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Muni market spotlight: State credit quality should remain largely stable

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Over the past five years, states have seen their fair share of volatility, constantly re-adjusting to their new version of normal. Fortunately, a majority of them were in a strong financial position entering the pandemic, helping them manage both the health and liquidity crises.

Matriarch of munis

In the years that followed, strong resiliency of the US economy, substantial federal aid, and proactive management teams resulted in historical levels of financial reserves and overall, strong credit quality. On our CIO muni risk scale of 1-5, 1 representing lowest risk, 48 of the 51 state obligors are assigned CIO Risk Categories 1 and 2.

While credit quality remains robust, each of the states' strengths and/or weaknesses vary across the 14 metrics that we assess within our frameworks to measure credit quality under our three broad risk drivers: economy, financial performance, and long-term liabilities.

State credit: foundational characteristics

State credit quality is among the strongest sectors of the USD 4.1 trillion municipal bond market, given the substantial resources states have available at their disposal to meet their debt obligations. These resources include strong taxing authority that provides them with revenue-raising ability, as well as substantial control over their budgeting process and expenses. Given their dominant position and direct and indirect links to other sectors, states' fiscal health has a far-reaching impact on the broader municipal market.

Fiscal health

Revenues and fund balances: Following record growth levels in 2021 and 2022, state revenues normalized in fiscal 2023 and 2024. Looking ahead to fiscal 2025, most states have forecasted flat revenues owing to the effects of tax cuts, unwinding of federal stimulus programs, modest economic growth expectations, and easing inflation. Median rainy-day fund balances remain healthy relative to general fund expenses, providing both liquidity and credit strength.

Pensions: Most states' pension systems are generally well-funded, with manageable unfunded liability burdens. For those with significant unfunded liabilities such as New Jersey and Illinois, pension concerns will continue to limit the positive momentum in fundamental credit quality and bond spreads.

Extreme weather: Weather events continue to occur more frequently and are more costly. Lack of insurance or future availability of federal emergency aid remains a long-term concern for states, as they have to bear the upfront costs.

The road ahead

Notwithstanding geopolitical risks and potential election-related volatility, state credit quality will largely remain stable in the short to medium term given their continued resilience, robust reserves, fiscal discipline, and broad budgetary flexibility. For more information, see our latest report, "*CIO Municipal Risk Framework: States – Resilient strength*," published 14 October 2024.

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For much more, see our latest **Municipal Market Guide: A setup for stronger year-end performance,** 17 October, 2024.