MILLER TABAK ASSET MANAGEMENT

So, How's That Prediction Coming Along?

A Status Report on Meredith Whitney's Forecast of Mass Municipal Bond Defaults

Time is running out for Meredith Whitney's municipal market default prediction to come true. Defaults fell 60 percent in the first half of 2011 compared with the same period last year, according to the Distressed Debt Securities Newsletter. Whitney, a bank analyst, predicted "hundreds of billions of dollars" of municipal defaults within 12 months in a December 19th, 2010 "60 Minutes" broadcast, fueling a wave of selling in the $2.9 trillion market. Instead, the number has fallen as cities slashed spending to balance budgets and state lawmakers stepped in to guard against insolvency and local bankruptcies. From January through June, defaults fell to 24 totaling $746 million, according to the newsletter from Miami Lakes (FL)-based Income Securities Advisor. That compares with 60 in the first half of last year, totaling $2.29 billion, and 144 in the first six months of 2009, at $4.89 billion. Standard & Poor's counted 28 municipal-market defaults totaling $511 million in the first six months of 2011, compared with 53 totaling $1.55 billion in the first half of last year.

Most of the bonds that have defaulted are project-oriented and fall in the junk credit category. In addition, more and more state and local government budgets are improving from a combination of spending cuts and revenue increases. First quarter state tax revenues rose 9.1 percent, year-over-year according to the Rockefeller Institute for Government. This is the fifth consecutive quarter of improvement.

It is no surprise Meredith Whitney wants to distance herself from her prediction of the municipal market's meltdown. "I never said that there would be hundreds of billions of defaults. It was never a precise estimate over a specific period of time." So said Whitney on Bloomberg Radio. This is what she said on "60 Minutes": "You could see 50 sizeable defaults. Fifty to 100 sizeable defaults. More. This will amount to hundreds of billions of dollars' worth of defaults." As for timing, "It'll be something to worry about within the next 12 months." What this sounds like is Whitney saying there will be hundreds of billions of dollars' worth of municipal bond defaults within the next 12 months. That sounds like a precise estimate over a specific period of time. And that is how it has been reported and dissected in the press since then, with not a word of protest from Whitney. Until recently. Whitney told Bloomberg Radio host Tom Keene that she thought "60 Minutes" did a "really good job" on the story. "But the risk is that they take bits and pieces of an hour-and-a-half interview and certain portions are more magnified than others." Whitney also later told Keene: "In the cycle of this municipal downturn, I stand by it. But we never had a specific estimate for that. That's not the nature of our research."

So now we have Whitney standing by something she said she never said, and unfortunately -- for her -- recorded for posterity. Maybe the call is still for hundreds of billions of dollars' worth of municipal bond defaults, but now over the duration of "this municipal downturn," whatever that means. The

record year for defaults was 2008, when $8.5 billion in municipals went bust. What so astonished municipal market investors about the Whitney call was its outlandishness -- "hundreds of billions" in a market that has not seen a year in which defaults reached even $10 billion. Nobody denied that states and municipalities were in trouble, on many fronts, and that some issuers might default. Still, Whitney's outlook, then and now, sounds extremely unreasonable.

Whitney shed more light on the "60 Minutes" call last month at the Milken Institute Global Conference. The states, she said, were cutting aid to localities. "The local municipalities have nowhere to go and their bias is to save their constituents before they save their bondholders," she said. This, then, was the foundation of the Whitney prognostication, which acted as a sort of punctuation mark to almost two years of hysterical headlines, misguided commentary, and know-nothing blog posts about the municipal market. The numbers did not add up because her prediction really was not about the numbers. It was about mass repudiation of municipal debt obligations. As arguments go, there is a certain logic to it. Make a few bondholders suffer, and some people may think you are a hero. Raise taxes, and lose the next election. And yet, as arguments go, Whitney's claim is an unsupported assertion. In the modern era, there is little to suggest that serious public officials will shirk their duty to bondholders. The results would be catastrophic, far worse than any temporary boon to taxpayers. Past performance is no guarantee of future behavior, but there has been nothing to signal that mass repudiation will become the trend at any time, let alone within the next six months.

The analyst also said in the radio interview that there would be a "waterfall" of credit-rating cuts in the municipal market as a result of state financial difficulties that will force some investors to sell the securities. She declined to specify a timeframe for the downgrades. Six months earlier, Warren Buffett said Berkshire Hathaway Inc., where he is chairman and chief executive officer, had been trimming its investment in municipal debt. He told a hearing of the U.S. Financial Crisis Inquiry Commission in New York that a "terrible problem" was brewing in the market. Unfortunately, no one bothered to question Buffet on the wisdom and irony of his selling billions of dollars of municipal bonds, fearing an economic depression, and then turning around and purchasing an economically-sensitive railroad corporation.

Municipal defaults are rare. Moody's Investors Service said in a study released in February 2010 that the 10-year average cumulative rate in the municipal market was 0.09 percent from 1970 to 2009 for the securities it ranks, compared with 11.06 percent for corporate debt. Most were concentrated among nonprofit health-care and housing projects. Just three were general-obligation bonds, out of 54 in all, Moody's said. Moody's reported in January that no state and only a few local governments would default this year on debt it rated, after none did in 2010.

The failure of property developments financed with tax-exempt debt led to a record $8.5 billion of municipal defaults in 2008, the middle of the 18-month recession that ended in 2009, and accounts for the slowing pace. There are simply fewer of the so-called dirt bonds left to falter. Jefferson County (AL) was the last local government to trigger a default, when it could not meet payments on $3 billion of securities tied to a sewer system in 2008 after the complex financing unraveled. Communities such as Georgia's DeKalb County have sought to cope with financial stress by raising local taxes, while in

municipalities such as Newark, New Jersey's biggest city, mayors have slashed jobs to cut costs. In some cases, such as New York and Pennsylvania, state governments have intervened to prevent fiscal meltdowns at the local level.

State and local government spending declined at a 3.3 percent annual pace in the first three months of this year, according to a U.S. Commerce Department report in April. It was the steepest drop since a 3.8 percent tumble in the same quarter last year, and the second-most since a 7.4 percent drop in the three months ending in June 1981. States and localities have cut more than 580,000 jobs since payrolls peaked in 2008, according to U.S. Labor Department data compiled by Bloomberg. Municipalities are also seeking new revenue as tax collections lag behind fiscal 2008 levels and state aid is slashed.

State intervention in Pennsylvania, through a mechanism called Act 47, has given cities on the verge of insolvency an alternative way to resolve fiscal difficulties. In Harrisburg, where the City Council voted to prepare for a bankruptcy filing last month, state lawmakers crafted legislation to suspend aid for the municipality should it seek court protection. New York put suburban Nassau County, one of the nation's wealthiest, under control of an oversight board after finding that its budget was in deficit. Michigan enacted a law this year giving state-appointed fiscal managers the power to take control of financially stressed local governments. States from Wisconsin to Ohio, New Jersey and Massachusetts have also taken steps this year to reduce employee costs for local governments. From curbing contract bargaining to imposing higher employee contributions for health care and pensions, legislatures and governors have sought to ease fiscal burdens for municipalities.

The key point to take away is that there are very substantial assets in the state and local government space, and they are not being considered when these dire forecasts of massive defaults are made. Even the worst culprits in the municipal market are curing their deficiencies and trying to avoid the unwise action of municipal bankruptcy or default. The Vallejo (CA) bankruptcy is an example of foolishness. So far, it has wasted $10 million and has nothing to show for it.

In this environment, MTAM anticipates that credit quality in the municipal sector could deteriorate somewhat, leading to more rating downgrades. Yet we expect that most state and local governments will likely retain medium-to-high investment grade ratings. We do not envision a municipal market crippled by widespread defaults or bankruptcies. We believe, moreover, that fundamental credit performance throughout the market—as measured by default rates relative to debt in the market—will remain mostly stable.

We expect that many state and local governments will continue to operate in a constrained revenue environment, with many having to make difficult budget and policy choices. We expected that budget deliberations for fiscal 2012 would be very challenging given the slow pace of economic recovery and the phase out of federal stimulus funds.

It is important to note that there has been a steady trend of revenue growth in recent months for nearly all states, but recovery remains uneven and not at the pace to offset stimulus funds and other spending pressures. Large projected state budget deficits for fiscal 2012 were solved partly by reducing state aid to local governments. State fiscal pressures may, therefore, challenge the cash and

budget management activities of many local governments. We believe liquidity management will be especially important for governments with structural budget misalignments.

Whitney's comments were panned by most credible economists as reckless—and rightly so. There is virtually zero chance of "hundreds of billions" in municipal defaults in 2011. Nevertheless, many retail investors reacted to her warning by what appeared to be an indiscriminate sell-off of their tax-free bond holdings. In light of these events, MTAM believes that long-term investors would benefit from a refreshed understanding of the characteristics of the tax-free bond market.

There are a multitude of reasons that state and local government defaults will remain rare. Chief among the reasons municipalities will continue repaying their debt is that they have to. Governments know they need to borrow regularly and cannot afford to repulse investors by defaulting on bonds. Aside from losing access to the capital markets, filing for Chapter 9 bankruptcy is not an easy way out, anyway. It can be a difficult process that does not ease the debt burden after all. Moreover, repaying debt normally does not impose a big cost on municipalities; paying off debt represented only 8% of revenue at the state level.

While governments may have to cut costs, raise taxes, or tap reserves, the predictions of large-scale municipal government defaults is overblown. The most obvious rebuttal to the worries over defaults is municipalities' stellar credit history. The cumulative default rate on municipals rated investment grade by Standard & Poor's is 0.2%. Municipals rated investment grade by Moody's Investors Service fared even better, with a default rate of 0.07%. Of course, just because it has not happened yet does not mean it will not. After all, markets endured several unprecedented or previously rare travails in 2008. However, as compared with the Great Depression period of 1929-1937 when 16% of outstanding municipal debt defaulted, the sheer magnitude of the Depression negates the similarities. Furthermore, economists and policy-makers are more sophisticated now and better equipped to mitigate financial crises.

While MTAM acknowledges that a small increase in the overall municipal default rate is likely, we do not see a repeat of the Depression-era with systematic, nationwide problems. We expect any credit problems, as they occur, to be more localized and mostly among smaller, less traditional issuers and rarely from government bodies. We look for more defaults in land-backed deals and special-purpose districts (hotels, casinos, etc.). Many of the default filings these days have been from community development districts in Florida. Governments with unlimited taxing power are in a different category.

Despite the credit challenges facing municipal bond issuers in 2011 and 2012, there are always good opportunities, even for the very conservative investor. Essential service revenue bonds without the budgetary concerns of state and local governments and limited payrolls can be attractive, but we stress that an essential service issuer cannot flourish if the underlying governmental entity is in dire economic circumstances. A healthy outlook holds for most infrastructure issuers due to fundamental strengths reflected in the provision of essential public services, adequate balance sheets, and generally sound governance and fiscal management practices. In the case of the enterprise sectors comprised of higher education, health, and housing, credit quality will be maintained primarily as a function of their ability to increase fees, control costs, and improve overall operating margins. Sound debt and fiscal

management practices, preservation of adequate liquidity, and strong governance oversight will be significant determinants of credit quality for issuers during the coming period of financial adjustment.

Despite MTAM's view that credit risk is not as nearly severe as some observers would suggest, we continue to take a very cautious view toward the riskier municipal sectors and smaller, weaker municipal issuers, and any issuers where the budgetary pressure become extreme.