>
</tbody>
</table>


Labor and unemployment

New Jersey’s employment base is generally diverse, with no sector representing greater than 22% of the whole. Leisure and hospitality, a sector that was particularly vulnerable to pandemic-related job losses, has now effectively fully recovered, representing 8.8% of employment as of December 2022. This level illustrates a rebound from a low of 5.1% reported in June 2020. Unemployment also has continued to decrease, stabilizing at approximately 3.4% in December. This level is a significant turnaround from the height of the pandemic when unemployment reached a high of nearly 16%.
The overall economic recovery following the onset of the COVID-19 pandemic has been stronger than anticipated. Unemployment has continued to fall and has now once again reached pre-pandemic levels. This positive momentum has been supported by an improving job market and a strong demand for workers. Easing pandemic restrictions has also allowed for a return to in-office work for many businesses, as well as domestic and international travel. Risks moving forward surround the potential for heightened inflation and restrictive Fed policy over a prolonged period, which could exacerbate the need for corporations to reduce employment as the demand for goods and services begins to fade, at least temporarily.

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New Jersey General Obligation Update

Moody’s Rating: A2 / Positive as of September 30, 2022
S&P Rating: A - / Positive as of August 19, 2022
Fitch Rating: A / Positive as of September 12, 2022

Moody’s affirmed the state’s general obligation rating at A2 and revised the outlook to positive on September 30, 2022. The updated outlook reflects New Jersey’s “accumulation of healthy fund balances and strong tax collections that have accommodated full pension payments and retirement of some debt. The state’s improved reserves position it to better withstand potentially less favorable economic and revenue trends in the year ahead. The rating continues to reflect long term liability and fixed cost burdens that are much higher than those of most states.”

S&P affirmed the state’s general obligation rating at A - and revised the outlook to positive on August 19, 2022. “The outlook revision follows the second consecutive year the state has budgeted the full annual actuarially determined contribution to its retirement systems,” according to S&P. However, “the state also will continue to face pressures from its high debt and other postemployment benefit (OPEB) liabilities, despite recently strong financial performance.”

Fitch upgraded the state’s general obligation rating to A, from A-, and maintained its outlook at positive on September 12, 2022. Fitch notes that “the strong fiscal momentum of recent years and consistent policy actions to confront its long-term fiscal and liability challenges reflect a notable improvement in budget management. These steps have materially improved the state's near-term resilience and are likely to yield further gains going forward. A solid economic rebound, robust revenue collections and the presence of federal support have enabled it to build a sizable fiscal cushion, while simultaneously addressing high debt and pension liabilities and considerable unmet capital needs.”

Spotlight on a New Jersey Revenue Bond: New Jersey Turnpike

Moody’s: A1 / Stable as of November 17, 2022
S&P: AA - / Stable as of November 18, 2022
Fitch: A+ / Stable as of November 18, 2022

As an instrumentality of the state of New Jersey, the New Jersey Turnpike Authority consists of both the NJ Turnpike and Garden State Parkway. The Turnpike is a 148-mile stretch of the Route 95 corridor running through the western portion of the state, while the Garden State Parkway spans 173 miles along the eastern seaboard. Both roads are tolled and the net revenues from which secure the Authority’s outstanding bonds. Contrary to other transportation projects in the state such as NJ Transit, there is no state appropriation or general obligation backstop of New Jersey itself to support debt service of the Turnpike Authority. Thus, the Turnpike’s credit quality is based solely on the revenue generating ability of the toll roads themselves.

For this reason, the Turnpike Authority receives credit ratings from the three public rating agencies that are above the state’s GO due to its strong market position and recent financial performance. Traffic volumes have, on average, recovered following the remnants of the pandemic, with commercial traffic up 9% and offsetting passenger traffic that is down 8% relative to pre-covid levels in 2019. Revenues have also been on the increase, driven primarily by large toll rate increases that have recently occurred of 36% for the NJ Turnpike and 27% for the Garden State Parkway. Moving forward, toll rates are expected to increase annually at a steady 3% to keep up with a rising debt service schedule. In the meantime, this additional revenue has contributed to an above-average level of debt service coverage, which is reported at 2.09x per the authority’s fiscal 2022 disclosure.

Looking forward the Turnpike’s capital improvement plan is a credit element to monitor, which is large and anticipated to require therearound $1 billion of additional debt per year moving forward. While sizable, the Turnpike Authority’s higher toll rates, robust liquidity position, and sufficient cushion in debt service coverage make this capital plan within financial reach at least over the near-term. The improvements over time are also becoming increasingly necessary to address the state’s aging infrastructure of roads and bridges at a time when the NJ Turnpike and Garden State Parkway reported over 600 million in combined vehicle transactions during 2022. This essentiality is something that the state recognizes as well, evidenced by the Governor’s approval and support of the authority’s recent toll rate increases and overall budget.

*New Jersey general obligation bonds and New Jersey Turnpike Authority issues comprised 3.16% and 3.18%, respectively of Invesco New Jersey Municipal Fund’s (ONJAX) portfolio as of 12/31/2022. Holdings are subject to change without notice.

Investment Insights | Invesco Fixed Income 6
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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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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