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MUNICIPAL BONDS: CHALLENGES AND OUTLOOK

A SIGNATUREFD WHITEPAPER

abstract

Municipal bonds are the bedrock of our client portfolios. They provide the stability of cash flow and income along with tax favored treatment. As taxes increase, municipal bonds become even more important in creating effective portfolios. Despite our appreciation of municipal bonds' role in a diversified portfolio for tax-sensitive investors, we believe some municipal bonds may experience problems in today's environment. Having researched the topic and discussed it with bond fund managers and other experts, we are currently seeking to increase the relative safety of our clients' municipal bond holdings by taking steps to diminish the likelihood and impact of municipal bond problems within client accounts. To be clear, municipal bonds are not a risk free asset, and our analysis and actions will not completely protect portfolios from losses. However, we are monitoring the municipal bond market closely in an effort to reduce risk. We wrote this paper to summarize the situation and present our outlook for municipal bonds.

INTRODUCTION

Municipal bonds have received increased media attention recently amid worries about fiscal and regulatory challenges. The recession has hit states and municipalities hard; estimated budget gaps for the 2010 and 2011 fiscal years stand at $200 billion, or about 15% of state operating budgets.[1] Difficult choices must be made to balance budgets, and investors wonder whether governments will be able to effectively close the gaps. If budget shortfalls are not successfully overcome, there is worry that widespread bond defaults and credit downgrades could occur. In our view, it is likely that the challenges municipalities face today will lead to an elevated number of defaults over the next three to five years. It is also possible that as volatility emerges in the municipal bond market - which investors now seem to view as completely safe - selling pressure could lead to market-wide illiquidity and price declines. However, historical evidence, the characteristics of the bonds, and positive tailwinds in the municipal market

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suggest that problems are not likely to be catastrophic or asset-class wide. As a result, despite our cautious view of municipal bonds and the increasing importance of rigorous credit analysis in this sector, we believe the majority of the securities in the asset class are fundamentally sound and municipal bonds will continue to play an important role in a diversified portfolio.

CURRENT CHALLENGES

REGULATORY ENVIRONMENT

The issuance of Build America Bonds (BAB) in 2009 changed the landscape of the municipal bond market. These bonds are taxable to investors, while the state and local issuers receive a 35% subsidy from the federal government for the interest costs. Some investors are concerned that the federal subsidies for these bonds will be revoked, leaving states with debts at high interest rates that they will be unable to repay. That possibility does exist, but many issuers would still be able to service their debt despite a loss of subsidy.[2] The possible changes do mean that each issuer must be diligently examined to understand the true risk of owning the bond should the regulatory environment change.

There has also been some concern over the fact that the IRS reduces BAB subsidy payments by the amount of states' liabilities to the IRS, but we believe this treatment is likely not going to be a problem for most issuers[8] since debt service payments are a small percentage of overall state budgets and, while the policy causes a mismatch in the timing of cash flows, it does not alter the fiscal health of the state. Additionally, Senators Ron Wyden (D – OR) and Judd Gregg (R – NH) introduced a tax reform bill that, if passed, would reduce the tax benefit of municipal bonds, particularly for high-income investors. The chances of this bill passing in its current form are viewed as relatively low, however, and it is important to note that it would not affect bonds issued before 2011.[7]

THERE ARE MANY CHALLENGES FOUND IN THE CURRENT ENVIRONMENT

Increased Liabilities Credit challenges are one of the key worries in the municipal market today. Because recoveries in sales and income tax revenues tend to lag the overall economy by 12-18 months,[2] states are still experiencing reduced income levels. Meanwhile, spending pressures are increasing. In particular, much has been made of pension liabilities as benefit obligations to retirees grow, but it should be noted that states are already addressing the issue through pension reform,[10] and pension liabilities, while increasing rapidly, can be a relatively small part of overall state budgets.[11] The budget shortfalls are real though, and federal stimulus and continued investor demand for fixed income assets have supported increased borrowing as a way to fund the deficits. According to the Wall Street Journal, "State and local borrowing as a percentage of the country's GDP has risen to an all-time high of 22% in 2010 from 15%, with projections that it will reach 24% by 2012."[3] This increase in borrowing might lead investors to view the market as increasingly risky, which could lead to credit downgrades and price declines relative to other types of bonds. While short-term price movements and possible illiquidity are concerns, the investor will continue to receive interest income and return of principal despite declining prices unless the bond defaults, which makes default risk the more ominous threat.

Default Risk The current elevated level of borrowing, when coupled with rising costs and lower revenues, raises concerns about possible defaults, and we may indeed see more defaults in the months ahead. However, defaults in the municipal bond market have been statistically rare. Over the past year, for example, issuers defaulted on only 0.002% of outstanding municipal debt[3] and even during the Great Depression, a period with drastically worse unemployment than today, a much larger decline in GDP, and severe deflation, only 2.7% of the outstanding municipal debt defaulted.[4] We acknowledge that relying solely on history as a guide for future default levels is not sufficient to ensure the safety of this or any asset class. The probability of an increase in the rate of defaults is why we believe credit analysis will be a key aspect of municipal investing in the months and years to come. However, the scant number of defaults seen so far during this tough environment points to the characteristics of the municipal bond market that differentiate it from the corporate bond market and mitigate some of the risks inherent in debt investing.

STRENGTHS AND OUTLOOK

Unique Characteristics Unlike the Federal Government, all states (except Vermont) and their municipalities require lawmakers to balance budgets annually, so states cannot accumulate large deficits over several years.[1] While single-year deficits can be daunting, problems must be addressed quickly. For example, over twenty states have already taken steps to enact pension reform and reduce costs,[10] and states have done a good job of addressing budget issues. All but three states passed on-time budgets for their new fiscal years beginning July first. According to Moody's, "The remarkable number of on-time budgets underscores the overall management strength of state governments even in the face of a severe recession."[12] Furthermore, in contrast to corporations, local governments are essentially monopolies with nearly unlimited power to raise taxes and fees to meet costs and pay debt.[4] The low level of debt service cost as a percent of general fund spending (averaging about 5%) and the amortizing nature of municipal debt mean the burden of paying off debt is generally manageable, and there is little chance of a sudden large-scale debt rollover problem like those that can occur in sovereign and corporate debt.[4]

THERE ARE OVER 50,000 DIFFERENT ISSUERS OF MUNICIPAL DEBT FROM ALL AROUND THE COUNTRY.

Ongoing Nature of States Even if states are able to meet their debt service payments, some concerns have been raised about the willingness of states to pay debt in the future. As one of our bond managers, Wasmer, Schroeder, & Co., states, "A decision by an individual state government to default on its debt would truly be the 'nuclear option' and would have far reaching implications," including political ramifications and devastated credit standing.[6] States, unlike corporations, are obligated to provide essential services and are therefore perpetual in nature. They cannot file for Chapter 11 bankruptcy, and they are dependent on the bond market to supply funding, so while potential willingness of a particular issuer to pay will be an important part of credit analysis going forward, the emergence of a widespread unwillingness to pay seems unlikely.

Diverse market There are over 50,000 different issuers[5] of municipal debt from all around the country issuing $2.7 trillion of securities featuring bonds of different types, varied purposes, and a wide range of credit quality.[4] Bonds can be backed by "the full faith and credit and taxing power of a state or local government" (General Obligation bonds), fees from utilities, specific taxes, revenues of a non-profit such as a university or hospital, or others.[4] The structure of the bond determines the source and legal requirements of repayment, and each type of bond faces unique risks and concerns. The geographic diversity of the market along with the varied sources of funds suggest that portfolio losses could be mitigated by avoiding issuers who are more likely to struggle in the event that conditions worsen.

Reduced Supply Since the introduction of the Build America Bond program, much of the municipal debt issued has been taxable rather than tax-exempt.[9] As a result, there is a reduced supply of traditional tax-exempt municipal bonds available. If the Wyden and Gregg bill were to pass, newly-issued tax-exempt bonds would have less of a tax advantage for high-income investors than bonds currently being traded, so the tax-exempt bonds investors currently hold could become even more dear. This reduction in supply amid what may be increasing demand is a compelling reason to hold municipal bonds despite current challenges in the market.

Increased Demand The availability of a large number of taxable Build America Bonds has created demand from pension funds and other non-taxable entities that previously could not benefit from the tax-exempt treatment of most municipal bonds. Among taxable investors, impending tax increases will increase the relative benefits of the tax-exempt municipal bonds, leading more investors to buy these bonds. Higher taxes already loom via the expiration of the Bush tax cuts, and the fact that marginal income tax rates for the highest tax bracket are well below historical norms means there may be room for even more tax increases as the federal government seeks ways to address increasing deficits.[9] In addition, as the US population ages and the Baby Boomers enter retirement, the newly retired investors will likely seek to invest a greater portion of their risky assets in the relative safety of bonds,[9] leading to even more inflows of cash to the bond market.

CONCLUSION

According to the Center on Budget and Policy Priorities, "The recession caused a state fiscal crisis of unprecedented severity," and "states will continue to struggle to find the revenue needed to support critical public services for a number of years."[13] The challenges that states and municipalities face today suggest that the municipal bond market is likely to experience more volatility and greater defaults than ever before. However, we believe that because of the fundamentals of the municipal bond market and continuing investor demand for the asset class, the scenario of a devastating widespread sell-off, though possible, is not likely. The positive tailwinds of increased flows to bonds, rising taxes, and a search for cash flow receive less media attention than cautionary headlines regarding municipal bonds but are, in our view, more indicative of the future path of this asset class. Note that despite the drumbeat of negative sentiment from the press, the Barclays Capital 5-Year Municipal Bond Index returns are positive for the month, quarter, year, and past twelve months as of June 30, 2010. This is a challenging environment for investing in any asset class, and we will continue to monitor the municipal bond market and other portfolio assets to ensure that we are doing all we can to reduce risk and generate return in our client portfolios. With municipal bonds in particular, we remain vigilant in monitoring the way investors view the problems states are facing and the risks inherent in the bonds themselves in an attempt to avoid pitfalls to the extent possible. If you have questions regarding the topics discussed in this paper or any other investment matters, please feel free to contact your primary relationship manager or email us at invest@signaturefd.com.

WE BELIEVE THE POSITIVE TAILWINDS OF INCREASED FLOWS TO BONDS, RISING TAXES, AND A SEARCH FOR CASH FLOW ARE INIDICATIVE OF THE FUTURE PATH OF THIS ASSET CLASS.

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600 PEACHTREE STREET, N.E.
SUITE 2700
ATLANTA, GA 30308
WWW.SIGNATUREFD.COM