GLOBAL FINANCIAL MARKETS INSTITUTE

Article **2014**

Municipals Update: the Good, the Bad, and the Groundbreaking

by Ethel Yamamoto, MBA
GFMI Subject Matter Expert

Municipals Update: the Good, the Bad, and the Groundbreaking

We thought it might be helpful to update our municipal bond market view from last year with our "crystal ball" for 2014. First, we will examine the overall market for any changes and insights to the future. Next, we will review two issues that have essentially been resolved. Lastly, we will move on to the legal environment where "groundbreaking" rulings will have major consequences for either pension funds, municipalities, or both.

Muni Market

The municipal bond market (muni market) has been essentially flat at $3.7 trillion for the past two years. Do we expect it to continue in 2014 for the third consecutive year? This doesn't appear likely as is already evidenced by a 10.5% decrease in general obligation (GO) and revenue bond issuances for YTD September 30, 2014 over the same period in 2013. Why might this scenario be happening? Although local governments' needs for capital requirements and deteriorating infrastructure continue to increase, fiscal austerity and political pressures continue to constrain issuance expansion. These political aspects can't be ignored as the public outcry against increasing public debt has materialized in the form of "no" votes against referendums/revenue bond issues. The voting public is alive and well and very vocal when it comes to taking more money out of their wallets from increased local, sales and property taxes.

Investor Base

Individuals remain the largest investor group in the muni market despite a declining trend from a peak of 54% in 2004 to its current level of 44% for 2013 and first half of 2014. The old adage, "appearances can be deceiving," is true in this case. Individuals have not reduced their holdings in absolute dollar terms; they have actually increased each year for the last 10 consecutive years. It's the muni market itself that has expanded by $850 billion or 30.1% from $2.8 trillion in 2004 to its current level of $3.7 trillion in 2014. In second place, mutual funds have remained relatively range bound: 25% in 2004 and 28% for 2013 and year to date 2014. Insurance companies and banks battled for third and fourth positions over the past 10 years, but have remained fairly consistent at 13% and 12%, respectively, for 2013 and 2014.

Can we assume that this investor composition will continue? The reasons for individuals to buy municipal bonds remain unchanged: yield/income pursuit preferable to equity volatility, perception of low credit risk, and continuation of tax exempt benefits. Individuals continued to pile into U.S. muni mutual funds for 13 consecutive weeks (each week during Q3 2014), which is the longest stretch since 2012, according to Lipper U.S. Fund Flows data. Insurance companies still need to put their large premium base to work. Banks with more than $250 billion in assets, however, are faced with a new Federal Reserve Board (Fed) regulation effective January 1, 2015 under Basel III requiring large banks to maintain a certain ratio of high quality liquid assets (HQLA) to total net cash outflow under which municipal securities will not qualify.

There is an eligible list of HQLA, where such assets are approved as highly liquid and of high credit quality. I find it curious that Basel III will include European local government bonds with a certain rating, minimum issue size, and maximum 10 year tenor while U. S. rules exclude this option. Major banks and the Securities Industry and Financial Markets Association (SIFMA) have submitted proposals to support inclusion based on similar criteria. If the Fed does not adopt similar criteria for this new liquidity coverage ratio, banks will be forced to unload a significant amount of these securities to other investor groups, hedge funds, and banks not under HQLA requirements. Banks would, furthermore, be reluctant to provide a secondary market using proprietary capital, which would increase liquidity risk for the bondholder.

What highly publicized potential events haven't materialized?

Defaults

Remember December 2010 when Meredith Whitney (founder of her own advisory group) predicted "hundreds of billions of dollars of municipal defaults within 12 months"? This specter of a high degree of defaults, fortunately, hasn't occurred. In fact, Moody's notes that there have been an average of five defaults per year from 2008-2013. The one year default rate for muni issuers remains extremely low, averaging just .03% over this same 2008-2013 period. (Moody's coverage universe is 15,700 issuers.) Furthermore, ultimate recovery rates on average for munis remain high at 60% covering the period 1970-2013, compared with only 48% for corporate senior unsecured bonds over the period 1987-2013. (Specific bond recovery rates are highly diverse, ranging from 100% to 2%, depending on creditor class ranking.)

Although defaults continue to be far and few between, bankruptcies are on the rise which, generally, result in protracted negotiations among the various creditor classes, recovery compromises, and a lengthy exit.

Tax exemption

The highly rumored elimination of tax exemption for this investment has "come and gone" for the moment, thanks to political inertia and paralysis. Long live the muni market! However, don't get complacent as this topic will surely surface again since both the Treasury and IRS have strong incentives to recoup revenue loss from tax exempt issues. The last available public information regarding estimated revenue loss was $35 billion in 2006.

Legal Environment

Detroit, MI

Detroit, the largest municipal bankruptcy as of July 18, 2013, was crippled by $18.5 billion in debt owed to a multitude of creditors, waning revenues, and a high level of uncollected debt that resulted in a reduction in basic services (such as police, fire, EMS, etc.). Detroit made major headlines again when the U.S. Federal bankruptcy judge there ruled in December 2013 that pension fund payments are not entitled to "extraordinary protection," although the state's constitution provides protection against such benefit cuts. As of October 16, 2014, the city is near to finalizing settlements with the creditor groups that will entail shedding $7 billion in debt, pension cuts of 4.5%, and the elimination of city paid healthcare for retirees. If this plan is approved, Detroit's battle between federal law and a state's constitutional benefits protection will cease. But then, there's always Stockton!

Stockton, CA

On June 28, 2012, Stockton, CA was the largest city in terms of population to file for bankruptcy protection. Although debt was only $700 million, the city was financially insolvent due to high retiree costs, an imprudent and costly downtown revitalization development, and lower property taxes from the housing market crash. A U.S. Federal bankruptcy judge ruled on October 1, 2014 that Stockton's pension could be impaired, giving the city the right to break its contract with California Public Employees Retirement System (CalPERS), who has argued that pension payments are guaranteed under California law and cannot be cut. CalPERS has a unique position as a state agency with statutory powers that include liens on a city's assets for pension bills. If Stockton discontinues pension payments, CalPERS contends it has the right to a lien of $1.6 billion while the federal position is that CalPERS' statutory powers were suspended upon bankruptcy and the pre-bankruptcy contract can be broken. On October 30 the judge will render his decision whether Stockton can exit bankruptcy

The federal judges in both the Detroit and Stockton bankruptcies have issued "groundbreaking" rulings regarding pensions, but Detroit's imminent settlement means that it will be up to Stockton to "carry the torch" to contest whether federal bankruptcy trumps a state's constitutional guarantee/provision. Do we see the Supreme Court in the distant horizon?

Crystal Ball for 2014

Most of the concerns in 2013 have improved or been resolved: better labor market, low degree of defaults, and tax policy uncertainty. The only major concern in 2013 that continues for the foreseeable future is looming pension liabilities. Are there any new concerns for 2014? I surmise the application of HQLA in its present form which impacts market liquidity is cause for pause although the "buy and hold" to maturity investor will largely be unaffected. I expect some compromise on the matter, such that the banks will continue to play a major role in the market and will not be at a capital disadvantage. Overall, I don't anticipate major investor changes in the muni market as it remains an important asset class with a growing aging population that favors fixed income instruments. The low default experience, tax exempt nature, and high recovery rates vis a vis other investment options and asset classes reinforce the appeal of these securities. Caveat emptor: All investments are issuer specific, so beware of those municipalities who are already in dire straits and experience increasing population flight, which is a portent of things to come.

References

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

http://www.msrb.org/News-and-Events/Press-Releases/2014/MSRB-Publishes-Second-Quarter-2014-Statistics.aspx

http://www.moodys.com/research/Moodys-Municipal-bond-defaults-remain-low-in-number-but-new--PR_298814

http://www.investmentnews.com/article/20141014/FREE/141019973

http://www.reuters.com/assets/print?aid=USBREA1GOOJ20140217

http://www.online.wsj.com/articles/judge-says-cities-in-bankruptcy-may-reject-pension-contracts-1412202138

http://www.fitchratings.com/gws.en/fitchwire/fitchwirearticle/Proposed-HQLA-Rules?pr_id=818437

http://www.dealbook.nytimes.com/2014/10/01/judge-rules-that-bankruptcy-in….ates-calpers-lien-against-stockton-calif/?_php=true&_type=blogs&_r=o

http://www.cbs.news.com/news/state-budgets-the-day-of-reckoning

http://www.abcnews.go.com/Sports/wireStory/detroit-arena-lamd-creditor-bankruptcy-26239334

About the Author

A professional portfolio manager with a focus on credit and corporate banking, Ethel has a broad knowledge of various domestic and international markets and investments. She has held various banking positions with major investment centers, where she held responsibility for the risk management strategies of those institutions' credit groups.

Ethel's background transcends corporate finance, corporate restructurings, supervisory and regulatory audits & reporting, collateralized debt obligations, portfolio review & provisions, and overall risk management and counterparty risk for the credit markets. Her skills earned her placement as a Guest Lecturer and as a Panel member for the University of San Diego's School of Business, in addition to being a founding member of the School of Business Alumni Association Council.

Now a private portfolio manager, Ethel oversees a high seven figure investment portfolio, focusing on the overall credit investment strategy and management while coordinating with that account's assigned money manager. A diversified portfolio of municipal bonds represents 20% of the total, as an asset class.

Prior to her current consulting, Ethel was with Bank of America (Los Angeles, CA) for 16 years, where she held various domestic and international banking positions. She then expanded her career with Paribas (acquired by BNP and now known as BNP Paribas) where she was a senior officer in different capacities and locations worldwide, for another 16 years.

Ethel is regarded for her approachable means to lecture and educate others on credit analysis, risk management and portfolio strategies & management – both from an international and domestic perspective.

PO Box 388
Jericho, NY 11753-0388
+1 516 935 0923
www.GFMI.com