# Muni Crisis: How Serious Is It?

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## The muni bond market is under stress, but the scope of defaults appears limited.

A number of market analysts and media reports have suggested there could be a wave of municipal bond defaults. Fidelity Fixed Income Institutional Portfolio Manager Chris Pariseault sees "significant challenges facing some issuers," but he told *Viewpoints* he doesn't foresee default rates reaching the level of a crisis. Find out why, plus what you can do to weather the storm.

### Q: Why are people concerned about the municipal bond market?

**Pariseault:** Many factors have contributed to the concerns surrounding the municipal market.

The general economic slowdown has had a well-publicized negative impact on state and local government revenues and budgets. The revenues of many other municipal issuers, like toll roads and utilities, are also tied to the overall level of economic activity. Other issuers, like many school systems and health care providers, rely on state funding. So most municipal issuers have been operating within tighter budgets.

Also fueling the concerns have been underfunded pensions and retiree health care obligations impacting some municipal issuers, and the phase-out of federal support for the muni market in the form of aid to the states and the expiration of the Build America Bond (BAB) program. Due to these factors, some prognosticators have suggested that the municipal bond market might become the scene of the next subprime-mortgage-like market meltdown.

### Q: What is your take on this risk?

**Pariseault:** I don't think municipal bonds are exposed to the kind of systemic risks that would cause a domino effect of defaults. There is no single risk factor—such as leverage, poor underwriting standards, or speculation—that is causing stress to the whole muni market. Different issuers are under varying degrees of stress. And budget stress in the past has not automatically translated into widespread defaults on bonds.

There are credit features unique to the issuers of municipal bond debt that help shield them from default. General obligation bonds, for example, are secured by the full faith and credit of an issuer's unlimited taxing authority to pay its obligations. I think debt loads and annual debt service costs are manageable for the vast majority of municipalities. The weighted-average state debt service for the top 20 states with the most debt outstanding for example, is 3.9% of expenditures.[1]

So, our team thinks the likely outcome will continue to be some combination of spending cuts and tax increases—not widespread defaults on debt. In some cases, there is significant political pressure to address structural imbalances in post-retirement benefits, with certain issuers having to make very difficult decisions regarding employee pensions and health care costs in years to come.

### Q: Why are muni market investors not likely to experience the same level of losses or market volatility as subprime mortgage?

**Pariseault:** Subprime investors had one underlying assumption that fueled speculation in the asset class: that the housing market would continue to appreciate. The entire market was dependent on this factor so the risk was in fact systemic: Cracks in the housing market led banks to stop lending, which in turn reduced demand. The cycle of easy credit and speculation came to a grinding halt. Those with exposure saw the value of their investments plummet and widespread defaults resulted. Then the world was exposed to the underwriting dysfunction that was rampant throughout the market and the significant amount of leverage incurred to boost returns.

### Q: How is what's happening in the muni market different than what we have seen unfold in Europe's debt market?

**Pariseault:** The big difference between what's going on in the U.S. with municipal bonds and what's going on in Europe is the distinction between a deficit problem and a debt problem. In Europe there are governments running large deficits as a percentage of gross domestic product (GDP)—for example Greece is at 15% of GDP. But some European nations also have significant outstanding debts which are maturing within the next few years.[2]

So, some European sovereigns have to find ways to tap the markets to roll over maturing debt. They are doing this by trying to convince investors that their austerity measures will alleviate fiscal pressures during a very volatile economic environment. If they are unable to get new financing, I think there is little hope for bondholders unless there is coordinated intervention. These are very different issues than what has been happening in the municipal market.

In the municipal market, economic stress is exposing years of undisciplined fiscal practices that have culminated in budget deficits for many municipalities. There could be an uptick in municipal defaults, but we do not expect a widespread wave of defaults. As of the end of 2010, the amount of bonds in default was 0.15% of municipal market debt outstanding of roughly $2.9 trillion.[3]

### Q: Even if widespread defaults appear unlikely, are there segments of the municipal market that look particularly risky to you?

**Pariseault:** Yes. The municipal market is not a homogenous market and investors should be aware of the risks that exist. Looking back to 2008, the calendar year returns for the larger municipal bond funds in the Lipper General Municipal debt peer category ranged from -42% to +4%. This far surpassed the average range of about 4% over the past 20 years. The lesson for investors is the value of bond research and fund research—managers need to understand what they own and investors need to understand how their municipal bond manager approaches the market.

### Q: So it's important to be a discriminating municipal bond buyer?

**Pariseault:** No question. Until early 2008, bond insurers played a huge role in the municipal market, as roughly 50% to 60% of new-issue tax-exempt municipals came to market as insured.[4] It was a very cost-effective way for many municipal issuers to get market access. The insurance made it very easy for most investors to go out and buy their own bonds because there was a perception that one didn't have to worry much about the underlying credit quality of issuers.

However, the bond insurers increased their leverage and invested capital in derivatives and structured securities to boost returns—not unlike a lot of the banks. They didn't have sufficient capital to cover their losses and they ended up taking enormous write-downs. They lost their investment grade ratings, which brought an end to their business and in many cases, left bondholders exposed to the creditworthiness of issuers they had never understood in the first place.

Municipal issuers now have to come to market based on their own credit strength. To an individual investor buying individual bonds, it means having to understand and evaluate the credit. In this low-yield environment, we've seen some investors go down the credit-quality spectrum in an attempt to maximize their after-tax income stream. That can be a dangerous proposition if they're not doing their credit homework, which I think is a strong argument for professionally managed portfolios. The municipal bond team at Fidelity always takes the underlying credit of the issuer into account. Our municipal research team has played an integral role in avoiding certain insured bonds that have defaulted.

### Q: Despite all the fundamental concerns, municipal bonds generally performed well through most of 2010. Can you explain?

**Pariseault:** From the beginning of 2009 through November 2010 the municipal market experienced significant inflows from investors seeking the relative safety and after-tax returns of the asset class. Also, some investors who had been in money market funds were dissatisfied with yields, so they invested in longer-term municipal bonds, seeing it as a relatively safe asset class from a credit and volatility perspective.

The other big technical factor driving bond prices higher was that tax-exempt supply had been siphoned away by the BAB program. This program has since ended.

### Q: Then what happened in the final months of the year?

**Pariseault:** There was a reversal in flows and yields surged higher. We experienced a couple weeks of $2 billion to $3 billion dollars flowing out of the asset class. There were several reasons for that—higher Treasury yields due to stronger economic data, the extension of Bush era tax cuts, downgrades of tobacco bonds, and uncertainty surrounding the extension of the BAB program all caused a reduction in demand and selling pressure.

### Q: Finally, are there any investing principles municipal market investors might consider going forward?

**Pariseault:** There are significant challenges facing some issuers in the municipal bond market. While the challenges may be of a similar nature, they affect issuers differently in terms of magnitude. It is critical to determine a municipal issuer's ability and willingness to satisfy its obligations on a case-by-case basis. Our team is not painting the market

with a broad brush; we are using our vast experience and resources to weigh the fundamental and technical influences on the market, and then to determine when and how to avoid undue risk and exploit potential opportunities. Yield does not equal expected return. Typically, bonds or mutual funds that offer high yields may also come with commensurate risks. So, it is important to choose your municipal bond investments wisely.

1. FMR Co, December 2010.

2. Bloomberg, Greek Deficit Tops EU Ranking, Maria Petrakis, November 15, 2010.

3. Bank of America/JP Morgan, as of December 31, 2010.

4. Thompson Reuters, December 2010.

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