

## Assessing Municipal Credit: Diverging Trends in 2025

### A Market That Rewards Discipline

The municipal bond market enters the final quarter of 2025 navigating a complicated mix of fiscal headwinds and credit opportunities. Federal policy changes, the expiration of pandemic-era support, and slower revenue growth in some jurisdictions have created pressure points. Yet the overall picture is not one of broad deterioration. Instead, the story is defined by divergence: some states are strengthening their credit standing while large cities and certain sectors face growing stress. For investors, municipals continue to offer resilience, attractive after-tax yields, and strong legal protections that make them a cornerstone of fixed-income portfolios.

### State Credit Momentum

Two of the most striking credit developments this year come from Connecticut and New Jersey. Both states, long regarded as challenged by heavy pension obligations and persistent deficits, have shown how disciplined fiscal management can shift investor confidence.

Connecticut recently earned upgrades from both Moody's and Fitch, reflecting its adherence to fiscal guardrails and consistent pension funding. Since 2019, the state has contributed nearly \$10 billion to its pension systems, drawing praise for its "debt diet" approach and strict adherence to spending limits. Reserves are stronger, liabilities are being moderated, and the credit profile now sits comfortably in the double-A range. <sup>1</sup>

New Jersey, too, has turned a corner. Moody's lifted the state to Aa3, its second upgrade of the year, citing a robust surplus, reduced debt through defeasance, and five consecutive years of full actuarial pension contributions. A projected \$6.75 billion undesignated fund balance provides room to navigate future pressures, while improved fiscal discipline has also earned an upgrade from S&P, the first since 2023.<sup>2</sup> These examples underscore how strong governance and structural reform can drive tangible rating improvements.

### Cities Under Pressure

The picture is less encouraging at the local level. Research shows that at least 20 of the nation's 25 largest cities face projected budget gaps for fiscal 2026.<sup>3</sup> The federal aid that bolstered urban budgets during and after the pandemic has largely been spent, leaving cities to contend with rising labor costs, pension obligations, and revenue streams that are struggling to keep pace.

Chicago illustrates the challenge, with unfunded pension liabilities and new wage agreements adding long-term strain. San Francisco continues to struggle with historically high office vacancies that depress its commercial property tax base. Houston and Denver, both once flush with reserves, have already drawn on rainy-day funds to close gaps. These problems highlight the structural imbalances confronting many urban governments.

Still, the worst fears of a post-pandemic urban fiscal crisis have not materialized. Populations in many cities have stabilized after earlier declines, and crime rates have moderated. Boston, despite facing falling commercial values, has maintained its AAA bond rating thanks to a diverse tax base and continued development. Rating agencies note that cities entered 2025 with reserves at historically strong levels—median balances equal to 45% of general fund revenue, according to S&P. This cushion gives municipalities breathing room, even as they work to bring budgets back into structural balance.

## Sector Divergence and Policy Risks

Beyond the state-local divide, risks and opportunities vary sharply across sectors. Healthcare remains the most vulnerable. The One Big Beautiful Bill Act reduces Medicaid and ACA marketplace funding by more than \$1 trillion over the next decade. Large hospital systems may absorb EBITDA declines of 2–5%, but rural, children's, and city-owned hospitals could see revenue losses of 6–12%, enough to threaten solvency without state support.<sup>4</sup> Academic medical centers are doubly exposed because they rely on both Medicaid reimbursements and federal research grants. The resulting strain could also spill into higher education finance, given that teaching hospitals often account for a significant share of university revenues.

Higher education faces separate challenges from enrollment declines and rising costs. While flagship universities with strong endowments remain stable, tuition-dependent schools face mounting fiscal pressure.

Transportation credits, though improving, remain tied to cyclical patterns of demand. Airports have stabilized with strong debt-service coverage, but regional transit systems dependent on farebox recovery remain vulnerable to shifts in commuting and travel behavior.

Finally, pensions and long-term liabilities remain a defining factor for many issuers. States such as New Jersey are showing that steady contributions can reverse years of negative momentum. Others, particularly local governments with growing obligations and weak funding discipline, remain constrained by rising costs that crowd out essential services.

## Local Leadership and Resilience

Despite these pressures, local leaders are demonstrating adaptability. The National League of Cities' *2025 State of the Cities* report highlights priorities such as economic development, infrastructure investment, housing, and public safety.<sup>5</sup> Cities are pursuing downtown revitalization to broaden their tax bases, investing in workforce development to expand employment, and addressing housing affordability with initiatives that strengthen both communities and revenues.

This adaptability underscores why municipal defaults remain exceptionally rare. Legal protections—including statutory liens and state intercept mechanisms—help protect bondholders, while state oversight often steps in before outright distress can materialize.

## Investor Case: Municipals Retain Their Edge

Despite diverging fundamentals, municipals remain attractive for several reasons. Ratios of long-dated municipals to Treasuries remain above 90%, offering strong after-tax value.<sup>4</sup> Statutory protections continue to ensure priority of payment, and investor demand is broadening, with separately managed accounts growing rapidly and banks and insurance companies returning to the long end of the curve. Rating actions show divergence, with more negative outlooks in pressured sectors, but upgrades still outpace downgrades overall.

For investors, the implication is clear. High-quality state general obligation bonds offer stability and, in some cases, improving credit trajectories. Essential service revenue bonds, such as utilities and transportation assets with broad user bases, remain reliable. Healthcare and higher education require greater selectivity, with diversification and scale as key differentiators. Caution is warranted in urban general obligations, but reserves and state oversight continue to limit default risk.

## Conclusion: Divergence Creates Opportunity

The municipal credit landscape of 2025 is not one of uniform weakness, but of divergence. States such as Connecticut and New Jersey are demonstrating the benefits of fiscal discipline and receiving upgrades, while many cities face structural deficits and rising costs. Sector risks remain concentrated in healthcare, higher education, and certain transit systems, but municipal resilience, strong legal frameworks, and attractive relative value continue to anchor the asset class.

For investors willing to differentiate among issuers and focus on fundamentals, municipal bonds provide both stability and opportunity. Even amid fiscal and policy uncertainty, the market continues to reward selectivity, offering enduring value in the form of tax-free income and historically low default risk.

## References

1. Bloomberg, *Connecticut's "Debt Diet" Pays Off With Two Bond-Rating Upgrades* (Sept. 2025).
2. Bloomberg, *New Jersey Wins Upgrade as Pension Contributions Remain Strong* (Sept. 2025).
3. Pew Charitable Trusts, *Big Cities Face Deficits: Should States Worry?* (Aug. 2025).
4. SAC, *Navigating Opportunities in Municipals Amid Policy Change* (Sept. 2025).
5. National League of Cities, *State of the Cities Report 2025*.

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