# Municipal Bond Outlook

## Recent developments

There have been many recent discussions, headlines and now Congressional hearings, focusing on the $2.9 trillion municipal bond market. Spurring this attention was a research report (and ensuing press coverage) issued by a high profile analyst. The report suggested there would be a high rate of default on local (not state) municipality and local taxing authority general obligation bonds. These concerns, voiced by some analysts, politicians and the popular and financial press, were fueled by recession-exacerbated state budget deficits and state and municipal unfunded pension costs and other post-employment retirement benefits. There has also been some early stage discussion in Congress regarding allowing states to access the U.S. Bankruptcy Code to resolve their debts (presently only municipalities other than states may utilize the bankruptcy provisions). While this idea has not gained traction and in our view is unlikely to gain traction, it has been unsettling to bond investors. Finally, as a result of the raised profile of these issues, investors have withdrawn funds from municipal bond mutual funds forcing funds to sell bonds into the market, lowering prices and elevating yields.

## Background

Approximately two-thirds of the municipal bond market is comprised of revenue bonds and the remaining one-third are general obligation bonds. Individual investors directly hold approximately 35-40% of outstanding bonds, and mutual funds and money market funds together own approximately 35% of outstanding bonds. Banks and other financial institutions own approximately 20-25% of outstanding bonds.

States are generally required to maintain a balanced budget and are not permitted by law to operate with annual deficits. Unfunded pension liabilities are required to be funded over a period of years and are not an immediate liability or near term cash squeeze trigger. Similarly, retiree healthcare benefits are an ongoing expense and not a near term lump sum cash requirement.

Our client portfolios are generally comprised of high quality revenue bonds and large high quality issuer general obligation bonds. Our average maturity and duration (sensitivity to higher interest rates) is generally short, thereby mitigating interest rate risk. Most client bond portfolios are diversified by state and issuer.

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**Our point of view**

There is not an imminent widespread default risk. State and municipal governments need access to the capital markets and any Congressional action that would create further credit uncertainty is remote since it would impede such access. Such would result in severe budget cuts that would greatly and negatively impact the overall economy. If, however, capital market access was destabilized, we believe the integrity of the system would be protected even if Treasury or Federal Reserve action was required as the consequences of systemic failure would be too severe. This, however, is the "last resort" analysis.

In the first instance, high quality revenue bonds are secured and collateralized by a pledged stream of revenues designed to cover debt service (interest and scheduled principal payments). In a Chapter 9 bankruptcy of a municipality these revenue bonds have special status and have a lien on these revenues. They are not compromised in a bankruptcy proceeding so long as the revenue stream remains. As for large issuer general obligation bonds, we expect that budgets balanced through spending and service reductions, increased tax rates and continuing economic recovery giving rise to tax revenue increases, coupled with changes in benefits and pensions going forward, should improve state finances.

Nevertheless, we recognize that perceptions and fear can greatly impact markets in the short-term and result in reductions in bond values. During the past two years we have, accordingly, diversified bond portfolios (geographically and by issuer), shortened maturities and increased credit scrutiny. While municipal bonds are not without risk, we continue to consider the particular portfolios of bonds held by our clients a risk mitigator in an investment portfolio that is well diversified by asset class and believe that they provide an appropriate after tax yield to full bracket taxpayers as compared to other fixed income investments. We will continue to monitor developments and keep you advised.

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