

Thought for the Week: Tuesday, September 7th, 2010

The Next Shoe to Drop?

Should I Sell or Keep my Municipal Bonds? is one of the most common questions we are asked. Although a proper answer to this question will depend on what type of bonds you have, what they are paying and which municipality, this week's thought looks at the general outlook for Munis.

The Municipality Debt Situation

As with the U.S. Government, many **municipalities are facing high debt levels coupled with falling revenues**. At the time of writing, state debt levels were approximately \$140 billion; higher than at any time during the recession

Detailed assessment of each state and municipality clearly shows many could be deemed 'technically bankrupt' now or in the near future. The parlous state of their balance sheets means **everyone should look closely at their Muni Bond holdings**. If company balance sheets were in the same position, warning bells would be ringing across all bond desks!

How Safe are Munis Historically?

The table below shows Municipal and Corporate Bond default rates for the last 40 years.

Municipal Bonds (Munis) are commonly available in three types:

- **General Obligation (GO)** which are secured on the full faith and credit of the issuer.
- **Revenue** which are based on the stream of future income deriving from a specified project or asset.
- **Assessment** which are based on the property tax income collected by the issuer.

Each different type of Muni possesses very different credit risks.

The **risk of default does increase significantly with non-investment grade bonds**, the less scary name for "Junk" Bonds.

Everyone with Muni holdings should look at their credit rating.

When Munis look like bad credit risks from a fundamental 'ability to pay investors' perspective, why does no one appear worried about mass default?

Cumulative Historic Default Rates (in percent)

Rating category	Moody's		S&P	
	Muni	Corp	Muni	Corp
Aaa/AAA	0.00	0.52	0.00	0.60
Aa/AA	0.06	0.52	0.00	1.50
A/A	0.03	1.29	0.23	2.91
Baa/BBB	0.13	4.64	0.32	10.29
Ba/BB	2.65	19.12	1.74	29.93
B/B	11.86	43.34	8.48	53.72
Caa-C/CCC-C	16.58	69.18	44.81	69.19

Source: U.S. Municipal Bond Fairness Act, 2008.

The Harrisburg Surrender

One of the worst kept secrets in the bond world was the fact that the Harrisburg, PA municipality wasn't taking repayment of their bond debt seriously. Last week, **Harrisburg finally defaulted on \$3.3M of bond repayments**. Harrisburg is an extreme case of a municipality that messed up their finances by committing to an incinerator project it couldn't afford. But it does raise the specter of widespread Muni Bond default, especially when so many are struggling financially.

With California's and Illinois public finances in trouble and Los Angeles and Detroit amongst others with little ability to pay bond holders, **will there be a continuous flow of defaults when each Muni reaches Maturity and the principal has to be repaid?**

Will Municipal Bonds be the Next Shoe?

Default speculation had driven municipal bond yields to a 13-month high relative to U.S. Treasuries. This suggests **investors are already pricing—in the increased credit risk associated with default potential**.

However, **we don't expect wholesale Municipality bankruptcies** – if the Government bailed out Banks and Car Manufacturers, don't we think they'll help schools and hospitals?

More specifically, look closely at the fine print of how default might work:

- **In Harrisburg**, the default was insured by Ambac. Bottom line: Ambac will pay the investors their money and then go after Harrisburg to make them whole.
- **In California**, the state's constitution says primary education is the only group standing in line before bond holders for tax receipts.
- **In the case of most G.O. bonds**, the bondholders (or insurer) can take the issuer to court to seek an order to raise property taxes to pay debt. This is the nature of "full faith and credit" of general-obligation bonds. Revenue and Assessment Bonds do not generally have the same level of protection.

Are cascading "domino-effect" Muni Bond defaults the next shoe to drop?

Probably Not.

...but Beware Municipal Bond Prices

There is another issue more pressing than outright default: **What happens if an investor wants to sell the bonds before the maturity date?**

Right now, given the fiscal problems in some states, it may be difficult to sell the bonds for their original price. Many bonds are not traded or priced on 'electronic exchanges', unlike stocks. This can result in a surprise when the price offered for a bond is significantly different to the price shown on an investor's last statement.

Although we do not expect large-scale defaults, **investors should be prepared for increased perception of credit risk leading to further price reduction of Munis**. While people who own Munis issued by the state where they pay taxes get a bigger tax break than those who hold the bonds of another state, there is a **greater case now to forgo some of that tax benefit for broader diversification**.

At some stage, the risk perception should abate leading to excellent values in the Muni space.