



# Current Municipal Bond Market Environment

## Overview

This Research Note discusses the current state of the municipal bond market. Despite the concerns swirling around the municipal sector we still believe that municipal bond portfolios, including both tax exempt and taxable Build America Bonds, if properly managed, can represent a sound, income producing, risk reducing investment.

## Headline Risk

There has been much written recently about the deteriorating credit quality of municipal bond issuers in light of the sluggish economy, falling property values and tax revenues, and high unemployment. Most states are presently experiencing fiscal stress and find that they are hard-pressed to raise taxes on their equally stressed citizens. In addition to the issues relating to budgetary deficits, most states also face burgeoning future economic stresses relating to massive under funded pension obligations. Forty six states are presently in a deficit position, and face combined annual budget shortfalls approaching \$112 billion according to the Center on Budget and Policy Priorities<sup>(1)</sup>. Unlike the federal government which has the power of the printing press and can better sustain persistent budget deficits, states cannot issue currency and generally must be more fiscally responsible.

Headline risk is increasingly evident in national publications, and many authors have called into question the safety and viability of municipal bonds and whether it is still prudent for investors to own them in their fixed income portfolios.<sup>(2)</sup> Because fixed income allocations are typically used as a risk reduction investment (i.e., income producing, capital preservation) and not for capital appreciation, it is fair to raise the issue of whether or not municipal bonds should still be used for this purpose.

We expect to see continued headline noise in coming months, such as we have recently witnessed regarding San Diego (CA), Central Falls (RI), Harrisburg (PA), and with states such as CA, IL, NY, and NJ. In the case of the insolvent city of Central Falls, RI, it was announced on July 6, 2010, that Central Falls repaid \$4.1 million of tax anticipation notes on time the previous week. After filing for bankruptcy in May 2010, the state court appointed a receiver to take over financial control, but subsequently the general assembly passed legislation to cover the debt and take it out of state court receivership. The message sent by this state is for its municipalities to go to the state for help rather than file for bankruptcy.<sup>(3)</sup>

Alarming notions, such as bankruptcy, are bandied about in the press, and there is much confusion, fear, and misunderstanding of what the true risks are in the municipal bond space. Conflicting messages abound even within the same

publication in articles published in close time proximity to each other<sup>(4) (5)</sup>. Such headlines tend to sell papers but don't necessarily give the whole picture.

### **Prior Historical Debt Crises and Muni Performance**

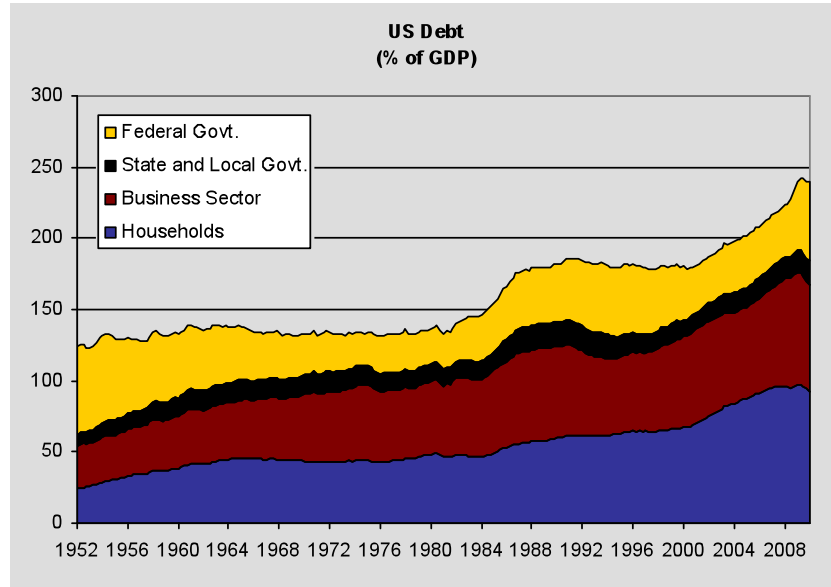
In their special commentary of December 2009, Breckinridge Capital Advisors reported that in 1841 and 1842, nine states defaulted on their debt obligations following the Panic of 1837. In the 1860s and 1870s another nine states defaulted<sup>(6)</sup>. During the Great Depression, in 1933, when the US suffered 25% unemployment and the economy contracted by a third, only one state, Arkansas, defaulted on general obligation (GO) debt. Even so, the state ultimately paid investors back 100 cents on the dollar.<sup>(7)</sup>

In the more recent era, Moody's reported in February 2010, that for rated municipal bonds over the time frame 1970 – 2009 only 54 municipal issuers defaulted out of a universe of 60,000 rated issues (Moody's rates roughly 80% of the dollar volume). The cumulative issuer default rate after 10 years of issuance was a miniscule 0.09%. Of those that defaulted, not one of them was AAA rated. Defaults in the municipal realm as a whole have been rare, and those that were GO debt were virtually nil. Since 1970, despite examples such as New York City, Washington Public Power Supply, Orange County and Vallejo, which filed for bankruptcy in 1975, 1983, 1994 and 2008, respectively, only two GO issuers with an investment grade rating by Moody's have defaulted.<sup>(7) (8) (5)</sup>

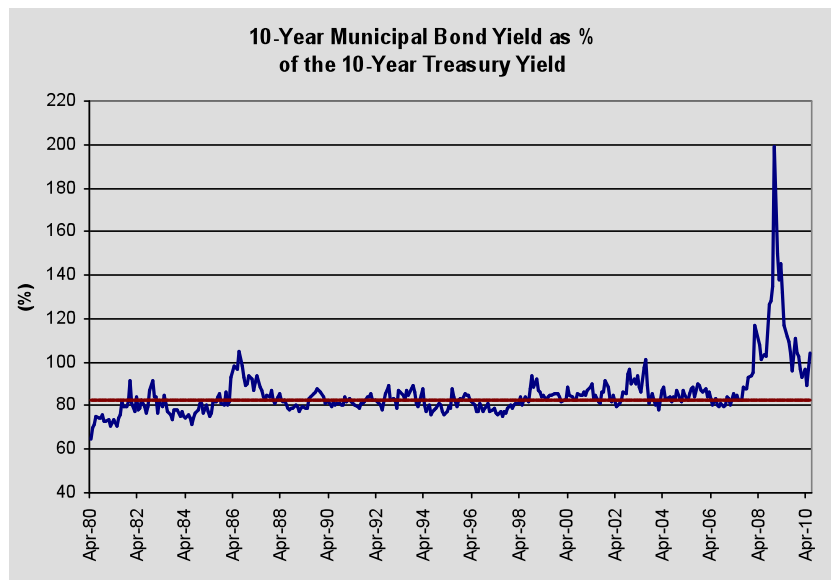
### **Current State Fiscal Conditions**

Breckinridge also reports that since January 2009, states have received \$150 billion in federal subsidies, cut spending by \$87 billion, and raised \$32 billion in new revenues, yet expectations are for state budget shortfalls to continue<sup>(6)</sup>. By next January, the \$787 billion federal stimulus funding will have dried up barring new congressional actions. The budget holes are so large that some economists fear that state leaders won't be able to ride out this economic cycle as they have done in the past. Average sales and income tax revenues have been falling for five straight quarters for the first time since 1962. California is grappling with a \$19 billion budget gap and Illinois is not far behind<sup>(1)</sup>.

To put this in a historical context, as bad as the current state indebtedness is, it is a tiny fraction of that which existed in the 19<sup>th</sup> century and the Great Depression. Debt service expense is less than 7% of general fund revenues in California and less than 5% of all revenues in New York. To contrast, back in 1841 the interest expense of LA, FL, MD, AL, and MS exceeded annual state revenues. In 1876, interest payments were 22% of revenues in SC and 32% in FL. In 1933, Arkansas' debt service payments totaled \$13 million of the state's \$14 million budget. Total outstanding municipal debt as a percentage of GDP is around 19%, less than what it was in the early 1990s and the last twenty year's peak, 21.2 % in 1991.<sup>(6)</sup> The chart below shows municipal, federal, corporate, and household debt as a percent of GDP since 1952. While municipal debt is sizeable in absolute terms, it is a fairly small portion of this nation's debt burden. Tax supported debt to gross state product is still manageable, even for the largest issuers – NJ (6.2%), NY (4.4%), CA (3.8%), and IL (3.7%) according to Income Research & Management (IR&M).<sup>(9)</sup>



While the risk of municipals may be rising, investors are receiving more attractive yields. Even on a pre-tax basis, municipal bond yields are once again yielding near or even more than U.S. Treasuries depending on the maturity. This makes Municipal bonds very attractive at this time on a relative basis (see chart below).



Source: Barclays and Federal Reserve Bank

## Muni Bankruptcy Protections

Municipal issuers rarely file for bankruptcy. When they do, the rights of issuers and bondholders are subject to the federal bankruptcy code, state-specific insolvency laws, or both. Today's state legal protection for GO bondholders is quite strong. General Obligation bonds require states to raise taxes to repay investors. States cannot file for bankruptcy, as established by a Supreme Court ruling in 1937.<sup>(9)</sup> In a Moody's special research comment, it was noted that the generally low credit risk of municipalities is in part a consequence of the unique laws applicable to such entities. While corporations can file for bankruptcy under Chapter 7 (liquidation) or Chapter 11 (capital structure reorganization), municipalities, when allowed by their governing state laws, file for bankruptcy under Chapter 9. Bankruptcies of municipalities under Chapter 9 differ from corporate bankruptcies in several respects:

- Involuntary bankruptcy filings are not allowed;
- Chapter 9 provides only for an adjustment of the municipality's debts not its liquidation; and
- The municipality's powers are not affected by the filing.

These bankruptcy differences provide for a municipality to continue its existence – including maintaining its operations and revenue collections – during a bankruptcy and allow for a potential payment on its defaulted debt, if any, in the future.

Additional protections accrue to GO bond holders. General obligation bonds are backed by the full faith and credit of the issuing municipality. The strength of this pledge ensures that all revenue-producing powers of the municipality are promised to be utilized to satisfy the debt, including the municipality's ability to levy taxes sufficient to pay such debt.

Moody's notes that to the extent that a default on general obligation debt occurs bondholders have the right to seek a writ of mandamus. "The writ, ordered by a court, directs the appropriate governmental official to levy and collect taxes to pay debt service or to make required debt service payments from other available funds of the municipality. This ability to invoke mandamus provides a great degree of comfort that, in almost all circumstances, ultimate recovery on defaulted general obligation payments will eventually equal 100% of principal and interest. Many other state and local government-related bond issuers share these low risk characteristics, in part because they benefit from the implicit support of the state and local government authorities that create or sponsor them. For example, most water and sewer authorities and public university systems are extremely strong credits, not only because they possess dependable revenue streams and local monopoly positions, but also because they are quite likely to receive financial support from their sponsoring authorities in the event of distress. These are known as essential service revenue bonds."<sup>(10)</sup>

## Credit Quality

Most municipal issuers are high quality credits. According to a Moody's study covering U.S. municipal bond defaults and recoveries from 1970-2009, more than 85% of municipal issuers are currently rated A or higher. In contrast, the global investment grade corporate market finds only 37% of the issuers rated

single A or higher. Historically this has translated into lower defaults and higher recovery rates for munis than corporates. Ten-year cumulative default rates for investment grade municipal bonds were 0.06% versus 2.50% for investment grade corporate bonds over this time period. Average recovery rates were much higher for defaulted munis as well at 67% versus 37.5% for defaulted corporate bonds.<sup>(11)</sup> For GO bonds however, that number goes up sharply. Standard & Poor's reported a 100% recovery rate for rated GO bonds, over the past 30 years.<sup>(6)</sup>

Another study stated that even excluding the highest quality segments of the municipal market – GO bonds, the default rate on municipal bonds rises to only 0.3%. This is still below the overall default rate of investment grade corporate and below the Aaa-rated corporate default rate of 0.5%. Typically municipal defaults occur in the lower-rated or non-rated sections of the market and the riskier sectors noted above and much less so in the high grade GO bonds and essential services revenue bonds. For lower grade debt, the five year historical defaults for muni and corporate bond issuers were 3.4% and 21.4%, respectively.<sup>(5)</sup>

Municipal investors may be worrying unduly given the debt's low default ratio relative to other asset classes. According to a Bloomberg report, companies are 98 times more likely to default than muni issuers over a 10-year period based on data from Moody's.<sup>(2)</sup> It is important to note that these historical municipal credit studies referred to above are based on ratings in place prior to the recent global ratings scale changes. Municipal bond credit ratings have been undergoing change this year. These recalibrations are intended to put munis on the same level with corporate and sovereign debt.<sup>(12)</sup>

### **Common Sense Constraints**

The vast majority of municipal defaults that occur are in non-essential sectors such as industrial development bonds, healthcare/nursing homes, and multi family housing. It is prudent to limit exposure to these high risk sectors when building a municipal bond portfolio. Other higher risk sectors to avoid include, tobacco bonds, US possession bonds (e.g. Puerto Rico), airport revenue bonds, parking facility bonds, convention center bonds, lease bonds, and non-rated or other non-essential service bonds, even if insured. Municipal bond purchases should focus on GO bonds and essential service bonds such as water/sewer, highway transportation, and university revenue bonds. We generally recommend that individuals avoid less liquid AMT bonds, and more volatile long term maturities (depending on liquidity needs), as well as limiting the credit quality to A or higher for shorter term bonds and AA or higher for maturities longer than 3 years.

### **Build America Bonds (BABs)**

BABs (taxable bonds issued by municipalities) are experiencing a surge in market acceptance not only domestically but globally. The amount of outstanding issuance has now reached \$121 billion as this market has become more liquid and mainstream. This is remarkable given that the sector only began in 2009 as a result of the ARRA (American Recovery and Reinvestment Act) as part of the US economic stimulus plan. BABs offer investors high quality, relatively high yields, and more longer dated maturity options within an

asset class with historically low defaults. However, careful sector screening is important for BABs just as it is with tax exempt municipal bonds.

Some investors in Europe and Asia are discovering the Build America Bond program and are finding the bonds more appealing than sovereign debt. Investors are actually voting with their wallets and investing in U.S. states. Taxable BABs have spread through the municipal bond market like wildfire, with more sales by states, cities and other municipal issuers wanting to obtain the program's 35% federal rebate on interest costs. In May 2010, BABs made up a third of new issues, according to the U.S. Treasury.<sup>(13)</sup> The BABs market is seeing more acceptance not only from the issuer side but from the investor side. We are also beginning to see a general trend among larger issuers to use Build America Bonds rather than tax-exempt debt.<sup>(14)</sup> The long duration and high quality of BABs appeals to insurance companies, LDI mandates (pensions), and endowments. This has broadened municipal demand and helped stabilize the muni market as BAB issuance has displaced and dampened somewhat new tax exempt supply.

In a June 2010 conference call by PIMCO on the municipal market, they refuted the common misperception that BABs are mainly issued by weaker credits. In their March 2010 Outlook they also noted that they continue to focus domestically on programs like Build America Bonds. They stated that the ratings of BABs don't truly reflect the general high quality of this asset class and pointed out that there is a dearth of credit research on issuers in this market. While this is beginning to change, they believe that there presently exists a higher embedded risk premium in BABs versus corporate bonds which is not reflective of BABs stronger credit quality.

There are some risks and concerns with BABs that also need to be considered. While the BABs market is growing and gaining wider acceptance, bid-offer spreads are still wider for BABs than tax exempt municipal bonds. The current liquidity for BABs in the secondary market is not as strong as the liquidity of tax exempt municipals. It is also difficult to buy large size positions, especially in the short to intermediate maturities. Legislative risk is also critical to understand. Even though the U.S. Congress has been hinting that it will extend or maybe even make BABs permanent, there is talk that the 35% subsidy rate may be reduced to 30% or possibly even 28% (which could potentially harm the program). No one knows if the Federal government will be willing to continue to subsidize the BABs program given our weak economy, spiraling budget deficits, and pending elections. The changing political climate and need for new tax revenues could make the BABs subsidy a future budget casualty. If Congress signals that this subsidy will be reduced to 28% or elects not to extend the program past 2010, then new issuance would likely spike in 2010 (BABs are slated to end this year) and cease in 2011 (if not extended) or be reduced sharply (if the subsidy is reduced), thus damaging the secondary market liquidity for BABs.

## **Conclusion**

We believe that while there are many problems facing states and municipalities today, and the budget pressures are likely to persist for quite some time, the political will to act exists. There is certainly a risk that defaults may occur. However, states have much less leeway to run perpetual budget deficits than the federal government, and generally have to make the hard choices necessary

to balance their budgets. We are seeing evidence of this already happening as states are starting to take action. The NY Times reported that last month, local governments nationwide shed more than 20,000 jobs. Programs are being cut and teacher lay offs are mounting <sup>(15)</sup>. While the risk in the municipal sector is clearly elevated versus what it had been prior to the financial crises, and recovery from our severe recession progresses more slowly than we would like, we expect the majority of states to continue cutting costs and taking responsible actions to bring their budgets into balance.

States realize that they need to be able to access the capital markets in the future and to default on their debt would make it difficult to raise funds in the future for infrastructure needs. Politicians, voters, and public employees all have strong incentives to maintain this access. That said, there will likely be some smaller, fiscally distressed municipal bond issuers that may default, but these are expected to be concentrated mainly in the higher risk non-essential sector bond issues. Therefore, it is our belief that certain municipal bonds, both tax exempt and taxable BABs, still generally represent solid credit quality. Notwithstanding, it is important to realize that headline risk will likely continue in coming years, and to understand that municipal bonds are not risk free instruments and they do carry more risk than U.S. Treasuries, which are backed by the full faith and credit of the U.S. Government. This is why we feel it is important to recognize that municipal bond credit quality can be enhanced by adhering to reasonable exclusions (as noted above), and in so doing, the risk of holding a municipal bond portfolio, already viewed historically as one of low risk, can be reduced even further.

Given their attractive yields and stronger expected credit quality compared to investment grade corporate bonds, along with their growing popularity with issuers and investors (both domestic and foreign) alike, we believe that the BAB program will be extended by Congress and quite possibly even made permanent. Provided the 35% tax subsidy is not reduced excessively, this sector should continue to grow. However, it should be reiterated that given our historically high budget deficits, there is a risk that Congress could lower or even eliminate the federal subsidy, thereby crippling the BABs market.

Footnote sources:

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