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On the Radar

FAQS ON THE MARKETS AND ECONOMY

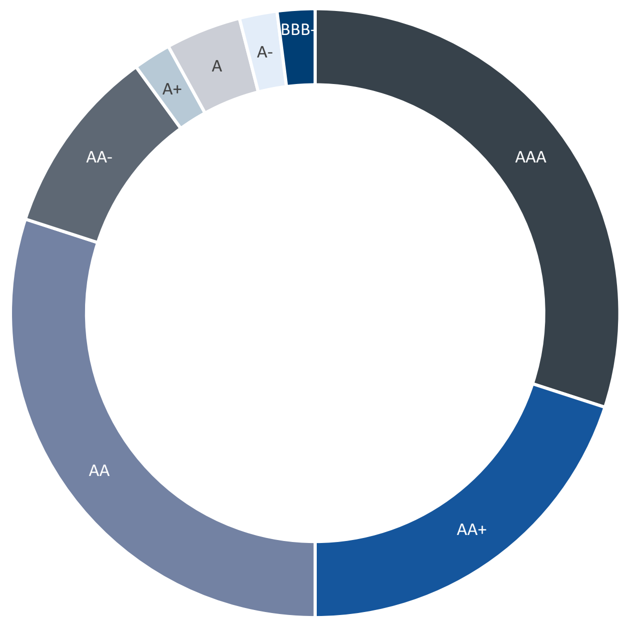
How are states responding to pandemic-induced budget pressure?

There is significant uncertainty in projecting state revenue collections, but early and evolving estimates illustrate a challenging landscape. Likely, total revenue loss will exceed that experienced during the financial crisis, in which general fund revenue declined by about 12% from FYs 2008-2010. State budget actions have largely focused on expenditure reductions — service and program cuts, layoffs and furloughs and diminution or deferral of municipal and education aid. We expect deficit borrowing to edge higher and states to utilize their comprehensive cash management tools for preserving liquidity on their balance sheets.

According to the S&P 500, about 15% of state ratings (sector median is AA) are on a negative outlook, and investors should assume that downgrades may occur, in particular, to lower-rated states. Downgrades could amplify market volatility and liquidity for some borrowers. While credit stresses' form and magnitude will vary from state-to-state, we expect the sector to manage near-term implications of the pandemic and economic weakness adequately. Further federal aid would dampen the fiscal shock, but its absence would likely exacerbate state budgetary issues. Given recent upticks in caseloads in some regions, reopening rollbacks or pauses will likely delay economic progress. States, as co-sovereigns, have relatively wide-ranging powers to control their revenues and expenditures. Accordingly, actual payment default risk among state borrowers should remain quite low.

Positively, most states enjoyed several years of reasonably good budget performance before the pandemic. Revenue surpluses, rainy day replenishment, and ample liquidity were some of the factors supporting state quality and resiliency (states tend to budget pro-cyclically). The CARES Act and various Federal Reserve programs provided important resources to help states navigate the current environment. The timing of the pandemic was not helpful to state budget adoption, with most states beginning FY 2021 in July. Revenue declines and increased spending demand from COVID-19 forced policy-makers to enact difficult decisions.

S&P State Ratings Distribution



Source: Municipal Market Analytics as of July 2020.

According to FY 2019 state data, personal income and sales taxes represented approximately 45% and 30% of general fund resources, respectively. However, not all states levy taxes uniformly, so the impact of COVID-19 on revenue collections will depend, in part, on their unique fiscal and economic structure. Monthly revenue performance for May (latest available data, which usually reflects a one-month lag) shows broad declines in sales taxes equal to more than 20% year-over-year, according to the Urban Institute Tax Policy Center (TPC). TPC estimates total revenue losses could amount to $200 billion for state fiscal years 2020-2021. Other organizations place losses much higher in the hundreds of billions of dollars. The CNR research team continues to monitor conditions very closely.

KEY QUESTIONS

Is more fiscal stimulus forthcoming?

What did the Fed decide at its meeting last week?

How severe was the decline in Q2 GDP?

Are dividend and income equities attractive?

Is more fiscal stimulus forthcoming?

While there is general agreement that more aid is needed, the sticking point continues to be reconciling the priorities between Democrats and Republicans, as well as the size of additional spending. Many issues are on the table, including an extension of boosted unemployment payments, another round of direct cash payments, increased assistance to state and local governments, funding for schools and students, hazard pay, and liability immunity.

All this is coming at a time when the recovery seems to be losing some momentum as COVID cases rise in different parts of the country and reopening measures are rolled back.

Income supports go a long way in explaining the recent resurgence in consumer spending. As a result of onetime support checks and expanded unemployment insurance, real disposable personal income grew by 9.6% in Q2 despite the fall in GDP.

Our sense is that a compromise will ultimately be reached somewhere in the $1-1.5 trillion range, providing additional relief to businesses, households and states. Both parties have incentive to get something done and there is room for negotiation.

Still, with the expiration of extended unemployment benefits at the end of July and the exhaustion of most PPP funds, lawmakers are facing a tight deadline this month to enact another aid package. The Senate's recess is scheduled to start August 10, and it will not meet again until after Labor Day, when campaigns for November elections shift into high gear.

For investors, the concern is that markets have already priced in additional fiscal stimulus, and should officials disappoint, sentiment could quickly reverse, leading to a sell-off in stock prices.

New Fiscal Package

Republican Plan	Elements	Democratic Plan
$200 a week through September, then 70% of wages	Unemployment	Continue $600 a week until January 2021
$1,200/$2,400/$500	Onetime Stimulus Checks (per person/married/dependent)	$1,000/$2,400/$1,200*
Begin phase-out when AGI reaches: $75,000 (Single) $112,500 (HH) $150,000 (MFJ)	Stimulus Check Income Limit	Begin phase-out when AGI reaches: $75,000 (Single) $112,500 (HH) $150,000 (MFJ)
$0	State and Cities	$1 Trillion
$105 Billion	Schools	$430 Billion
$0	Elections	$3.6 Billion

Source: CNR Research.

What did the Fed decide at its meeting last week?

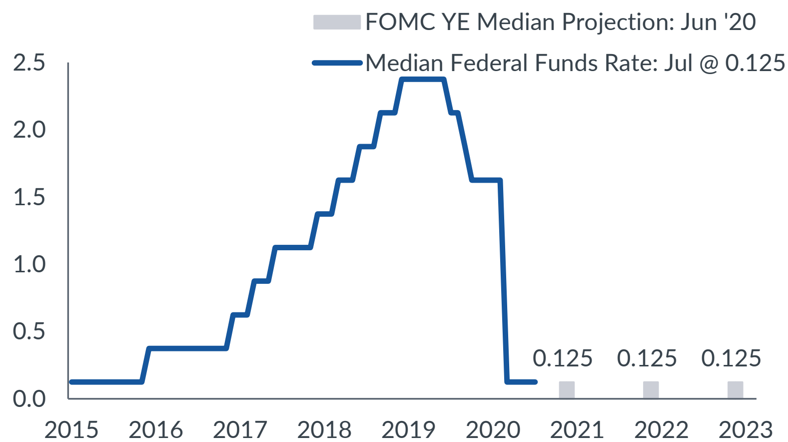
The Fed renewed its promise to help the economy if needed. The Fed will continue to use "its full range of tools" to guide the economy out of the recession. It knows full well that the pandemic poses considerable risks to the economic outlook over the medium-term and that it will weigh heavily on economic activity, employment, and inflation in the near-term.

Fed Chair Powell continued to repeat his statement that the Fed cannot heal the economy by itself. It needs help from Congress to provide more fiscal relief/stimulus.

Since the Fed last met in June, the increasing amount of COVID-19 cases has forced local politicians to reimpose restrictions on some activities, impairing economic growth. An economic turnaround cannot happen until Americans feel safe going about their daily business.

We believe the Fed is sounding more dovish, and it may be setting the stage for more easing of monetary policy at its September meeting.

Federal Funds Rate and FOMC Projections (%)



Source: Federal Reserve Bank as of June 2020.

How severe was the decline in Q2 GDP?

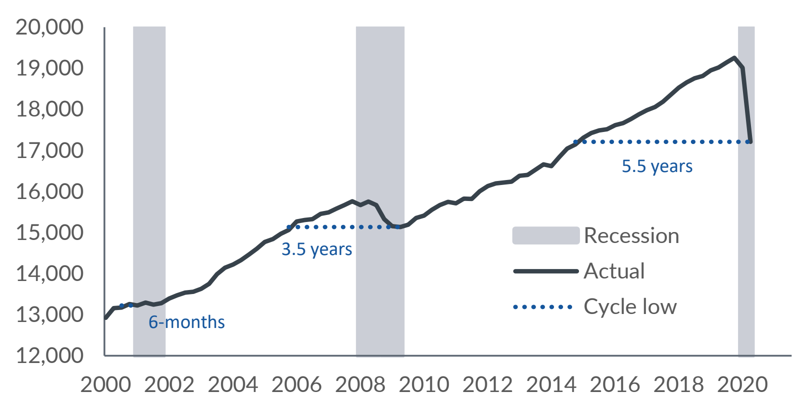
The U.S. economy had its worst performance ever, as the COVID-19 pandemic shuttered businesses. Economic growth plunged at a 32.9% annual rate. (The official data goes back more than 70 years, but unofficial data goes back to 1875.) At the same time, the recession is expected to be the shortest, as the worst is behind us. The economy is already on the mend with two consecutive months of record-setting job gains.

More than five years of economic growth have been wiped out by this recession, far greater than the 3 ½ years of global financial crisis, and just six months of the dot-com recession (see chart).

Without the Fed and the federal government's swift and powerful actions, the contraction would have been far more severe. The Fed cut interest rates and added liquidity into the financial markets, and Congress approved around $3 trillion in stimulus/relief. As a result, personal income rose by nearly 10% (due mostly to the $1,200 stimulus checks, payroll protection plan loans, and enhanced unemployment insurance), which should help consumption improve in Q3.

GPD

$, billions, 2012 chained dollars SAAR



Source: Bureau of Labor Statistics as of July 2020.

Are dividend and income equities attractive?

In the context of the current rally, we believe dividend and income equities offer some the greatest remaining value for investors.

High dividend stocks have historically performed well out of recessions, while also providing stability and boosting returns in times of market uncertainty.

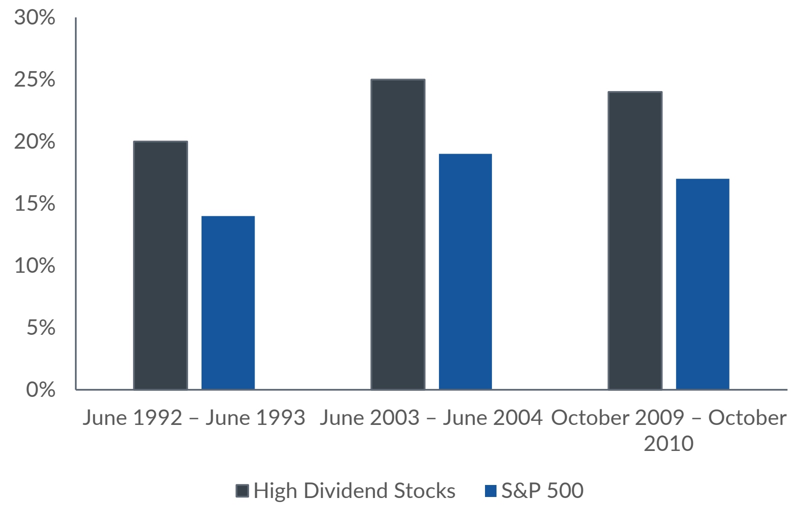
With interest rates so low (both short and long) and likely to remain that way for a prolonged period of time, we feel investors will be attracted to solid dividend names.

The income opportunity is there. Spreads for the three main equity income assets (consumer staples, utilities, and REITs) are at the highest levels in the past 10 years.

Having a solid portfolio yield that is as stable as possible will be the critical factor that can generate positive returns over time. The CNR dividend research team is focused on owning stocks that can maintain their dividends through the economic uncertainty ahead.

This would include being in steady cash flow businesses that have much of their revenue tied to "essential services." In addition, strong balance sheets with reasonable payout levels are important.

Performance: Year After Peak Unemployment



Source: Bloomberg. High Dividend Stocks: Dow Jones U.S. Select Dividend Index.

Index Definitions

The S&P 500 Index (S&P500) is a stock market index that tracks the 500 most widely held stocks on the New York Stock Exchange or NASDAQ. It seeks to represent the entire stock market by reflecting the risk and return of all large-cap companies.

Dow Jones U.S. Select Dividend Index (djdvy) represents the country's leading stocks by dividend yield.

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Any opinions, projections, forecasts, and forward-looking statements presented herein are valid as of the date of this document and are subject to change.

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Investing in international markets carries risks such as currency fluctuation, regulatory risks, and economic and political instability.

Emerging markets involve heightened risks related to the same factors as well as increased volatility, lower trading volume, and less liquidity. Emerging markets can have greater custodial and operational risks, and less developed legal and accounting systems, than developed markets.

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Investments in below-investment-grade debt securities, which are usually called “high-yield” or “junk” bonds, are typically in weaker financial health, and such securities can be harder to value and sell and their prices can be more volatile than more highly rated securities. While these securities generally have higher rates of interest, they also involve greater risk of default than do securities of a higher-quality rating.

The yields and market values of municipal securities may be more affected by changes in tax rates and policies than similar income-bearing taxable securities. Certain investors' incomes may be subject to the federal Alternative Minimum Tax (AMT), and taxable gains are also possible.

Investments in the municipal securities of a particular state or territory may be subject to the risk that changes in the economic conditions of that state or territory will negatively impact performance. These events may include severe financial difficulties and continued budget deficits, economic or political policy changes, tax base erosion, state constitutional limits on tax increases, and changes in the credit ratings.

Investments in emerging markets bonds may be substantially more volatile, and substantially less liquid, than the bonds of governments, government agencies, and government-owned corporations located in more developed foreign markets.

Returns include the reinvestment of interest and dividends.

Investing involves risk, including the loss of principal.

As with any investment strategy, there is no guarantee that investment objectives will be met, and investors may lose money.

Past performance is no guarantee of future performance.