Quick Takes

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Recent Headlines Bring Municipal Market to the Forefront of Investors' Minds

Many recent news headlines and stories have speculated about the threat that municipal securities pose to investors' portfolios. Yet, while credit risk in the municipal market has indeed increased over the last year and is probably at its highest point in recent decades, we believe that some of the fear is misplaced. We took a closer look at the details of the recent sell-off and found there is much more to the story than the news headlines have indicated and that factors other than credit quality have been playing a larger role in the recent tax-exempt market weakness. Our analysis concludes that most of this decline, while partially credit related, is the result of technical supply and demand factors, rather than a genuine credit meltdown.

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Dissecting the Tax-Exempt Sell-Off

In the fourth quarter of 2010, tax-exempt municipal bonds experienced widespread declines with the Barclay's Capital Municipal Bond Index returning a negative 4.17%. Those declines continued into 2011, with the index falling another 1.84% through the first three weeks of 2011. However, losses were not isolated to just the tax-exempt segment of the fixed-income market as nearly all fixed-income investments fell over that period. The reason for this is that treasury rates have been rising steadily since September, pressuring all fixed-rate investments.

There were also other supply/demand factors that contributed to the tax-exempt muni sell-off and will impact the sector in the future. On the demand side, the passage of the tax cut extension reduced the value of tax-exempt income for the next two years. On the supply side, moreover, the failure to extend the Build America Bonds (BABs) program portended a large increase in tax-exempt bonds going forward, particularly in longer dated maturities. Since BABs accounted for approximately 30% of 2010 municipal issuance, the failure to extend the program will lead to a massive increase in tax-exempt issuance in 2011 and beyond, primarily at the long end of the municipal curve.

The tax-exempt muni sell-off saw ten-year AAA tax-exempt rates rise from 2.38% on September 30th, 2010 to 3.42% on January 21, 2011. While this 104 basis point increase in top quality municipal yields was dramatic, the ten-year treasury rose 90 basis points over the same time frame, meaning that spreads on ten-year AAA municipal securities relative to ten-year Treasuries increased only 14 basis points. However, the longer end of the muni curve saw a larger 32 basis point increase in muni spreads as 30-year AAA muni rates rose 120 basis points, from 3.70% to 4.90%, while 30-year treasuries rose only 88 basis points. The relatively weaker performance of 30-year munis relative to ten-year munis is consistent with the fact that the failure to extend BABs will have a larger impact on the longer end of the muni curve.

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If credit conditions were the primary cause of lower muni prices, moreover, we would have expected to see lower-rated municipal securities fall more than their higher-rated counterparts. What we have found, however, is that the ten-year AAA, AA, and A rating buckets performed nearly identically in the fourth quarter of 2010. While the entire AAA, AA, and A rated buckets showed weaker performance for the lower rated segments, the difference was due to the longer duration of the lower rated buckets. That is why we chose the ten-year segment of the market, in order to eliminate any duration discrepancies.

These returns paint a picture that is more consistent with an across the board sell-off rather than a flight from lower rated issuers.

Municipal Credit Risk

In recent months, there have been a variety of news reports claiming there will be widespread municipal defaults in the coming years. While the concerns about higher municipal credit risk are certainly valid, the conclusions are extreme. Unfortunately, the timing of these stories coincided with the factors listed above to create the appearance that the predictions were coming true. This has led to massive outflows from tax-exempt muni funds over the last two months. Since mid-November, nearly $31 billion have been withdrawn from muni funds. This compares to only $12 billion over 16 weeks during the peak of the 2008/2009 credit crisis. Funds have been forced to sell bonds in order to meet redemptions at the exact same time that both supply and demand factors were moving against them. This has led to a vicious cycle whereby lower prices have increased fund redemptions, which led to forced selling, more price declines, and additional fund redemptions.

While it is clear that the rise in treasury rates, extension of the Bush tax cuts, and failure to extend BABs have been the primary contributors to the tax-exempt sell-off, increasing municipal credit risk has also been a contributing factor. Throughout the economic crises, municipalities largely relied on the use of reserve funds and stimulus funding from the federal government in order to balance their budget. Now that reserve funds have been drawn down and it is clear that additional stimulus funds will not be coming from Washington, municipalities are finally being forced to make substantive changes to their budgets. While many will consider increasing revenues, the environment for tax increases is not favorable right now. That leaves expenditure cuts, but with any easy cuts already gone, municipalities will have to look at the largest and most entrenched parts of the budget.

One of the focal points of those predicting widespread municipal problems is unfunded liabilities, primarily pensions. We agree that unfunded pension liabilities are a major concern. The combination of generous benefits, a weak decade of investment returns, and several years of smaller than required pension fund contributions has resulted in a situation where the aggregate funding level of state and local pension is estimated at 77% for 2010, according to the Center for Retirement Research at Boston College. (Some states and cities are in a much weaker position with around a 50% funded status.) While we have seen government officials starting to take steps to address the pension issues, much bigger actions are needed. Fortunately, if actions are taken soon enough, there are a lot of small changes that can be enacted in order to improve the sustainability of the pension programs such as: increasing employee and employer contribution rates, raising the retirement age, changing cost of living adjustments, changing benefit calculations, and others.
We are seeing increasing indications from government officials of their intent to address pensions, and the political environment has changed whereby the likelihood of enacting changes is the highest it has been in a long time.

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As a result of the pension problems, there have been several individuals calling for a new law that allows States to declare bankruptcy (under current law, states cannot file). These individuals claim that the ability for a state to declare bankruptcy will give them more leverage to negotiate with creditors, with unions being the most frequently cited group. Many people have come out publicly against the plan, including state officials and a well known municipal bankruptcy attorney. Observers feel that states already possess the tools which are necessary to address their unfunded liabilities, but state bankruptcy laws will only increase credit concerns in the municipal market, which will increase borrowing costs.

Municipal Bankruptcy

One of the most basic types of municipal debt is Unlimited Tax General Obligation (GO) bonds. An Unlimited Tax GO bond requires an issuer to pay timely principal and interest from any resource legally available to the issuer. If they do not have the money available, they are required to levy a tax on all taxable property within their boundaries, at an unlimited rate, in order to make the required payments. This pledge has allowed unlimited tax GO bonds to generally be considered the safest bonds within the municipal market. However, with the increasing talk of Municipal Bankruptcy (Chapter 9), the favored status of GO bonds is being questioned.

Vallejo Bankruptcy…
Worth the Effort?

Vallejo filed for bankruptcy in May of 2008 and had their order for relief confirmed in September of 2008. The City hopes to emerge from bankruptcy in the summer of 2011, after spending more than $9 million dollars on bankruptcy costs and wasting three years of management's time. Vallejo city officials have spoken out about the challenges they've faced, including City Council Member Stephanie Gomes who, in a recent news story from Bloomberg, said, "It's best to negotiate your way out of the fiscal problem… before you go into bankruptcy." [1] City Manager Phil Batchelor noted, "I would not recommend bankruptcy to anyone." [2]

Even the City's own bankruptcy lawyers have cautioned about filing Chapter 9 "…filing for bankruptcy protection under Chapter 9 should be considered a last resort, to be effected only after every effort has been made to avoid it." [3] While others will probably take their turn at bankruptcy, it is unlikely that they will find it to be an easy solution to their problems and may ultimately wish they had taken a different route.

[1] Vallejo's Bankruptcy 'Failure' Scares Cities Into Cutting Costs," Bloomberg. December 14, 2010.
[2] "Despite Declaring Chapter 9, Vallejo Hasn't Slammed Its Bondholders," Bond Buyer, January 21, 2011.
[3] Orrick, Herrington & Sutcliffe LLP, Municipal Bankruptcy: Avoiding and Using Chapter 9 in Times of Fiscal Stress. 2009.

Fortunately, Chapter 9 filings have been very rare. According to the American Bankruptcy Institute, there have been less than eight Chapter 9 filings per year over the last decade, including twelve filings in 2009 and six through the first nine months of 2010. The majority of these tend to be special taxing districts, healthcare issuers, and housing issuers. There have been only a handful of cities and counties to file for Chapter 9. While it is good news that we rarely see bankruptcy filings from cities and counties, we are unfortunately in a position where we know very little about what Chapter 9 will look like for these types of issuers given the limited precedence.

Given this lack of experience with municipal bankruptcy, the fear is that some municipalities will go through Chapter 9 and find it to be a panacea for all their problems, thus encouraging other municipalities to follow suit. A lot of commentators have suggested that bankruptcy is an easy option for municipalities experiencing tough times; however, when looking at the most recent case of Vallejo, California, bankruptcy has been more difficult than many proponents make it sound *(see Vallejo Bankruptcy… Worth the Effort?)*.

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Stabilization in the Municipal Market

Over the past week, the tax-exempt market has started to stabilize. As tax-exempt bonds continued to sell-off in January, investors began selling taxable securities and buying tax-exempt bonds as there were many opportunities to buy tax-exempt bonds at levels very similar to taxable bonds on a pre-tax basis, which made the tax-exempt bond very attractive on an after tax basis. These "cross-over buyers" have helped to stabilize the tax-exempt market, at least for the time being.

The taxable muni market has been faring better than the tax-exempt market, benefiting from the failure to pass a BABs extension as investors have grabbed for what will now become a more scarce asset class. While the rally in taxable munis was interrupted by cross-over buyers selling taxables and buying tax-exempts, we expect taxable munis to do well once the tax-exempt market stabilizes and investors again look to buy increasingly scarce taxable muni bonds.

We have also seen some positive signs on tax revenues as municipalities experienced healthy revenue growth in the third quarter of 2010 with state revenues up 3.9% year-over-year. This was the third straight quarter of year-over-year growth; however, revenues are still 7% below the same period from 2008. Revenue growth was even stronger at the local government level, with third quarter revenues up 5.2% over the prior year. As the economic recovery plugs along, we expect tax revenues will continue to show improvement in the coming quarters.

Finally, we have seen state leaders taking the first steps towards making fundamental changes to their budgets. Illinois, probably the poster child for short-term fixes over the last few years, finally came to the realization that their present course was unsustainable and dramatic action was necessary. Lame duck politicians made the difficult choice of enacting a large personal and corporate income tax increase that will raise an additional $6 billion per year for the next four years. While this will not solve all of

the state's problems, it will be a giant first step towards eliminating the cyclical budget deficit and paying down debts accumulated in recent years. In addition to this positive action from Illinois, we have seen multiple governors from across the country submit budget proposals that fundamentally address their budget deficits. California's proposal relies on both extending, temporarily, higher tax rates and meaningful expenditure cuts, while proposals from most others states have relied primarily on expenditure cuts in order to balance their budgets.

Galliard's Outlook and Positioning

We expect the headline risk surrounding municipal securities to continue as municipalities grapple with their budget deficits in a very public manner. While the concerns surrounding budgets and pensions are certainly warranted, ultimately we think the vast majority of municipalities will make the necessary adjustments to their budget. We do expect the incidence of defaults and municipal bankruptcies to increase over the next year or two, although that will be compared to very low levels of default in recent years. We believe that defaults will be limited to the very weakest municipal entities and will be concentrated in the same segments of the market as in the past: housing, healthcare, and unrated issuers. It is increasingly likely that we will see bankruptcy filings from cities and counties (i.e., Harrisburg, PA), but again we expect that to be limited to the weakest entities.