GFMI

GLOBAL FINANCIAL MARKETS INSTITUTE

Article

2013

Unlucky 2013 for the U.S. Municipal Market—Fact or Fiction?

by Julie Barnum,
Subject Matter Expert, GFMI

GFMI

Unlucky 2013 for the U.S. Municipal Market—Fact or Fiction?

The municipal market has been around for over 100 years and has been the primary engine for state and local governments to finance schools, hospitals, homes and all types of basic infrastructure.

The market is deep and liquid and stands at about $3.7 trillion as compared with the $8.4 trillion corporate bond market.[1] Due to their tax-exempt status, the majority of municipal investors are individuals and mutual funds.

Fixed income investors continue to search for yield and high credit quality. They can get 1.69% for a AAA rated muni versus 1.84% for a comparable treasury. After factoring in the tax advantage, munis look like an excellent investment. So why worry? The states and municipalities are rated at least the same or better than the U.S. government. Defaults are relatively low, but a few high profile bankruptcies may change the landscape for investors.

States cannot declare bankruptcy under Article 9 of the U.S. Constitution, although Arkansas defaulted on its' bonds during the Great Depression. What about cities and counties? California leads the headlines with Chapter 9 filings for Stockton, San Bernardino, Mammoth Lakes and Vallejo. Other California cities are on the verge of filing as well.

Outside of California, there have been high profile defaults for Jefferson County, Alabama, Central Falls, Rhode Island and Harrisburg, Pennsylvania.

Was Meredith Whitney right when she predicted 50 to 100 sizable defaults in 2010? The market sure listened to her and had a huge fear-based sell-off in early 2011. As we now know, the doom and gloom did not materialize, but could it happen in the future? Late last year Warren Buffett, arguably the most famous investor, terminated credit-default swaps insuring $8.25 billion of municipal debt. Is this cause for concern? Are risks mounting for municipalities as they work their way out of the Great Recession?

There are four main areas to watch in 2013.

The first challenge municipal issuers will have this year is Congress' willingness to maintain the tax-exempt nature of municipal bonds.

Even though the fiscal cliff has passed, Congress is still looking for new revenue sources (a.k.a. taxes) and the tax exemption is still on the table.

In reality, if the tax exemption for municipal bonds goes away, borrowing costs for local governments will go up which will have to be funded by new revenues (a.k.a. taxes). Sounds like a lose-lose proposition...

The second area to watch is the finances of the states and municipalities themselves. Prior to the Great Recession, states and municipalities gorged themselves on debt to shore up infrastructure or build pet projects (California high-speed rail going nowhere?). As tax revenues fell off, states and municipalities had the hard choice of either raising taxes or laying-off non-essential employees. Most did both with some devastating consequences. Even essential services, such as, police and fire were cut as well as the closing of parks, libraries and furloughing employees.

Analyzing a municipality is a real challenge. Before the Great Recession, the analysis was a bit easier as over 50% of the bonds were insured by the monolines, giving the bonds the coveted AAA rating. Today, most of the monolines are gone as they did not stick to their knitting and instead wrote credit default swaps against pools of subprime mortgages. We all know what happened to those mortgages. Assured Guaranty Municipal Corp., which had a 99.7% market share in 2012, was just downgraded by Moody's to A2. Now the analyst must do their own credit analysis on the muni, but the information is often so outdated, it is not worth the paper it is printed on. Municipalities annually issue a Comprehensive Annual Financial Review ("CAFR") that can be between 75 to 350 pages. Adding insult to injury, the Governmental Accounting Standards Board found that the average time frame for issuing reports varied by type and size of government: averaging from 126 days after the end of the fiscal year for large special districts to 244 days for small counties! The SEC put forth a report in 2012 recommending more transparency and timely reporting, but has yet to enforce any action.

The third concern is with pensions and other post-employment benefits for state and local employees. This is one of the largest looming areas of concern given that medical and health costs continue to escalate, life expectancies are increasing and more and more "baby boomers" are retiring.

Professor Raugh of Northwestern University estimated that unfunded pension liabilities are as high as $4.4 trillion—nearly $30,000 for every American household![2] Exacerbating this problem is the expected rate of return the pension funds expect to make. CalPERS, the largest pension fund in the U.S. recently dropped its expected rate of return to 7.50% from 7.75% on its $200 billion portfolio of investments. In the fiscal year ending June 30, 2012, CalPERS earned a paltry 0.14%!

As expected rates of return decrease, states and municipalities must fork over additional funds for their pensions. To put this into perspective, following are some figures which illustrate the wonderful power of (simple) present value.

© Global Financial Markets Institute, Inc.

GFMI

- PV of $10 million in 30 years at 10% = $573,085
- PV of $10 million in 30 years at 7% = $1,313,671
- PV of $10 million in 30 years at 4% = $3,083,186
- PV of $10 million in 30 years at 0.14% = $9,588,979

In other words, assuming a 7.0% vs. a 0.14% return, the pension fund would have to contribute over $9,000,000!!!

Just when municipalities are starting to slowly recover from the Great Recession, they may be called upon to ante up their pension contributions. The market will also be watching the legal battle with bankrupt San Bernardino and CalPERS as the city has halted its pension payments. CalPERS contends that the pension fund should be paid in full, even in a bankruptcy. In December 2012, a bankruptcy judge rejected CalPERS bid to force the city to continue making monthly pension payments but CalPERS has stated that they will challenge the ruling all the way to the U.S. Supreme Court.[3] Also, keep an eye on ratings downgrades: Standard and Poor's just downgraded Illinois to A- due to its unfunded pension obligations

And finally, just when you thought things were getting better, The American Society of Civil Engineers ("ASCE") just released their 2013 report entitled Final Failure to Act about the nation's infrastructure. According to the ASCE press release, "ASCE has a sober message for elected officials, policy makers, businesses, and general public: unless the U.S. invests an additional $1.57 billion per year in infrastructure-drinking water and waste water, electricity, airports, seaports and waterways, and surface transportation-between now and 2020, the nation will lose $3.1 trillion in GNP (gross national product), $1.1 trillion in trade, a $3,100 per year drop in personal disposable income, $2.4 trillion in lost consumer spending, and a little over 3.1 million jobs."[4]

Who is going to fund this? The financially strapped municipalities? The Federal Government who is already looking for new sources of revenue (aka taxes)? Or will state and local governments just delay much needed projects?

One idea that is gaining momentum is the use of Public Private Partnerships ("P3's") to help finance our crumbling infrastructure. P3's have been used all over the world to successfully build infrastructure projects, but have only recently been getting press here in the U.S.

Successful projects can usually be built up to 40% less than a public project and be delivered on time and to budget with no change orders.

In conclusion, the long-term outlook remains cloudy for the municipal market. There is still uncertainty about the labor markets and the housing market is slowly crawling out of its' deep hole. While there has not been the predicted number of defaults, there are still some very problematic municipalities out there. Congress is still examining the idea of reducing or eliminating tax-exemption of munis and there are continued concerns about pension liabilities. Lastly, we have aging infrastructure that must be repaired or replaced.

© Global Financial Markets Institute, Inc.

Any way you look at it, 2013 should prove to be a very interesting year for the municipal market.

References

1. http://www.sifma.org/research/statistics.aspx

2. http://www.investmentnews.com/article/20121021/REG/310219978

3. http://newsandinsight.thomsonreuters.com/Bankruptcy/News/2012/12__December/Bankruptcy_judge_rules_against_Calpers_in_San_Bernardino/

4. http://www.asce.org/ascenews/featured.aspx?id=23622322886&blogid=25769815007

© Global Financial Markets Institute, Inc.

GFMI

About the author

Julie Barnum has been a finance professional for over 30 years. She got her start at Union Bank where she privately placed tax-exempt bonds. Julie then embarked upon a 13 year career with Banque Paribas working in Los Angeles, Paris and New York—and held positions as the head of training for the corporate bank and senior credit officer.

Later, in her career, Julie became the Managing Director at New York Institute Finance. After which, she started her own consulting practice and has been training credit and corporate finance for financial institutions and Fortune 500 countries around the world. She also is a principal of a regional infrastructure merchant bank.

Copyright © 2014 by Global Financial Markets Institute, Inc.
PO Box 388
Jericho, NY 11753-0388
+1 516 935 0923
www.GFMI.com