After a long US economic expansion, states are guarding against a downturn, with some reserves reaching an all-time peak...

...yet determining when to build these reserves and how much to allocate to them is dependent on a number of other important factors.
As the longest US economic expansion continues, states are bracing for what seems to be the inevitable and storing up revenue surpluses for “rainy day reserve funds,” also known as budget stabilization funds. As a result, their financial health may be shifting in the eyes of both investors and credit rating agencies.

States have built rainy day funds in the past to attempt to weather recessions. Their rationale in doing so is to avoid having to take drastic measures when the economy is weak—such as tax increases. These budget cushions can help states to fund education, unemployment insurance and Medicaid initiatives regardless of where we are in the economic cycle. Following the longest economic expansion in US history, rainy day reserves have reached an all-time peak.1

Prior to the great recession, the rule of thumb was for states to maintain at least 5% of total revenues in reserves. This proved to be inadequate as some states found themselves running out of money in the aftermath of the global financial crisis.2 Since then, most states have put away more than 5% and some even had as much as 16% in reserves at the end of 2017.3

Credit rating agencies identify states they believe are in a better or worse position based in part on reserves, which can ultimately affect bond ratings. However, we believe more criteria deserve attention when analyzing the quality of state municipal debt.

Factors like tax revenue growth, the demographic profile; economic condition; structural balance; debt and pension/OPEB;4 and governance, in our view, deserve their fair share of analysis from bond investors too.

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