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Municipal Bonds

Timely thoughts on 60 Minutes segment

- We would like to take this opportunity to address some of the misconceptions that may have been created by the 60 Minutes program that first aired on 19 December 2010.
- Market reaction following the broadcast of the program has been muted with tax-exempt yields unchanged to slightly lower.

The television program provided viewers with a critical assessment of the fiscal stress facing state and local governments. Meredith Whitney, an equity analyst who gained significant notoriety by forecasting stress in the U.S. banking sector, was among the individuals interviewed for the program. Whitney recently shifted some of her focus away from her historical area of expertise to offer an assessment of state and local government finance. We have received numerous inquiries regarding her comments on the program and believe further clarification is appropriate.

- We agree with her assessment that the current disclosure regime in municipal finance is unsatisfactory. The absence of enforceable rules governing the timely disclosure of financial results has been a persistent problem and one that has received more attention recently. However, her comments regarding the absence of information since the middle of 2008 are simply incorrect. State governments have released their FY09 audits as have most local governments of any size. While these financial statements are produced at a slower rate than we would prefer, her suggestion that information is generally unavailable from as long ago as June 2008 is not accurate.

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Furthermore, state governments do in fact produce unaudited information on a fairly routine basis. For example, the California's Controller has posted the cash position of the State through the end of November and has provided summaries of General Fund revenue and collections to date. For the record, and despite comments made by host Steve Kroft on the program, California's rating of A1/A is not close to "junk."

- Ms. Whitney has forecast unprecedented defaults throughout the municipal sector in the next 12 months. In her words:

  "you could see 50 to 100 sizeable defaults … more … this will amount to hundreds of billions worth of defaults"

  Her prediction implicitly sets the stage for municipal defaults at twice the rate recorded in the Great Depression. We do not believe that this is a reasonable forecast. As we have said on many occasions in the past, this recession has placed a great deal of stress on state governments but the degree of damage does not approach the loss of revenue evident during the Depression.

  The amount of municipal bonds in payment default today is roughly USD 8.2bn according to data compiled by the independent research firm *Municipal Market Advisors*, in comparison to approximately USD 2.9 trillion of municipal debt outstanding. To achieve the default levels predicted by Ms. Whitney, municipalities would have to default at a rate greater than 30 times the current rate. Additionally, it is important to note that 62% of the par amount and 80% of the number of bonds in payment default were initially non-rated bonds. Safer sectors of the municipal market only comprise 0.5% of the par amount and less than 1% of the number of bonds that are in default.

- The program also referenced events in Harrisburg, PA. We have described the situation in Harrisburg in prior reports, most recently in our December market update report published on 16 December 2010. Harrisburg is a good example of an economically disadvantaged and politically dysfunctional community which has been exposed to a failed project financing for at least a decade now. In other words, this is a community which finds itself overleveraged by a single project that now threatens to undermine its ability to pay its GO debt. The city has not filed for bankruptcy; the State of Pennsylvania has now stepped in and will appoint a Coordinator to make recommendations for a fiscal recovery plan. Investors should keep in mind that Harrisburg's bonds were assigned low ratings prior to the current recession.

- Debt service does not represent an insurmountable burden on state governments. For example, debt service as a percent of revenues ranges from approximately 1.32% for Texas to 6.32% for New York. Based on data compiled by S&P, the further revenue loss necessary to jeopardize the payment of debt service on state government debt would have to be quite substantial. California would have to reg-

ister a further 45% reduction in General Fund revenue; Texas, 61%; and New York a sizeable 85% decline.

This level of deterioration is not likely to occur, in our view. According to data compiled by the Pew Center on the States, 28 state governments now report year-over-year increases in tax collections. Monthly sales tax collections are up in California and Illinois. Corporate taxes are up in Colorado and Arizona. New Jersey and Michigan are reporting year over year revenue increases. Does this mean that the period of fiscal stress is over? Not at all. We concede that a default by a higher-profile local government is still a possibility in 2011. But it does point to a degree of resilience not evident in the Whitney forecast.

- We agree with Ms. Whitney's belief that states will find a way to honor their debt. We do not believe a state government will default due in large part to three important elements:
    - Debt service as a percent of spending is modest at less than 10% of total spending on average. A bond default would not solve the challenge of structural deficits;
    - Strong constitutional or statutory protections in place to protect bond holders; and
    - Default would impair market access, increase future borrowing costs, and disproportionately harm the state's own citizens who usually comprise a large proportion of investors in the state's own municipal bonds.
- Local governments will continue to experience fiscal stress. As we discussed in our prior research reports, and more recently in our December market update, "we expect headwinds for the broad muni market to linger for some time and believe credit pressure for local governments will be more intense at the local level". That said, we do not expect systemic defaults among local governments.

Market reaction following the broadcast of the program has been muted. Compared to Friday, 17 December, the AAA Municipal Market Data benchmark curve is unchanged at the 5-year maturity point at 1.62%, 3 basis points (bps) tighter in the mid-section of the curve at the 10-year spot (3.15%), and unchanged at 4.66% for the yield on the long-dated 30 year municipal bond.

Appendix

Statement of Risk

Municipal bonds: Although historical default rates are very low, all municipal bonds carry credit risk, with the degree of risk largely following the particular bond's sector. Additionally, all municipal bonds feature valuation, return, and liquidity risk. Valuation tends to follow internal and external factors, including the level of interest rates, bond ratings, supply factors, and media reporting. These can be difficult or impossible to project accurately. Also, most municipal bonds are callable and/or subject to earlier than expected redemption, which can reduce an investor's total return. Because of the large number of municipal issuers and credit structures, not all bonds can be easily or quickly sold on the open market.

	Rating Agencies			Credit Ratings
	S&P	Moody's	Fitch/IBCA	Definition
Investment Grade	AAA	Aaa	AAA	Issuers have exceptionally strong credit quality. AAA is the best credit quality.
	AA+	Aa1	AA+	Issuers have very strong credit quality.
	AA	Aa2	AA	
	AA-	Aa3	AA-	
	A+	A1	A+	Issuers have high credit quality.
	A	A2	A	
	A-	A3	A-	
	BBB+	Baa1	BBB+	Issuers have adequate credit quality. This is the lowest Investment Grade category.
	BBB	Baa2	BBB	
	BBB-	Baa3	BBB-	
Non-Investment Grade	BB+	Ba1	BB+	Issuers have weak credit quality. This is the highest Speculative Grade category.
	BB	Ba2	BB	
	BB-	Ba3	BB-	
	B+	B1	B+	Issuers have very weak credit quality.
	B	B2	B	
	B-	B3	B-	
	CCC+	Caa1	CCC+	Issuers have extremely weak credit quality.
	CCC	Caa2	CCC	
	CCC-	Caa3	CCC-	
	CC	Ca	CC+	Issuers have very high risk of default.
	C		CC	
			CC-	
	D	C	DDD	Obligor failed to make payment on one or more of its financial commitments. this is the lowest quality of the Speculative Grade category.

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Appendix

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