Rain, rain go away…states save money for another day

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.

Often times, states begin building these reserves immediately following a recession, and the protective surplus typically reaches its peak prior to the next downturn, before it is put to use again. Following the longest economic expansion in US history, it should come as no surprise that—without economic intervention—rainy day reserves have reached an all-time peak. 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. 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.

Rainy day funds of 26 states surpass pre-recession levels
Days each state could run on rainy day funds, fiscal year 2018

Source: The Pew Charitable Trusts, Pew analysis of data from the National Association of State Budget Officers, 2019

Why all states are not created equal

1 Pew Trusts: Fiscal 50: States trends and analysis, August 20, 2019
2 Pew Trusts: Building State Rainy Day Funds, July 15, 2014
3 Tax policy center: The state of state (and local) tax policy, August 2018
Daniel Barton, head of research for tax-exempt bonds at Mellon, a BNY Mellon Investment Management firm, believes it is best not to over-generalize when it comes to evaluating how much states should set aside.

“States that have more variability in their revenue structure—for instance California because of capital gains receipts—should have bigger rainy day funds to compensate for greater variability. Meanwhile, states that have very stable revenue streams through economic cycles might not necessarily need to have such large reserves,” he says.

Mellon’s municipal bond team uses this case-by-case framework in their analysis and often aims to decipher the level of a volatility in a state’s revenue receipts, as well as if those states could compensate for deficits with a large rainy day fund balance.

Andy Shin, senior municipal research analyst in the team, adds:

“We also take into consideration the extent of financial flexibility states have. We look at whether a governor has the ability to cut spending unilaterally without legislative approval and if a state can raise revenues without voter approval. On top of that, we look at their fixed-cost burden of debt service, Medicaid spending, and last but not least, how vulnerable their pensions may be because of market volatility.”

The timing and severity of a recession is unpredictable, which makes it difficult for states to fully prepare. In this sense, there is no exact appropriate time to begin saving up a rainy day fund. States should continuously add to reserves regardless of where the nation sits within an economic cycle, according to Barton.

Some states are already putting greater focus into their rainy day funds for fiscal 2020 budgeting proposals, with more than one-third of governors having proposed increasing the size of their rainy day funds, according to Shin.

Other states have passively bolstered rainy day funds due to a healthy stock market over the past decade. Connecticut has a requirement that when it has a surplus of capital gains receipts, or tax revenue from resident investors, it goes straight into its rainy day fund.

**Where active management may benefit**

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, more criteria deserve attention when analyzing the quality of state municipal debt, says the Mellon municipal bond team.

Factors like tax revenue growth, of which a 2018 surge helped some states bolster rainy day funds; the demographic profile; economic condition; structural balance; debt and pension/OPEB; and governance deserve their fair share of analysis from bond investors too.

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4 The fiscal survey of states, Spring 2019
5 Pew: Insights From Fiscal 50’s Key Measures of State Fiscal Health, August 20, 2019
“We aim to be ahead of rating agency upgrades or downgrades. Projecting out these external factors, in terms of fiscal strength, and understanding what states are doing right or wrong, is where I think active management can really shine,” says Dan Rabasco, head of municipal bonds at Mellon.

Expanding on this notion, Rabasco says the team has fairly large-scale commitments in some states within its strategies, which Moody’s labeled as “weaker in terms of recession preparedness.” Rabasco says, through their analysis and due diligence, the team can still find opportunities within these states. In the case of one, he says it is a much more muted commitment to its general obligation debt and more of a focus on suitable mandates within the high yield space.

**Case-by-case evaluation**

Shin adds that the market labeled some states with a challenging outlook due to a variety of reasons, including unfunded pension liabilities and limited flexibility in their ability to change pension benefits because of constitutional protection. Despite this, Shin says the biggest factor influencing the common views is their rainy day fund balances (or lack thereof).

“One state in the Northeast has very little in terms or reserves outside the funds they deposited from the most recent April tax collection. It’s the same thing with another state in the Midwest. Those states have limited rainy day funds and that’s the main reason they were classified as the weakest to prepare for the recession,” Shin says.

“Having said that, in the case of the Northeast state, it is weaker by most quantitative metrics but if you look at the political willingness, I think there is a lot a more focus on restoring the credit rating than there has been in the past. Overall, the trend continues to be moving in the right direction.”

In the Midwest state, the team continues to find opportunities whether it has a bad name among investors or not. They do this by finding what they view as otherwise strong credits, which happen to be tainted by the name of the state or municipality they are issued.

Barton gives another example: “In the context of one major US city and its troubles, there are certain credits where since they are in that municipality, they are tainted in the market’s eyes. But, in our view, they are fundamentally strong credits that don’t have the same risk profile as the city.”

“We feel comfortable with some of those state’s credits in the revenue sectors since they have more stability through economic cycles and stronger legal provisions. In many cases those credits still offer a lot of spread because of the reputation of where they’re located.”

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6 Moody’s: All but two US states have sufficient reserves, financial flexibility to weather next recession, May 20, 2019.
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