

MUNICIPAL BOND MARKET COMMENTARY

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Recently, a steady stream of negative articles has raised concerns about the creditworthiness of municipal bonds. State and local governments have experienced steep declines in revenue over the last couple of years that have squeezed budgets and forced painful cuts. Many states also face long-term burdens such as underfunded pension plans and soaring health care costs for current workers and retirees. Even Warren Buffet has weighed in, saying there will be a “terrible problem” for municipal debt in coming years, and suggested that the federal government might be called on to provide assistance. Should municipal debt investors heed the warnings, or are the headlines overly alarmist?

Municipal Budget Woes

Let’s start by looking at the nature of the municipal budget woes. The current declines in tax revenue are cyclical in nature. State and local government revenue has always declined in a recession, generally lagging the economic cycle. Tax revenue – state income taxes, sales taxes, property taxes, etc. – has fallen sharply, with the greatest drop since the Great Depression. For fiscal year 2010, state and local governments were faced with having to close a combined budget deficit of \$96 billion, and this gap could be even greater in 2011 and 2012. State and local budgets have been squeezed, because unlike our federal government, most states and cities are required to balance their budgets. And for most jurisdictions, they have responded as they always do in recessionary periods – by cutting spending, depleting reserve funds, and in many cases increasing taxes and fees. These decisions are politically painful but necessary, and have included cuts to education, wage freezes, layoffs, reduction in services, deferred capital projects, etc. Among the ways Virginia balanced its budget this year was deferring its required payment to the state pension fund, though this must be repaid in future years.

The negative stories usually fail to mention that tax revenue has always rebounded, with a lag, as the economy pulls out of recession. In aggregate, state tax collections rose 2.2% in the 2nd quarter of 2010, following a gain in the 1st quarter. Led by rebounds in personal income tax and sales tax revenue, thirty states increased tax collections. Legislated changes and higher tax rates boosted revenue in some states, while the improved economy helped as well. However, state tax revenue is still 17% below the levels collected in 2008, according to the Nelson A. Rockefeller Institute of Government. In Virginia, the state recently reported that it completed its fiscal year ending June 30 with a \$400 million surplus thanks to sharp cuts in spending and higher than projected tax revenue. (It should be noted that much of this “surplus” was earmarked for expenditure in the subsequent fiscal year.)

Longer term worries include the underfunded status of most state pension funds due to declining tax revenue and market losses over the last two years. In the boom years, it was easy for politicians to legislate lavish retirement benefits for the public sector workforce, with the assumption that continued gains from the stock market would cover the obligation. With two bear markets in the last decade, assets in state pension plans were \$1 trillion short of the obligations as of fiscal 2008, according to the Pew Center on the States. Some states have sold pension obligation bonds, piling up more debt in the process, in order to make contributions to pension funds. Facing a backlash from taxpayers who now perceive compensation and retirement benefits of public sector workers to be greater than that of the private sector, some politicians have made initial steps to reduce benefits and require more contributions from public employees to their retirement and health plans. The private sector has been doing this for years. States with highly unionized workforces will fight this, and protracted court battles can be expected. Yet there is a good chance that changes to public sector benefits will be a long-term trend as states try to control overall spending.

Furthermore, state and local governments are not going out of business. They essentially are monopoly suppliers of many services that citizens expect government to provide. Historically, debt service has always been a high priority in allocating government spending. State and local governments have displayed the political will to make good on obligations to creditors. This continued willingness to rank bondholders above other stakeholders is being questioned, not surprisingly, as some municipalities contemplate bankruptcy.

Declining Issuer Defaults

Defaults among municipal issuers have actually declined this year. Among general obligations and essential service revenue bonds, considered the safe sectors, defaults are rare. According to Moody's, the average five-year historical cumulative default rate for investment grade municipal debt from 1970 to 2009 was 0.03%. Of the defaults that have occurred recently, many were in community development bonds, nursing homes, or housing developments. Often these bonds were non-rated and high-risk from the start and had no claim to government tax revenue. More worrisome is the looming default of Harrisburg, PA on its general obligation debt. While its budgetary woes can be traced to the city's guaranty of debt on a municipal incinerator project, the political implications of a default may lessen the stigma for other municipalities considering bankruptcy or debt restructuring. Some observers predict this may open the floodgates to a collapse of state and local issuers. However, there is no evidence that the market is particularly worried about this. Most municipal issuers enjoy ready access to debt markets as long as they retain investor confidence in their ability and willingness to repay debt. While additional defaults will occur, they are more likely to be viewed as isolated events rather than a contagion.

Credit Ratings Adjustments

This spring Moody's and Fitch completed a long-awaited upward adjustment to the credit ratings of many state and local governments. Some municipal issuers had complained for years that the rating companies used stricter criteria when assessing municipal creditworthiness, resulting in lower credit ratings than those assigned to corporations or structured products. After being put on the back burner during the financial crisis, Moody's and Fitch made upward shifts in credit ratings to 34 states and thousands of municipalities. The ratings firms depicted these changes not as indications of improved credit quality but as "recalibrations" of the municipal ratings scale to align it with scales used for other types of borrowers. Most general obligation debt saw upgrades of 1 to 2 notches on the rating scale, and certain revenue bonds benefited as well. In Virginia and eight other states, whose general obligations were rated Aaa under the old scale, ratings were unchanged. As for the other major credit rating firm, Standard & Poors insisted that it has always used a universal scale for determining credit ratings, thus no recalibration was required.

Bond Market Rally

With all the angst over municipal creditworthiness and budget shortfalls in the headlines, one could expect these concerns to be reflected in market prices. Yet market prices on municipal debt rallied sharply this summer, following the gains in Treasury bonds. Thin supply and robust demand for tax-exempt bonds coupled with expectations of higher federal income tax rates pushed prices up and yields down to historic lows. Overall issuance of new tax-exempt bonds is down, partly due to the success of Build America Bonds, which allow state and local governments to issue taxable debt with the promise of federal government reimbursement of 35% of the interest expense. By attracting new types of investors to municipal credit such as foreigners, pension funds, endowments, and insurance companies, BABs now constitute about 30% of total new issuance, thus reducing the supply of bonds that otherwise would have been issued in tax-exempt form. Based on today's low absolute yields, municipal investors receive lower compensation than ever before, which may be a headwind to further gains.

Conclusion

Despite doubts about the health of municipal finance, most state and local governments will manage through the current downturn. Municipal credit does require more diligence these days, and we advise staying with high quality issuers of general obligations and essential service revenue bonds. A well diversified municipal bond portfolio still makes sense for investors in the highest tax bracket looking for moderate income consistent with preservation of principal. Future returns on tax-exempt bonds may prove quite modest after this summer's rally, prompting some to stretch for higher yields by taking on more risk, or by considering other sectors of the bond market.

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