## Summer in the City

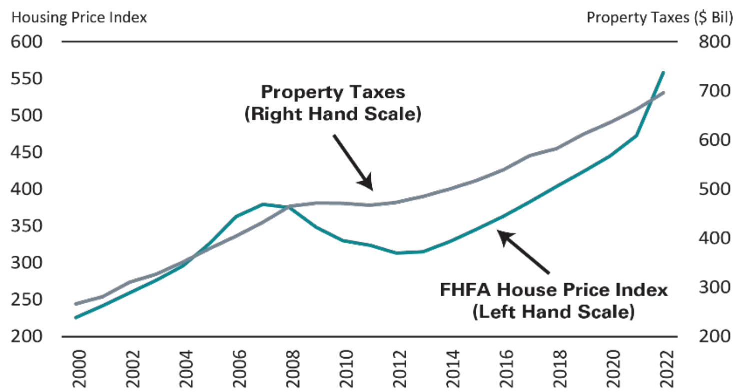
Summertime usually feels a bit quiet in New York City. It's easier to get a seat on the train, the lines at the deli counter are shorter, and sometimes the pigeons outnumber the people. However, since the pandemic, this quiet summertime feeling has stuck year-round in some cities across the U.S., creating a range of potential implications for municipal credit, particularly for cities' debts and mass transit systems. This area of the market rarely calls attention to itself, but the relentless press forecasting the death of downtowns has caught the eyes of many investors. The vast majority of our local government holdings reside in school districts, many of which enjoy added protection of state support. In contrast, our allocation toward city general obligation bonds and traditional mass transit debt is much lower—not due to credit concerns, but rather of the lack of attractive values. We understand the reasons for the negative sentiment, but we would not extrapolate them into fundamental concerns.

Local government credits benefit from durable revenue sources, of which property taxes are the largest and arguably the most stable. These taxes are based on assessed real estate values within a district. A typical local government derives over 60%[1] of its property taxes from residential real estate. This provides important diversification to, and insulation from, declining commercial property values. There is a big difference between owning bonds directly backed by office buildings and those backed by the full taxing authority of a city.

Typically, there is a significant lag between property price appreciation and tax growth. Residential housing price growth over the past few years will enhance local government revenues for years to come. The lag holds true in downturns as well. When looking back at the Global Financial Crisis (GFC), real estate values peaked in 2006, but peak property tax collections did not occur until 2010.[2] This lag provides time and flexibility for municipal governments to prepare and adjust.

Investors learned from the GFC that large declines in real estate values do not lead to commensurate declines in property taxes (see Exhibit I). Nationwide, inflation-adjusted real estate values declined by 27% peak to trough, while the peak to trough decline for property taxes per capita was only 8.5%.[3] Local officials frequently mitigate the impact of declining real estate values by increasing property tax rates. From a credit perspective, it is important to understand any relevant property tax caps as well as periodic rate hike limitations.

**Exhibit I: Property Taxes Rise Despite Underlying Market**



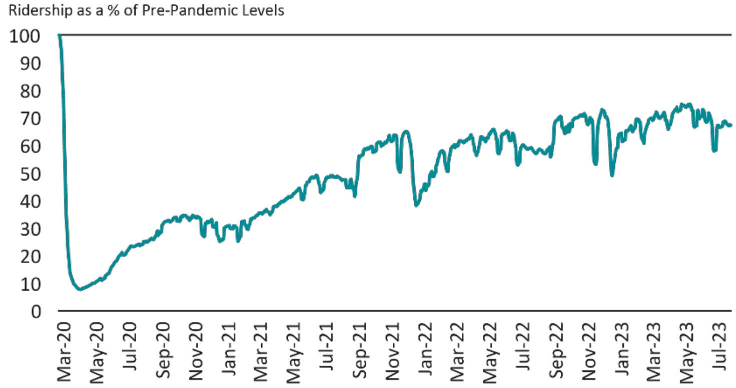

Data reported full year from December 31, 2000 to December 31, 2022
The FHFA House Price Index is a broad measure of the movement of single-family house prices.
Sources: Federal Housing Finance Agency, U.S. Census Bureau, and BBH Analysis

Sales tax collections are the next largest source of revenues for local governments and are more likely to be impacted by the shift away from downtowns. Ironically, sales taxes have benefited from inflation, helping cities fill their coffers. Although nationwide sales taxes currently sit at record levels, there are important considerations at the local level, such as business diversity. Beyond serving as a revenue source for local governments, municipal bonds backed directly by sales taxes also exist. When investing in these bonds, we prefer broad, general sales taxes as opposed to more narrow pledges, such as hotel taxes. We also require credits be well-structured, and able to withstand our stress-tests before we include them in any client accounts.

[1] S&P Global Ratings
[2] Lincoln Institute of Land Policy
[3] Lincoln Institute of Land Policy

In addition to aiding local governments, sales taxes also represent a major funding component for mass transit systems (see Exhibit II). Despite declining ridership trends across the country, mass transit credit has remained resilient. Strong economic growth has bolstered sales tax revenues, helping to offset ridership declines. At best, direct farebox receipts comprise half of a mass transit system's revenues. They rely on sales taxes and other forms of support from their respective states or local governments. The essentiality of mass transit systems persistently engenders broad support, which is foundational to their credit. Mass transit systems face tough operational choices, but we expect bondholders to remain largely insulated.

**Exhibit II: NYC Subway Ridership Has Yet to Recover**

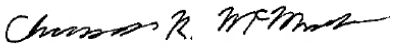



Data reported daily from March 7, 2020 to August 6, 2023
Pre-pandemic ridership is based on the average ridership for the week of March 1 to March 7, 2020
Sources: MTA and BBH Analysis

Even if shifting work trends lead to revenue declines, municipal governments still have other tools to address shortfalls. To rein in spending and cut core services is never popular, but it is an effective budget management tool. In 2020, in response to the onset of the pandemic, the public sector quickly shed 1.2 million employees.[4] The maintenance of healthy reserve balances to protect against downturns is another sign of good management. Large property and sales tax increases over the past two years, along with generous, federal pandemic aid, bolstered reserve balances across the country. Many of our local government credits are sitting atop reserve levels at, or near, record highs.

Local governments usually occupy a mundane corner of municipal credit. The COVID-19 pandemic drove a seismic shift in attitudes on work-life balance, with hybrid schedules now the norm. Office properties and the bonds they back have landed in the crosshairs. Some now extrapolate those fears to the bonds backed by cities, but local government credit does not deteriorate overnight; in most cases, it takes decades for a regional economy to drastically change. Weak long-term governance is usually the driver – think Detroit and Chicago. Capital protection is always front of mind, and our local government credits offer strong protections. We hope this allows you to comfortably enjoy the waning days of summer and beyond, even if the hustle and bustle of downtown stays muted for years to come.

*Gregory Steier*
*Principal*
*Head of Municipal Fixed Income Portfolio Management*



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[4] Bureau of Labor Statistics

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