Fixed Income Insight

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Challenges for Municipal Bond Credit Conditions in 2009

Municipal bonds did not go unscathed in 2008, amidst the worst economic decline in decades. Yields on municipal bonds took an unnatural turn by rising above Treasuries on a sustained basis even before tax benefits are calculated. While this abnormal relationship appears to present an opportunity and advantage for municipal bonds in 2009, caution remains the watchword because a number of credits are hitting a headwind that will not be easy to escape without the help of a reversal in the economy or a drawdown on federal assistance monies from a munificent "Uncle Sam." While low rated or non-rated non-governmental credits are the most prone to problems, state or local governments are not immune.

Many states are already suffering from shrinking tax and fee receipts that are inhibiting their ability to maintain program levels, provide aid to local units and make timely payments to vendors. Local governments dependent on property taxes are likely to be tested in no small measure by the steep declines in real estate values, which place downward pressure on reassessments. In addition, property tax delinquencies and foreclosures will shrink cash flow for places which are not advanced 100% of their property tax levy by the counties who collect them. Falling assessments usually means total levies must fall unless tax rates can be adjusted upward, which is not possible in all situations. Some states and localities are limited by property tax rate or levy caps. The impact of these valuation changes may become increasingly problematic over the next few years as reassessment practices lag actual real estate prices.

The challenges for many municipal credits are significant if left to their own devices and economic conditions. The Federal government may open up a new door that has not been available in the past. Details and implications of the plan are still developing. On January 9, 2009, the House Financial Services Committee introduced the TARP Reform and Accountability Act to amend the Troubled Assets Relief Program (TARP) provisions of the Emergency Economic Stabilization Act of 2008. The legislation, if approved, would provide some support to issuers of municipal securities, including the direct purchase of municipal securities and a provision to provide credit enhancements in connection with municipal securities whose purchase was by a Federal Reserve facility. According to the bill, the Secretary of the Treasury would be able to provide support to state and local governments and other issuers of municipal securities which are having difficulty accessing appropriate financing in the capital markets. It is not expected that the program would provide an open checkbook for indefinite period. In the near term, the broad language could substantially set the stage for providing liquidity and working capital for hard pressed state and local governments. The language is also suggestive that it could provide the same treatment for other non-governmental issues as well. More clarification is likely to be forthcoming in the coming weeks.

➔ *Why Municipals Faltered in 2008*

1. Bond insurance fell from its lofty perch. It cannot be overstated enough that for the last two decades much of the municipal investment grade market became complacent with regard to credit quality. Not only did traditional municipal borrowers perform with nearly an unblemished repayment record, but most issues carried bond insurance which provided them with gilt-edged "AAA" rating. When billions of non-muni securities guaranteed by the insurers related primarily to residential mortgage-backed securities started to unravel, the unquestioned trading value and liquidity support provided to insured munis came apart. In essence, the muni market was decommoditized with many dealers and market players unprepared for a world in which credit quality distinctions had not been made on an individual case basis in many years. Consequently, most munis, except for pre-refunded U.S. Treasury backed issues, lost immediate value as investors scurried to try to look through to the underlying municipal security.

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➔ *Why Municipals Faltered in 2008 (Cont.)*

2. Bond ratings were shaken. Insured municipal bonds lost their unquestioned status, including those that related to higher rated insurers like Financial Security Assurance, Inc. ("FSA") and Assured Guaranty. Since so many securitized financings that once held "AAA" or "Aaa" ratings were discredited, deserved or not, investors were not as confident that they could count on a rating today that could be much lower tomorrow. Newly conditioned to be more pessimistic, many investors valued bonds lower in value than what might otherwise be expected, especially on lower investment grade issues – insurer or no insurer. The same skepticism carried over to credit quality confidence on individual munis other than pre-refunded issues. While the declining economy suggested realistic caution, the upgrade to downgrade ratio (number) by all three rating agencies was more than 3:1, according to a compilation by *Smith's Research & Gradings*. The upgrade dominance versus downgrades relative to two sectors, general government and basic municipal utilities, was even more overwhelming. Many of these upgrades were made in part due to a developing mindset by the rating agencies as well as some government officials that the low municipal default experience in recent decades justified categorically lifting many municipal ratings. In the end, the new mentality for upgrading municipal ratings in the midst of declining economic conditions probably clouded the picture for market confidence in the ratings themselves. Late in the year, Fitch and Moody's postponed the official implementation of their proposal to lift muni ratings in line with a "global equivalent" scale. While existing ratings still provided the market with a tool to provide some level of distinction, it is also probably fair to say that the market maintained unusual skepticism beyond the ratings that incorporated a downside error factor in bond prices on issues, particularly those that were perceived to be less than squeaky clean.

3. Disarray among financial institutions participating in the municipal market affected underwriting, trading and institutional investors. Adding to the pressure on municipal bond prices, the loss of dealer capital and downsizings of underwriting and trading commitments by long term municipal bond dealer powerhouses like Lehman Brothers and Bear Stearns had a direct consequence on positions taken to support the muni market, including liquidity and support of dealer created vehicles such as auction rated securities (ARS). Many of the securities involved in the ARS market essentially were unable to be remarketed, thwarting their role in the short term market. Municipal hedge funds suffered, too, as positions in the market lost money. Rising interest rates in the long end of the market not only hurt many hedge funds but also many long mutual funds which historically have outflows when net asset values fall. Disruptions in the market amid rising interest rates also caused issuers to hold back bond issuance. The number of bond issues sold fell to the lowest level since 1993.

4. Municipal credit quality erosion emerged. Coming off the year 2007, one of the strongest for municipal credit quality in many years, economic activity decline turned in 2008. The unwinding of bond insurance and the ARS market triggered a fairly quick impact on bond issues that over-relied on both of these supports to lessen the burden of outstanding debt loads. The best known example was the $3 billion of sewer revenue bonds issued by Jefferson County, AL. Teetering on the largest bankruptcy since Orange County in 1994, Jefferson County remains technically in default to the banks and insurers which guaranteed them. Vallejo County filed bankruptcy in California in order to escape a heavily weighed down payroll structure that became overwhelming at the first sign of economic weakness. Municipal high yield bonds also weakened tremendously as failed projections became evident. The *Distressed Debt Securities* newsletter, which tracks default statistics, counted over $6.7 billion in municipal bankruptcy and default statistics. Still, investment grade defaults were mostly relegated to outlier situations. While the preponderance of municipal bonds appears to be well within their means to cover debt service, it is also evident that the market priced in perceptions of future weakness that could be threatening if economic or fiscal problems go unresolved. Quality spreads widened among issues that the municipal market sensed that the risks were higher. Generally, higher rated municipal bonds secured by general obligation and basic utility revenue bonds carried the lowest yields. Non-governmental revenue bonds tended to have the highest yields. Ten-year natural "AAA" municipal bonds ended the year with yields close to 3.5%, high relative to Treasuries but still relatively benign compared with historical actual rates. Conversely, ten year "BBB" rated GOs ended the year with yields a little over 6.5% according to the MMD Benchmark yield tables, among the highest in over a decade.

➔ *Expectations for 2009 and Beyond*

Many municipal bonds, especially long term issues, appear to present fixed income opportunities for risk sensitive investors. On January 8, 2009, investors in the 36% tax bracket could pick up a taxable equivalent yield of 7.8% by investing in a bond equal to the Bond Buyer 20-Bond Index of 5.02% (index comprised of GO bonds maturing in 20 years with average rating of AA). On the same day, twenty-year Treasuries yielded only 3.43%.

Most traditional municipals are still considered relatively safe because of their low historical default record over the past fifty years; however, selectivity remains the watchword. The floundering economy is apt to negatively impact tax revenues, charges and fees. However, federal support is likely to be forthcoming in some form or fashion given the President-elect and Congressional inclination to stop the bleeding as well as to pump prime the economy. The chances of federal support were substantially enhanced by the inclusion of municipal securities in the recently released proposed legislation to reform TARP. The details of how the federal plan would work or whether there would be limitations or "costs" to be included in the federal program are still forthcoming. Current IRS rules do not allow municipal bonds to keep their tax-exemption if a federal guarantee is provided. However, federal involvement could have a meaningful impact on cushioning the blow of declining revenues to municipal entities. Time will tell whether or not or to what degree the federal program raises municipal bond prices. In any case, key questions for credit quality and the implications for credit quality spreads are heavily dependent on containing the credit crisis within the expected revenue constrained economic environment. California's cash starved government may be the first to test how access to federal TARP monies might be accomplished.

While a short-lived economic downturn will likely mean that most municipal entities will emerge without serious problems in 2009, the scenario that causes the most anxiety is one in which weak conditions linger for multiple years resembling conditions from the 1930s. Shocks near term are more likely to impact credits that are heavily in debt, overleveraged or chronically managing on the edge and cannot withstand the erosion from the economic downturn. These credits are the most vulnerable and most likely that will call upon external support.

Without a reversal of economic trends or unprecedented federal support to municipal securities, financial problems will likely worsen in 2009 causing the weakest of the borrowers, especially niche situations like some land-secured districts, to experience severe credit problems leading to downgrades and an uptick in bankruptcies or even defaults. Without relief, we believe these problems will become a more intense threat to credit quality in 2010 rather than this year.

➔ *Key Credit Outlook Notes*

- It is difficult not to assess some negative credit momentum to most of the states since weak economic activity is causing their revenue sensitive taxes (e.g. income and sales) to fall below budget expectations. However, their general obligation security provides them with a very strong likelihood of ultimate full repayment. States are sovereign credits which cannot go bankrupt, but they can default. Their price levels do fluctuate dependent upon perceived threats to their cash flow and ability to meet all of their credit obligations on a timely basis. Currently, there are unusually wide variations in the quality spreads among the states based on perceptions of the stability of their underlying economy and overall fiscal posture. Arkansas was the last state to miss a general obligation payment. It did so during the Great Depression. States are among the most likely to apply for TARP monies for working capital. The limitations of the potential program, eligibility rules and the price to pay to be a part of the program are not yet known.

- Since local government general obligation bonds are primarily linked to property taxes, which are usually fairly stable, they have a strong security that normally favors repayment even during a recession. Usually, the borrower and/or the lender have a vested interest to maintain control of the property. Some states offer the ability for the counties to advance property tax payments to the local governments and then they take the responsibility for ultimate collections. The greater danger to local credit quality exists when real estate declines are substantial and prolonged.

➔ *Key Credit Outlook Notes (Cont.)*

- In today's real estate environment, in which declines of 25% or more are not uncommon, this risk poses a greater danger than normal to places that have not provided adequate reserves or set-asides. As real estate assessments fall, either property tax levies to governments must also decline or tax rates must be adjusted to increase the burden on taxpayers who are left holding the bag. Reassessments are performed on a delayed basis versus actual real estate trends. Therefore, the impacts on the financial coffers as well as the taxpayers are often delayed. Defaults and bankruptcies pertaining to large cities, counties and school districts have been relatively rare since the Depression. Special district bankruptcies, especially related to land backed districts, such as tax increment districts for economic development, are more common especially in a serious downturn affecting real estate.

- Revenue bond issues are dependent on economic growth to generate sufficient fees, or charges to cover debt service. The vast majority of the basic utility debt has a long time historical record of producing fairly stable cash flow even during downturns. Each municipal revenue bond sector presents its own risks relative to its unique security structure. Conditions may specifically affect one sector more than other. For example, there is heightened concern regarding land districts that are secured by development fees associated with the sale of real estate or rising property values. Other areas of concern for 2009 include, but are not limited to: retirement center bonds (dependent on endowment funds and reservations for new units), higher education (affected by hits to their endowment fund, cutbacks to student aid/loans and high tuition), hospitals (increase in uninsured and reductions in Medicaid funding), and recently built toll ways (failure to meet growth projections). Highly leveraged credits which are dependent on robust economic activity will have the toughest time in a deflationary environment, and they could find themselves in the most trouble if the economy does not recover rapidly enough in 2009.

- Current market prices appear to have built in an expectation of some credit problems. However, any high profile defaults or bankruptcies related to conventional governmental names are likely to have additional upward pressure on future rates -- maybe 50 basis points or more (depending on fiscal and economic similarities to bankrupt names). The severity of widening would likely be dependent in part on the perception of pessimism of the overall economy as well as the absolute level of interest rates at that time. It is worth noting that while credit risks are elevated, municipal valuations versus Treasuries have reached their cheapest levels in recent decades. Municipal bond prices will rise and yields fall on many issues if the TARP program is enacted since governments may be able to borrow to offset recently developing cash shortfalls.

- It appears that bankruptcies increase on a lagging basis after the low point in the economy. Typically, the weakest credits cannot recover as easily from an economic downturn/crisis. That is why defaults or bankruptcies are more likely in 2010 or later rather than today if existing conditions are not altered. Further, that is when debt loads and the pension and benefit burdens will become much heavier, especially if we are in a deflationary economy.

- The long term implications for municipal bondholder protection are clouded by the lack of details related to the proposed TARP reform plan. Under the current proposal, the Treasury Department would have the controlling say as to how the program would be implemented if passed.

➔ *Reasonably Good Prospects for Federal Intervention*

Based on recent developments and statements made by the incoming President, there is a fairly strong chance that Washington is ready to provide some level of aid to states and local governments. The scale, scope and dynamics of such support, however, are evolving. The end effect is likely to notably influence the outlook for municipal bond quality relative to the sectors which are affected.

➔ *Reasonably Good Prospects for Federal Intervention (Cont.)*

The TARP Accountability and Reform Act proposal alludes to the potential for the Treasury to buy municipal securities. That possibility raises many serious questions as to how the program would work, the size of the program, what issues would be eligible and to what extent any limitations or penalties would apply to those issues that are bought by the Treasury. Any purchase of municipal securities by the Fed could have significant implications for the municipal bond market to the extent that it reduces the supply of tax-exempt municipal bonds available to investors or even whether some or all municipals will have a "backstop" limited or full access to the Treasury.

In addition to the TARP Reform Act, policy ideas being floated around Washington with respect to the federal stimulus plan include some far reaching proposals that would provide monies to state and local governments to help provide financing for transportation infrastructure, schools, property tax relief and commercial paper type backstops for funding to the state/muni government debt market. There is additional talk of assistance for student loans, multifamily housing and programs to reduce the number of Americans without health insurance.

The specific details of a federal bailout program are merely ideas at this point and not a fait accompli. The radical implications of this proposal, if enacted, will be watched closely because they could significantly change the structure of the market for years to come. The more far reaching the federal action steps, the less likely that municipal bond credit problems will become widespread. However, there remain difficult political and economic questions that will likely emanate from the debate as well as implementation. Creating an expectation in the municipal arena just as in the private sector that, when problems occur the federal government will bail them out, may have unwelcome long term consequences to taxpayers as well as for fiscal accountability. Shifting the burden of ultimate fiscal responsibility from the state and local level government to the federal government could upend federalism as we know it. Unless limitations, incentives and penalties were clearly built into the plan to promote fiscal prudence at all levels, the outcome could have serious long term adverse consequences for the nation as a whole.

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Sources: Smith's Research & Gradings – December 22, 2008 Report/Newsletter; Distressed Debt Securities Newsletter – December 2008 Vol. XXI Issue; The Bond Buyer; Thomson Reuters

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