GW&K INVESTMENT MANAGEMENT

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States and Shifting Trade Policies

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Since the beginning of the year, the Trump administration has enacted a number of trade policies, including import tariffs on a variety of products ranging from washing machines and solar panels to steel and aluminum. Aimed largely at China, these restrictions have been met with retaliatory penalties on U.S. exports including food commodities, automobiles and electronics. Concurrent discussions with Mexico and more recently Canada, have led to revisions of the North American Free Trade Agreement (NAFTA) that can be viewed as more favorable than the measures exchanged between the U.S. and China. While policy development remains in the early stages and negotiations with trading partners will lead to refinements, we aim to provide some color on the impact on the credit quality of U.S. states. Albeit difficult to quantify, the new trade policies have the potential to dampen economic expansion, decelerate wage growth and by extension, slow state tax revenue growth.

Our evaluation of the possible ramifications for states begins with identifying the role of exports in total economic output. Using a measure of exports-to-gross-state-product (GSP), we have listed the top five export states in the below chart.

Of the names listed, we hold large positions of state bonds in both Texas and Washington. Taking a closer look, Texas' primary export partner is Mexico, serving as the destination for 37% of Texas exports in 2017. Canada and China are a distant second and third in terms of exchange, receiving 9% and 6% respectively, of state exports last year. Turning to Washington, the story is quite different. China claimed 24% of exports in 2017, trailed by Canada at 10% and Japan at 7%. Given its primary trading partner, Washington is subject to a number of trade tariffs on multiple fronts, including its aircraft and transportation equipment sectors, as well as its port system that provides a gateway for agricultural products grown elsewhere in the United States.

Given its many positive credit qualities, we are confident Washington will be able to navigate any challenges presented by shifting trade policies. The state is characterized by a broad, diverse economy with an employment profile that mirrors the U.S., outside of its overweight to aircraft manufacturing and information technology. Major employers include Boeing, Amazon, Microsoft and Providence Healthcare, with sizeable military bases and public universities providing additional stability. Employment and GSP growth (as measured by the Federal Reserve Economic Database) have outpaced the U.S. in recent years, registering gains of 6.2% and 2.5% respectively, in 2017 versus 4.2% and 1.6% respectively, for the nation as a whole. Wealth levels comfortably exceed the U.S., with 2017 per capita personal income of nearly $58,000, representing 112% of the national average.

Top 5 States - Exports/GSP 2017

State	Exports ($mil)	GSP ($mil)	Exports/GSP
Louisiana	57,005	246,264	23.1%
Texas	264,541	1,696,206	15.6%
Kentucky	30,857	202,507	15.2%
Washington	76,414	506,353	15.1%
South Carolina	32,199	219,093	14.7%

Sources: United States Census Bureau, Bureau of Labor Statistics

Washington has a history of strong financial management as evidenced by consecutive years of operating surpluses that have contributed to a healthy reserve position in excess of 13% of budget at fiscal 2017 year end. Despite the absence of a tax on personal income, revenue sources are varied and include sales taxes, business gross receipts taxes and, somewhat unique for states, property taxes. Following five consecutive years of annual employment growth at or above 2.5%, officials are projecting job gains of 1.9% for 2019. The restrained outlook, in conjunction with ample budgetary reserves, will position the state well in the event of a pullback caused by trade restrictions.

Debt burden is moderate with $20.4 billion of tax-supported debt outstanding at the end of fiscal 2017, which translates into 4.0% of GSP versus the Moody's median of 2.1%. Although the debt ratio appears somewhat elevated, annual debt service paid from general operating funds claimed a manageable 4.0% of expenses last year. Washington has a number of pension funds, all of which are reasonably funded. The aggregate funded ratio for all plans was 84% at the end of fiscal year 2017, well above the average state funding level of 73%, as reported by the Boston College Center for Retirement Research. Of equal importance, annual pension contributions are affordable at just under 2% of operating expenses.

It is our expectation that all 26 state holdings in our portfolios are capable of responding to the uncertainties associated with evolving trade policies. All share the common traits of a diversified economic base, prudent fiscal management and budget flexibility that will prove advantageous against the backdrop of a changing regulatory landscape.