

State of the state: Pennsylvania

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Overview

Pennsylvania benefits from a large and diverse economy that has seen consistent growth in the last several years.

The commonwealth's future credit-worthiness will likely be largely influenced by its ability to maintain available reserves without reliance of one-time revenues and the continuation of increased pension funding.

The Invesco Municipal Bond team is positive on the Philadelphia International Airport due to its strong balance sheet and ample liquidity. Both are strong proponents of the airport maintaining an investment grade rating.

State overview

We believe there are several major factors that weigh on the Commonwealth of Pennsylvania's direction of ratings. Despite increasing contributions over the last several years, Pennsylvania's pensions have continued to be funded under the 80% mark that the U.S. Government Accountability Office deems to be sound for government pensions.¹ Although reserve levels have seen recent improvements, these improvements are largely due to the COVID-19 pandemic-related federal aid and better-than-expected revenue collections, which we expect to decrease as economic activity normalizes.²

Despite these credit challenges, the Invesco Municipal Bond team believes the Commonwealth is on solid financial footing. Pennsylvania benefits from a large and diverse economy that has seen consistent growth in the last several years,³ as well as access to liquidity through the State Treasury or issuance of tax-anticipation bonds (TANs).⁴ Additionally, the Commonwealth has significantly increased its pension funded ratio in the last few years, contributing over 100% of the tread water* rate since 2018,⁵ showing management's commitment to addressing its weak pension funded ratio.

Key to maintaining credit quality will be the Commonwealth's maintenance of structurally balanced, timely approved budgets, maintenance of reserves levels, and continued progress on the Commonwealth's pension funding.

Fiscal year 2023

Per the 2024 executive budget, fiscal 2023 ended with an operating surplus equal to 6% of revenues.³ According to the Department of Revenue, fiscal 2023 ended with General Fund** revenues of \$44.9 billion.⁶ While this figure is down 7% year-over-year, this decline wasn't unexpected and fiscal 2023 revenues outperformed estimates, coming in 3.1% over budget.⁶

The two largest General Fund revenue streams, personal income taxes and sales taxes, showed mixed results. While personal income tax collections underperformed budget expectations by 3%, sales tax collections outperformed the budget by 1.5%.⁶ Personal income tax and sales tax collections represented 39% and 31% of General Fund revenues, respectively.⁶

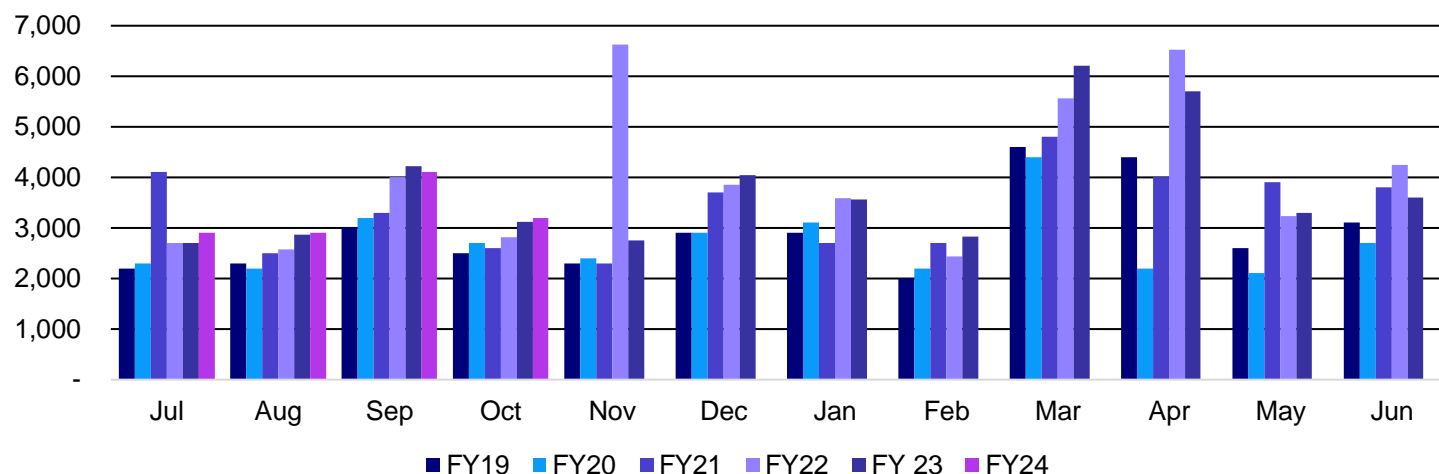
The Commonwealth continued its trend of increasing reserves by transferring \$2.1 billion, or 4% of fiscal year 2022's General Fund revenues, into its Rainy Day Fund at the start of fiscal 2023.⁷ This transfer brought the Rainy Day Fund balance to \$4.96 billion, or 42.3 days of spending, which is higher than the fiscal year end 2021 50-state median of 34.4 days cash-on-hand.²

The Commonwealth ended fiscal 2023 with a General Fund balance of \$15.8 billion⁸ or 31% of fiscal 2023 General Fund revenues.⁶ Since 2020, the Commonwealth has added \$5.1 billion to its Rainy Day Fund thanks in large part to stronger-than-anticipated revenue collections in the last three fiscal years.⁹

* Tread water rate refers to the amount of annual pension contribution required to hold the funded rate at current levels, all else being equal. A rate of more than 100% will increase the funded rate, whereas a rate of less than 100% will decrease the funded rate.

** The General Fund is the major operating fund of the state. It receives all state income not earmarked for a particular program or activity and not specified by law to be deposited in another fund.

Figure 1: Monthly General Fund Revenues (\$Millions)



Source: Pennsylvania Department of Revenue as of July 2023. FY refers to Fiscal Year.

Fiscal 2024 executive budget

The fiscal 2024 budget was passed on August 3, 2023, several weeks into the fiscal year,¹⁰ highlighting the Commonwealth's history of budget impasses. The enacted budget includes appropriations of \$45 billion, a 10% increase in spending from fiscal 2023.² The budget includes increases of 5% and 16% for education and human health and services, respectively.¹¹ These expenditure categories comprise the bulk of the budget, representing 79% of total spending.¹¹

Budgeted revenues are expected to remain flat year-over-year with sales tax revenue collections expected to remain at fiscal 2023 levels.⁹ Personal income tax revenues are budgeted to increase by 2.8%.⁹ The budget includes a spend down of \$1.4 billion of General Fund balance, or 3% of fiscal 2023 General Fund revenues.⁹ As of October 31, 2023, General Fund revenues are tracking in-line with the budget.³

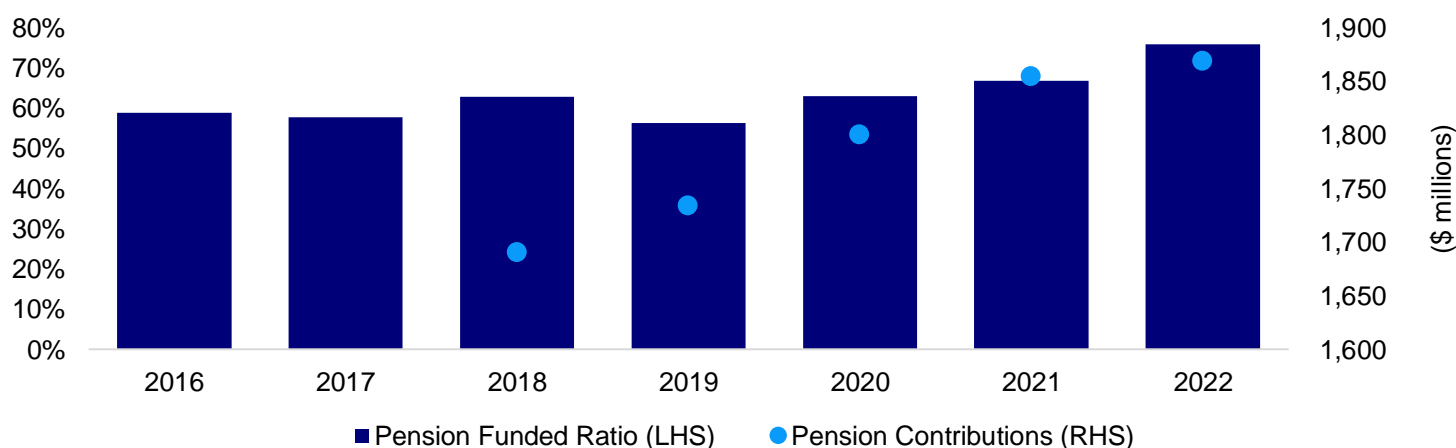
Liquidity

Pennsylvania benefits from strong access to liquidity. In the past, the Commonwealth has relied on the state treasurer for liquidity, borrowing \$1.5 billion in November 2019.¹³ In January 2020, the treasurer increased the line of credit to \$2 billion.¹³ The Commonwealth hasn't sold any cash flow notes since October 2020.⁹ Overall, cash and investments have increased from 13% of total governmental revenues in fiscal 2020 to 28% by fiscal year-end 2022.⁵

Pension Funding

The state's pension has been consistently underfunded, although the Commonwealth has been making steady progress to combat this, ending fiscal 2022 with a funded ratio of 76%.⁵ This ratio is up from 56% in fiscal 2019.⁵

Figure 2: Pension Overview



Source: CreditScope as of June 30, 2022.

Positively, since 2019, the state has made 100% of its required pension contributions.⁵ The Commonwealth has also contributed over 100% of its pension tread water rate since fiscal 2018, which demonstrates management's commitment to improving its pension funding practices.⁵ The Commonwealth's net pension liability decreased in fiscal 2022 by 20% to \$12.5 billion whereas pension contributions remained essentially flat.⁵

Economic update

Although Pennsylvania is the nation's fifth most populous state⁹ with a population of 12.9 million as of 2022,⁵ the commonwealth's population growth has been flat from 2010 through 2021.⁵ Flat population growth is expected to continue through 2030.¹³

Pennsylvania has two major metropolitan areas, Philadelphia and Pittsburgh.¹⁴ Despite natural gas remaining a major component of the state's economic profile, the service sector, including healthcare, has seen recent growth.¹⁴ Additionally, some large tech firms, including Google and eBay have moved to the state, drawn by talent of students from many of the Commonwealth's universities.¹⁵ As of June 2023, education and health services comprise the majority of the state's non-farm employment with 21% of non-farm employees, followed by the trade, transportation and utilities industry at 19%.¹⁶ From June 2022 through June 2023, the trade, transportation, and utilities industry grew 1%, while education and health services grew 5%.¹⁶

In 2021, Pennsylvania's real GDP* (Gross Domestic Product) growth rate was 4.4%, dropping to 2.2% in 2022.³ Real GDP growth is expected to average of 1.5% through 2025.³ Historically, Pennsylvania's economic growth has lagged that of the nation.⁹ Positively, there are economic signs of recovery. As of September 2023, the unemployment rate was 3.1% compared to the national unemployment rate of 3.6% for the same month.¹⁶ Wealth indicators for the commonwealth are mostly in line with those of the country.¹⁷

Pennsylvania General Obligation Update

Moody's Rating: Aa3 / Positive as of September 11, 2023

S&P Rating: A+ / Stable as of August 22, 2022

Fitch Rating: AA- / Positive as of August 29, 2022

Moody's has maintained an Aa3 rating since May 2016, but changed their outlook to positive from stable in September 2023. The rationale for the outlook change was improved reserve levels. Their rating is based on credit positives such as improving pension funding metrics, better-than-expected revenue performance, and stable access to liquidity. Credit negatives cited are higher than average leverage and below average economic performance.

S&P has maintained an A+ rating for the state since 2017. Reasons cited for the rating include stronger than anticipated economic performance resulting in surpluses and increases in reserves. Concerns mentioned in the latest report include the challenges the Commonwealth will face to balance future budgets without one-time federal aid funding as well as challenges stemming from pension underfunding.

Fitch has assigned an AA- rating since July 2019. The outlook was revised from stable to positive in April of 2022, citing the Commonwealth's operating surplus and subsequent increase in reserves. However, Fitch also notes the state's history of implementing one-time budget measures, structurally imbalanced budgets, and slower economic growth compared to the nation.

Spotlight on a Pennsylvania Revenue Bond: Philadelphia International Airport

Moody's Rating: A2 as of January 6, 2023

S&P Rating: A+ as of June 22, 2023

Fitch Rating: A as of September 1, 2023

The Philadelphia Airport System is owned by the City of Philadelphia and operated by the city's Department of Aviation. The system is made up of Philadelphia International Airport (PHL) and its general aviation reliever airport, Northeast Philadelphia Airport (PNE). The Philadelphia International Airport is ranked the 21st busiest airport in terms of passengers and 15th in terms of freight.¹⁸ The airport continues to serve as a major hub for American Airlines, which accounted for approximately 65% of the market share in fiscal 2022.¹⁸ Our municipal bond team has built a position in the Philadelphia International Airport over time by participating in multiple bond offerings.

The airport has experienced continued recovery from the coronavirus pandemic in fiscal 2022 and 2023, with enplanements increasing to 11.7 million in fiscal 2022, and a further increase of 14.5% in fiscal 2023 to 13.4 million (83% of 2019 levels), reflecting the restoration of capacity airlines to accommodate growing demand. Furthermore, management expects full volume recovery to 2019 levels by fiscal 2025-2026 as international enplanements return.

Monitoring the financial performance of credits is a primary focus for the Invesco Municipal Credit team as borrowers continue to manage operating and economic challenges post pandemic. The Philadelphia International Airport continues to maintain a strong balance sheet in fiscal 2022 with ample liquidity (597 days cash on hand) and appropriate financial leverage (66% debt to capitalization) in relation to its rating category. In addition, debt service coverage (DSC) rebounded to its pre-pandemic level of approximately 1.7 times in fiscal 2022 from 1.3 times the previous year. Having characteristics such as a sufficient liquidity cushion, the ability to access financial markets, and having a manageable debt level are likely to help the Philadelphia International Airport successfully navigate through this challenging economic environment while maintaining an investment grade rating.

Pennsylvania general obligation bonds and Philadelphia International Airport issues comprised 0.68% and 3.33% of Invesco Pennsylvania Municipal Fund's (OPATX) portfolio as of 12/31/2023. Holdings are subject to change without notice and are not buy/sell recommendations.

*GDP measures the monetary value of final goods and services produced in the state annually.

Sources:

1. U.S. Government Accountability Office, July 10, 2008.
2. House Appropriations Committee, 2022/23 Budget-in-Depth, dated July 20, 2022.
3. Pennsylvania Governor's Executive Budget 2023-2024, published March 7, 2023.
4. S&P Rating Report, as of August 22, 2022.
5. CreditScope as of June 30, 2022.
6. Pennsylvania Revenue Department, July 3, 2023.
7. Moody's, dated August 26, 2022.
8. Pennsylvania Treasury January 2024.
9. Moody's, dated September 11, 2023.
10. Associated Press, Augst 3, 2023.
11. Fiscal 2024 Enacted Budget, August 3, 2023.
12. Moody's, dated June 30, 2020.
13. Pennsylvania Independent Fiscal Office, October 2023.
14. Commonwealth of Pennsylvania General Obligation Bond Offering Statement, September 2022.
15. Commonwealth of Pennsylvania General Obligation Bond Offering Statement, June 2021.
16. CreditScope as of September 30, 2023.
17. CreditScope as of December 31, 2022.
18. Federal Aviation Administration
19. Merritt Research Services as of June 30, 2022.
20. Fitch, dated September 1, 2023.

Invesco Municipal Bond team

The Invesco Fixed Income Municipal Bond team's investment philosophy is based on the belief that creating long-term value through comprehensive, forward-looking research is the key to providing clients with diversified portfolios that aim to maximize risk-adjusted returns.

Proprietary credit research and risk management are the foundations of our investment process, supported by a deep and experienced team of investment professionals with expertise that spans the entire municipal investment universe. We maintain an integrated, team-based investment process that combines the strength of our fundamental credit research analysts with the market knowledge and investment experience of our portfolio managers.

Our position among the top five municipal investment managers by assets in the US* enables us to access preferred market opportunities and gain valuable market insight. Our team has established relationships with more than 120 national and regional municipal debt dealers in the US. We believe these established relationships, as well as our size, allow us to achieve fluid execution in daily transactions. Our ability to aggregate trades across multiple portfolios also enables us to obtain lower institutional pricing, which can contribute to portfolio performance.

About risk

Municipal securities are subject to the risk that legislative or economic conditions could affect an issuer's ability to make payments of principal and/or interest.

Junk bonds involve greater risk of default or price changes due to changes in the issuer's credit quality.

The values of junk bonds fluctuate more than those of high-quality bonds and can decline significantly over short time periods.

All fixed income securities are subject to two types of risk: credit risk and interest rate risk. Credit risk refers to the possibility that the issuer of a security will be unable to make interest payments and/ or repay the principal on its debt. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa.

Municipal bonds are issued by state and local government agencies to finance public projects and services. They typically pay interest that is tax-free in their state of issuance. Because of their tax benefits, municipal bonds usually offer lower pre-tax yields than similar taxable bonds. The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

Before investing, investors should carefully read the prospectus and/or summary prospectus and carefully consider the investment objectives, risk, charges and expenses. For this and more complete information about the funds, investors should ask their financial professional for a prospectus/summary prospectus or visit [invesco.com/fundprospectus](https://www.invesco.com/fundprospectus).

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This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions, there can be no assurance that actual results will not differ materially from expectations.

Past performance does not guarantee future results.

A credit rating is an assessment provided by a nationally recognized statistical rating organization (NRSRO) of the creditworthiness of an issuer with respect to debt obligations, including specific securities, money market instruments or other debts. Ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest); ratings are subject to change without notice. If securities are rated differently by the rating agencies, the higher rating is applied. Not Rated indicates the debtor was not rated and should not be interpreted as indicating low quality. A negative in Cash indicates fund activity that has accrued or is pending settlement. Pre-Refunded / Escrowed to Maturity (Prerefunded / ETM) bonds are issues backed by an escrow account, invested in US Treasuries, which is used to pay bondholders. Other includes bonds rated below single B and bonds currently not paying a coupon. For more information on the rating methodology, please visit www.standardandpoors.com and select 'Understanding Ratings' under Rating Resources on the homepage; www.moodys.com and select 'Rating Methodologies' under Research and Ratings on the homepage; www.fitchratings.com and select 'Ratings Definitions' on the homepage.

The opinions expressed are those of the author, are based on current market conditions and are subject to change without notice. These opinions may differ from those of other Invesco investment professionals.

*Source: Simfund as of December 31, 2023.