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Investment Insights | Fixed Income

State of the state: New Jersey

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Overview

- The near-term outlook for New Jersey has continued to gain momentum with significant reserves accumulated through 2022 to fund additional spending, including the state's first full pension contribution in 25 years, as well as various debt defeasance initiatives.
- The direction New Jersey's credit ratings will take depends on the state's ability to address its persistent underlying structural budget gap without the need to rely on deficit financing bonds or one-time stimulus programs over the longer term.
- The investment team likes Rutgers University due to management's success in fostering strategic partnerships, which ensure the school's financial health and allow them to keep an emphasis on affordability for its students.

State overview

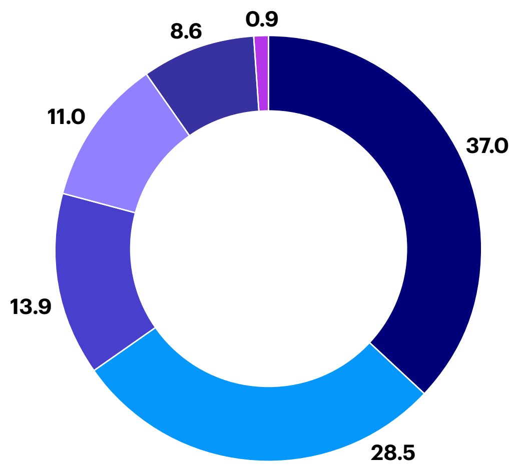
New Jersey has continued to demonstrate near-term positive momentum following a period of uncertainty associated with the COVID-19 pandemic. While the state remains exposed to retirement liabilities that are among the largest in the country, the recent trend of strong revenue and liquidity growth related to debt issuances and the post-pandemic economic recovery has helped boost fund balances and the state's overall financial flexibility. For example, the state's undesignated fund balance for fiscal year (FY) 2021 reached a relative high of $6.9 billion, or nearly 16% of annual expenses.[1] Largely due to this increase, the state has enjoyed credit upgrades from both S&P and Moody's to A- and A2, up from BBB+ and A3, respectively. The state has also been taking proactive steps to address its sizable liability burden, including a debt reduction program and increased pension contributions. In fact, in this fiscal period New Jersey made its first full required pension contribution in 25 years, with plans to continue this practice for the coming fiscal year 2023. The state also benefits from a large economy with high wealth levels, as illustrated by an average personal income that is 118% of the national average.[2] 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.

While New Jersey has made recent progress, the state faces longer-term challenges, particularly its reliance on residual resources from federal stimulus programs to cover budgeted appropriations. Without a demonstrated ability to balance its budget solely with recurring revenues, New Jersey could potentially make 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 fashion.

Fiscal update: Revenues

New Jersey budgeted funds revenue (%) fiscal year 2022
As shown in the chart below, New Jersey revenues are heavily dependent on gross income and sales taxes. Combined, these two income streams account for 65% of budgeted revenues.[3]

Fiscal 2022 Revenues — Budgeted (%)

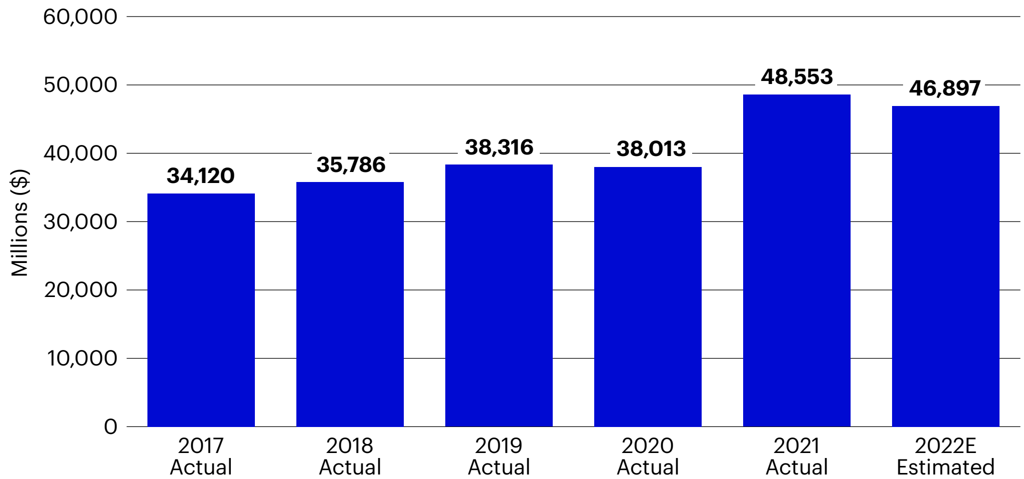


Gross Income Tax	**37.0**
Sales and Use Tax	**28.5**
Other Major Taxes	**13.9**
Corporation Business Tax	**11.0**
Misc. Tax and Fees	**8.6**
Casino Taxes and Fees	**0.9**
State Lottery	**0.0**

Source: State of New Jersey Governor's Budget 2023.

As the economy continues to recover post-pandemic, so too does the state's financial health. Through May of 2022, gross income tax revenues were 20% higher than the prior fiscal 2021 period while sales taxes increased 12%.[4] Overall revenues, however, are expected to decline on the year given that fiscal 2021 totals included approximately $4 billion in one-time COVID-19 general obligation debt to bolster the state's finances. This level of borrowing was not needed in 2022.[3]

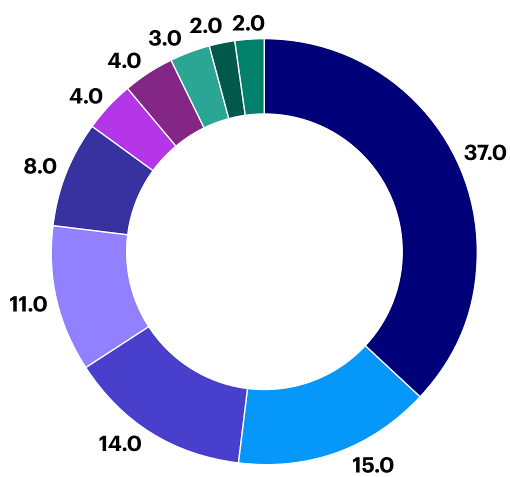
Historical and Estimated 2017 – 2022 Revenues



Source: State of New Jersey Official Statement dated April 22, 2021; State of New Jersey Governor's Budget 2023.

Fiscal update: Expenses
Significant expense drivers for the state are education, human services, and employee benefits, as well as long-term liabilities. Pensions, current and retiree health insurance, and debt service expenses are captured within these various line items in the pie chart below. Notable for fiscal 2022 is the continued expansion of the state's budget, which includes increases in K – 12 funding and pension contributions.

Fiscal 2022 Expenses — Budgeted (%)

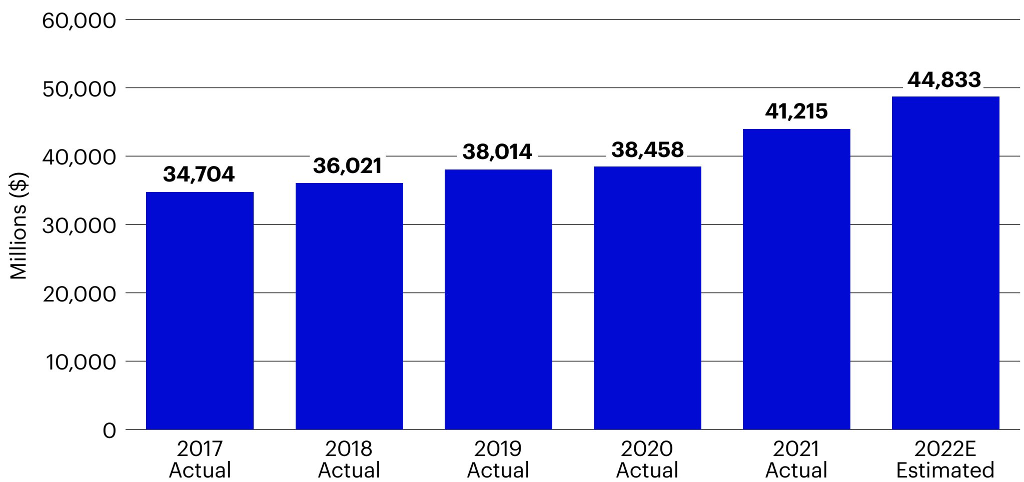


Education	**37.0**
Human Services	**15.0**
Other	**14.0**
Employee Benefits (Health)	**11.0**
Treasury	**8.0**
Transportation	**4.0**
State	**4.0**
Children and Families	**3.0**
Health	**2.0**
Corrections	**2.0**

Source: State of New Jersey Governor's Budget 2023.

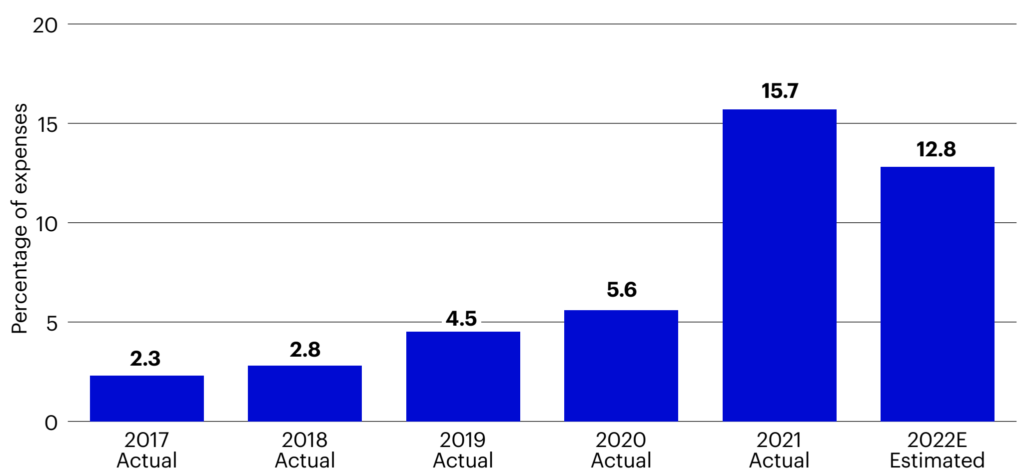
Another positive for New Jersey's credit is the stronger-than-expected revenues in FY 2021, which led to less reliance on reserves to cover expenses. According to the state's latest budgetary disclosure, the reduction in New Jersey's undesignated fund balance in FY 2022 is expected to only be about $643 million, which would leave the state with a fiscal year-end balance of $6.2 billion, or 13% of annual expenses.[3]

Historical and Estimated 2017 – 2022 Expenses



Source: State of New Jersey Official Statement dated April 22, 2021; State of New Jersey Governor's Budget 2023.

Budgetary Fund Balance as % of Expenses



Source: State of New Jersey Official Statement dated April 22, 2021; State of New Jersey Governor's Budget 2023.

2022 budget estimates and 2023 governor's budget

The use of current reserve balances to fund future expenditures is expected to accelerate in the coming year. As proposed in the fiscal 2023 budget, the state's undesignated fund balance is expected to decline by approximately $2 billion as funds are consumed through increased spending.[3] Looking forward, this rate of decline affords New Jersey about three years' worth of cushion before this practice proves unsustainable. If left unaddressed, the need for additional deficit financing bonds or budget cuts would be increasingly necessary.

New Jersey pension funding

New Jersey's retirement obligations are significant hurdle and account for a far greater portion of the state's long-term liabilities than its outstanding bonds. Funding ratios remain low; however as we've noted, the state has been making progress in addressing this liability in the form of contributing its full annual pension payment in FY 2022, the first time in 25 years. The state also anticipates full funding in 2023 and notes that the 2023 payment of $6.8 billion represents a significant 12% of proposed spending.[5] As fund balances decline, 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 first half of 2022 has pulled back a large portion of those prior gains.

	FY17	FY18	FY19	FY20	FY21	FY22e
Valuation date	July 1, 2016	July 1, 2017	July 1, 2018	July 1, 2019	July 1, 2020	June 30, 2021
Assets	75,348	79,313	81,433	82,293	79,867	82,053
Liabilities	243,591	221,601	209,560	207,123	208,173	196,569
UAAL	(168,243)	(142,289)	(128,127)	(124,830)	(128,307)	(114,516)
% Funded	30.9	35.8	38.9	39.7	38.4	41.7

Source: State of New Jersey Official Statement dated April 22, 2021.

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.[2] This level, which is among the highest in the nation, is supported by the state's proximity to the New York state metro area as a major employment center. While New Jersey's tax structure is high, especially for earners making above $1 million a year, housing remains more affordable than comparable New York City options.

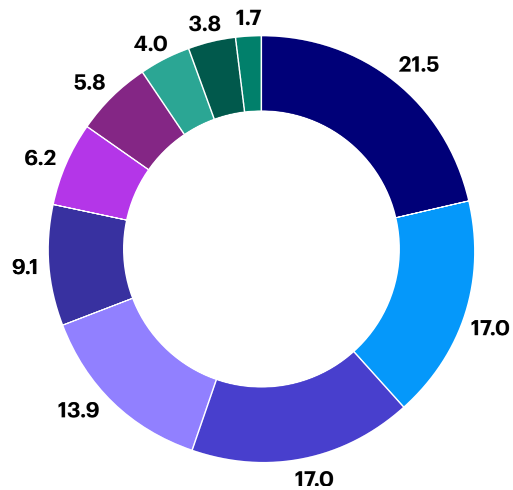
	2016	2017	2018	2019	2020	2021
NJ PCPI	62,213	64,410	67,142	69,626	73,460	74,805
US PCPI	49,812	51,811	54,098	56,047	59,510	63,444
NJ PCPI/US PCPI	125%	124%	124%	124%	123%	118%

Source: Bureau of Economic Analysis, as of Dec. 31, 2021.

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 9.1% of employment as of May 2022. This level illustrates a rebound from a low of 5.1% reported in June 2020.[6] Unemployment also has continued to decrease, reaching 3.4% in May. This level is a significant turnaround from the height of the pandemic when unemployment reached a high of nearly 16%.[6]

New Jersey Employment, by Industry Through May 2022

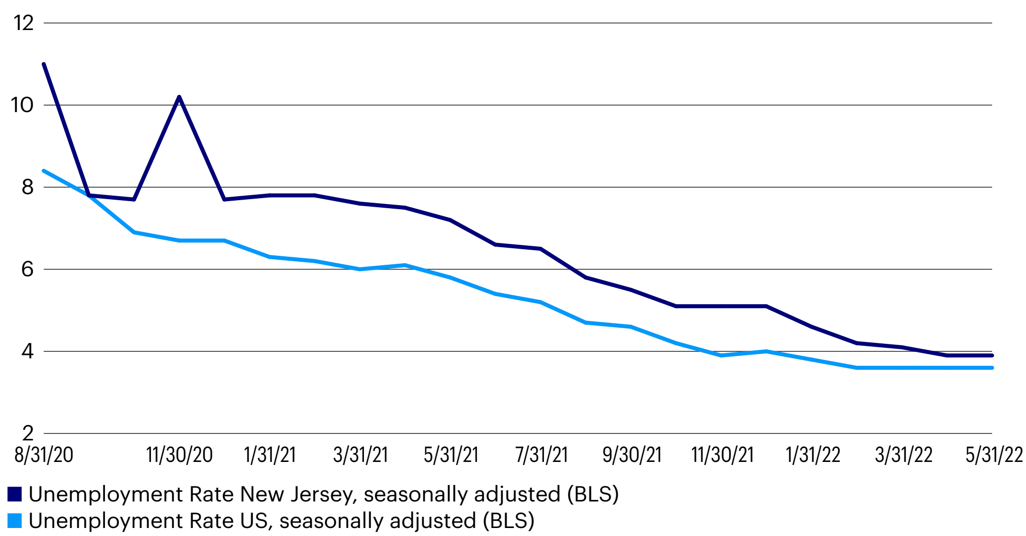


Trade, Transportation, Utilities	**21.5**
Education and Health Services	**17.0**
Professional and Business Services	**17.0**
Federal, State, Local Government	**13.9**
Leisure and Hospitality	**9.1**
Financial Activities	**6.2**
Manufacturing, State	**5.8**
Other Services	**4.0**
Lodging, Mining and Construction	**3.8**
Information	**1.7**

Source: Bureau of Labor Statistics, as of May 31, 2022.

The economic recovery following the onset of the COVID-19 pandemic has so far been stronger than anticipated. Unemployment has continued to fall and, as of the spring of 2022, is once again approaching 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 demand reduction in the face of heightened inflation over a prolonged period, which could temper the progress made to date.

New Jersey Monthly Unemployment Rate, August 2020 Through May 2022



Source: Bureau of Labor Statistics, as of May 31, 2022.

New Jersey General Obligation Update
Moody's: A2/ Stable outlook
S&P: A-/ Stable outlook
Fitch: A-/ Positive outlook

- Moody's upgraded the state's general obligation rating to A2, from A3, and revised the outlook to stable on March 2, 2022. The updated outlook reflects New Jersey's "continuing trends of strong revenue and liquidity and its steps to more aggressively address liability burdens, including completion of a debt-reduction program and increased pension contributions, which are consistent with improving governance and fiscal management. The rating also acknowledges that, despite the state's diverse economy and wealthy tax base, it retains retirement benefit liabilities that are among the largest of the 50 states and that will present recurring fiscal pressure and increase the state's vulnerability to financial market downturns."[7]
- S&P upgraded the state's general obligation rating to A-, from BBB+, and revised the outlook to stable on March 31, 2022. "The upgrade reflects what we view as material improvement in the state's structural deficit and near-term liquidity, with recent surplus revenues being used to promote what we view as longer-term financial stability and an improved commitment to prefunding liabilities, although credit pressures remain."[8]
- Fitch affirmed the state's A- general obligation rating and revised the outlook to positive from negative on August 12, 2021. "The revision of the outlook to positive from negative reflects the rapid turnaround in the state's fiscal condition as it recovers from the coronavirus pandemic. A solid economic rebound, state balancing actions during the pandemic and multiple rounds of federal assistance are now providing the state with both a solid financial cushion and extra capacity to accelerate progress on its high liabilities. Fitch views the state as being well positioned in the near term to continue progress on its longer-term fiscal challenges while managing through current uncertainties, including the lingering effects of the pandemic and duration of the strong economic and revenue rebound it is currently experiencing."[9]

Spotlight on a New Jersey Revenue Bond
Issuer: Rutgers University*

Moody's: Aa3/ Stable outlook (07/14/2022)
S&P: A+/ Negative outlook (01/06/2022)

- Rutgers University is New Jersey's flagship public university boasting nearly 70,000 full and part-time students as of Fall 2021.[10] Rutgers is rated by Moody's and S&P at Aa3 and A+, respectively. Fitch does not rate the university. Rutgers maintains four campuses located throughout the state in New Brunswick, Newark, Camden, and the university's academic health center, Rutgers Biomedical and Health Sciences. The New Brunswick campus is considered the main campus, serving approximately 63% of students.[11]
- **Why the investment team likes the credit.** Rutgers University has both a deep history and modern relevance that bolster its overall institutional importance. Established in 1766, Rutgers is unique in that it is the only university in the United States that is a colonial chartered college (1 of 9), a land-grant institution, and a state university.[12] Over the years, the university has continued to evolve and expand. Rutgers is now home to New Jersey's largest network of research laboratories where it receives more federal research funding than all other New Jersey colleges and universities combined.[11] Rutgers is also New Jersey's largest academic health center and patient care provider through Rutgers Health. The university achieves this effort through a very diverse student base which represents all 50 states and 130 countries.[11]
- Despite enduring the numerous challenges related to the COVID-19 pandemic, the university's student demand has remained strong, and in some areas has even improved. For example, management anticipates the New Brunswick campus to receive its largest incoming class in its history in Fall 2022.[10] Additionally, student quality has historically been high but improved further through the Fall of 2021 with the average SAT score reaching 1,344 for students attending the main New Brunswick campus.[10]
- Regarding the university's financial position, management has shown some aptitude in navigating large capital investment while not adding materially to its debt load, which is somewhat higher than peers. The university has maintained an emphasis on affordability through the years, which has necessitated a commensurate level of deliberate planning to ensure financial stability for the school. These requirements have materialized in the form of strategic partnerships, such as with RWJ Barnabas Health Systems in the university's healthcare enterprise, and joining the Big 10 conference with respect to its athletics department.

*Invesco New Jersey Municipal Fund (ONJAX) has an allocation of 6.08% in this issuer as of June 30, 2022.

1. 2021 Comprehensive Annual Financial Report.
2. Bureau of Economic Analysis, as of December 2021.
3. State of New Jersey Governor's Budget 2023.
4. Office of Legislative Services Revenue Snapshot May 2022 .
5. S&P Pension Spotlight, as of June 21, 2022.
6. Bureau of Labor Statistics, as of May 2022.
7. Moody's, as of March 2, 2022.
8. S&P, as of March 31, 2022.
9. Fitch, as of August 12, 2021.
10. Rutgers, The State University of New Jersey, 2021 Continuing Disclosure Update dated May 3, 2022.
11. Rutgers by the Numbers, as of July 2022.
12. Rutgers Alumni Association, as of July 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.

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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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.

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