RESEARCH NOTES

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Municipal Bond Market 2009: Little Risk, But Little Value

The financial crisis and economic recession have placed severe strains on state and municipal budgets, with a double whammy of declining tax revenues and increased demands on "safety net" services. Should municipal bond investors be concerned about defaults or liquidity risks? In particular (for our clients who are Maine residents), what are the impacts and risks in the local municipal market? Finally, have these concerns created a buying opportunity for taxable investors?

Credit Risks - National Market

In April, Moody's and Standard & Poor's issued reports striking slightly different tones on the issue. One key point of the Moody's analysis was that "the negative sector outlook does not suggest that prospects for local government credit ratings are uniformly negative."[1] It emphasized the fact that the municipal market is exceedingly diverse, and that credit pressures will be influenced by exposure to specific factors including: reliance on the variable rate debt market; industries such as real estate development, auto manufacturing, and financial services; volatile revenue sources (sales tax, real estate transfer tax, etc.); dependence on a higher level of government (the state); and legally mandated fixed expenditures.

Despite its cautionary tone, Moody's noted that in many states assessment practices will limit the impact of home sales prices on property tax revenues, and that reliance on variable rate debt is not widespread. In conclusion, the report says "…while we expect most local governments' ratings will be maintained, the elements discussed above may well result in increased ratings revisions for U.S. local governments."[1] In other words, some downgrades can be expected, but they will likely represent a minority of credits.

Standard & Poor's offered a more sanguine view, stating "…we do not expect the housing market's troubles to result in widespread deterioration in municipal credit quality… however there could be isolated instances of financial and credit distress."[2] S&P notes the following inherent strengths of the muni market: favorable diversification of revenues; cash reserves (from generally good financial

[1] "*Moody's Assigns Negative Outlook to U.S. Local Government Sector*" Moody's Investors Services, April 2009
[2] "*Local Governments Prove Resilient In Weathering The Housing Slump*" Standard & Poor's, April 14 2009

management practices in recent years); taxable property values that do not closely follow market values; and finally, "governments can and do adjust budgets when necessary." [2]

Thus, while state and municipal budgets are generally experiencing elevated levels of stress, risks of downgrades – let alone defaults - appear limited and highly dependent upon specific factors that can be identified, with some level of expertise, in the local market.

The Maine Market

The rating agencies also issued recent reviews of the State and several local credits. In almost every case, the existing ratings were confirmed, with a "stable outlook" indicated. For the State's General Obligation bonds, the highlights included "a relatively stable economy; improved financial performance due to more controlled budget growth; favorable debt position with low debt burden and rapid amortization of debt."[3] This may come as a surprise to those of us who follow the proceedings in Augusta, but the reality is that Maine's debt burden is low and rapidly amortized compared to most other states, and the constitutionally mandated balanced budget forces fiscal discipline.

The Maine Municipal Bond Bank is a State agency which acts as a conduit issuer for local cities, towns, school administrative units and water and sewer districts, and whose bonds comprise a large portion of the Maine tax-exempt market. In confirming its "AAA" rating, S&P cited a strong underlying credit profile and default tolerance, solid structural features including two pledged reserve funds, and a substantial number of borrowers with good credit quality and diversity.[4]

Portland (Aa2/AA), Bangor (A1/AA) and Scarborough (Aa3/AA) recently issued bonds as well, and the rating reports were generally favorable. Moderate debt burdens, stable financial positions, diverse local economies and strong management were common characteristics (Bangor was downgraded one-half a notch by Moody's due to heavy capital spending and one-time litigation costs – but raised a half-notch by S&P).

Bond Insurance

Obviously, the financial positions of most bond insurance companies have been severely compromised in the past year, as evidenced by the rating downgrades of many of the larger bond insurers to junk status, from a formerly universal "AAA" status. We have never advocated purchasing bonds based solely on the insurance backing, and strongly recommend today that the risk be judged on the strength of the underlying credit, not the insurance.

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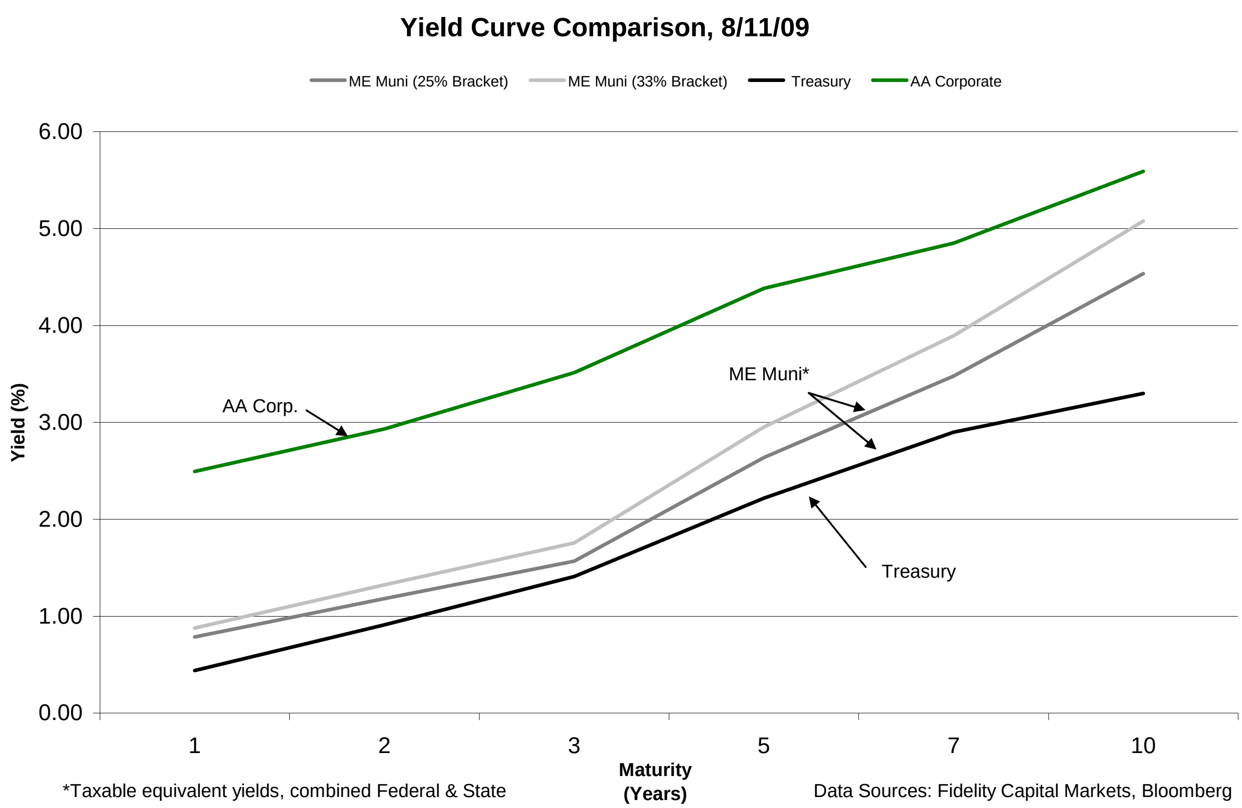
[3] "*Maine; Appropriations; General Obligation*" Standard & Poor's, May 27 2009

[4] "Maine Municipal Bond Bank; State Revolving Funds/Pools" Standard & Poor's, July 17 2009

A Buying Opportunity?

Historically, municipal bonds have been among the safest investments available, with defaults occurring very rarely. Even in the current climate, the preponderance of evidence so far suggests that default risks are low in both the national and local market. However, credit risk is only one element of the investment decision. The other important question is: do municipal bonds offer adequate risk-adjusted returns today?

To determine the answer, one should compare a municipal bond yield to other bond market sectors using "taxable equivalent" yields, which offer apples to apples comparisons. Since the majority of our clients are Maine residents, in the illustration below we compare the taxable equivalent yields from this week's Maine Municipal Bond Bank issue to those available from U.S. Treasury securities and investment-grade corporate bonds:



As the chart shows, the Maine Municipal Bond Bank curve presents a modest yield advantage to investors relative to Treasuries. This spread relationship is within its normal historical range, signifying investors' collective judgment that credit concerns for investment grade municipals have eased in the past several months. Corporate debt, of course, is riskier than municipal debt backed by taxing power - so one would expect some additional yield as compensation for that risk. However, even though corporate spreads have come in substantially since earlier this year, they continue to look generous, reflecting still tenuous economic conditions.

Conclusion

Although investors need not be overly concerned with credit risks in the municipal bond market, an increased level of due diligence and selectivity is warranted. One of the more painful lessons of the past year is that bonds do involve risk, and fixed income portfolio management requires as much professional expertise as the equity side.

Given our view that the Treasury market is currently a very expensive asset class, combined with the elevated (though not alarming) credit risks for municipals, we conclude that municipal bonds offer little value today. By contrast, carefully-selected corporate bonds present a viable after-tax alternative for investors in all tax brackets. We would recommend that new fixed income commitments - even for taxable portfolios - favor corporate bonds over municipals and Treasuries for the time being. Consistent with our ongoing views about the potential for inflation and interest rate increases, portfolio durations should remain short. Although existing municipal bond positions (with higher coupons than the current market) need not be sold, portfolios should be reviewed for specific risk factors.

As always, the use of municipal bonds in any portfolio should be weighed in the context of the client's tax situation and expected returns relative to other fixed income sectors and other asset classes in general. Eventually, we expect yield relationships to return to normal, at which point municipal bonds may again be a better option for upper-bracket investors.

If you have questions or comments regarding this or any other Research Note, click here to contact the Research Department.

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