

The State Budget Crisis and Municipal Bonds

January 2011

Summary

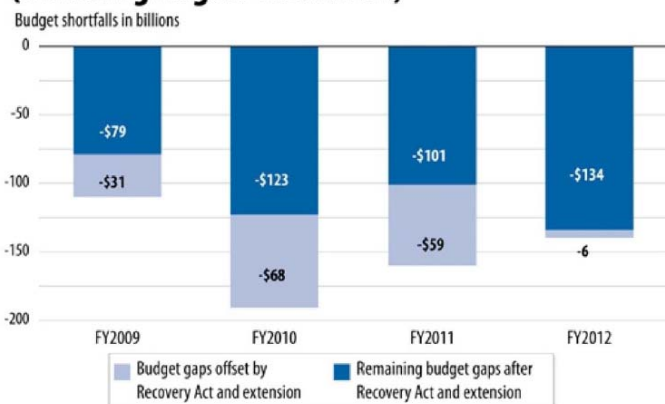
- Municipalities face the largest deficits on record in 2012 (net of federal support)
- These deficits do not represent a debt crisis
- Widespread defaults will not occur although prices will be volatile

Budget Deficits Lead to Difficult Choices

Municipal bonds are currently front and center in the battle to protect fixed income portfolios from the next round of credit losses. While the initial waves of financial contagion led to severe stress in the corporate market, corporations have regained profitability while municipalities continue to struggle with declining revenues and rising costs. The media has raised concern about potential municipal defaults to peak levels, encouraging us to respond.

Municipal finances typically follow the business cycle with a year or two lag so it's no surprise that municipalities are currently in the limelight. However, the scope of the collective state budget crisis is staggering. State budget shortfalls totaled \$110B in fiscal year 2009 and reached \$191B in 2010 (29% of state budgets). Budget deficits for fiscal years 2011 and 2012 are expected to improve as states have adjusted spending and anticipate rising revenues, but deficits remain high. Most concerning is the pending expiration of federal support which to date has mitigated a significant portion of these deficits.

State Shortfalls After Use of Recovery Act Funds (Including August Extension)



FY = Fiscal Year
 Source: CBPP analysis using data from U.S. Department of Health and Human Services, U.S. Department of Education, Congressional Budget Office, and state budget documents.
 Revised September 2010



The enactment of the American Recovery and Reinvestment Act (ARRA) in early 2009 authorized roughly \$140B in federal funding for states in the form of enhanced Medicaid, education and public safety funding over the subsequent 2½ years. The August jobs bill extended some funding through June, 2011, but that's where it ends. Although the Center on Budget and Policy Priorities estimates the combined fiscal 2012 budget deficit at \$140B is less than the 2010 peak, it will be the largest deficit states have faced on their own which means more difficult choices are on the way.

Compounding the deficit problem is the underfunded status of most public pensions (see table on page 2). The most recent available information shows plan funding levels dropped to 80% in June 2009 from 85% the prior year according to the National Association of State Retirement Administrators. These lower funding levels coupled with an industry-wide move toward lower investment return assumptions means that the annual required contributions for many plans is rising despite the economic downturn.

It is important to note that underfunded pensions typically represent problems in the future, not problems today. In fact, most plans have time to make up the difference in some way. Many entities have taken significant steps to address pension shortfalls, including reducing benefits and increasing employee contributions, and many more will consider changes in the next fiscal year.

The Political Challenge of Addressing Current Municipal Deficits

Unlike the federal government, virtually all states are required to balance their budgets every year or biennium. At least 46 states have already addressed deficits through significant spending cuts that affect all major areas of state spending: healthcare, services to the elderly and disabled, K-12 education and higher education. States have tried to mitigate these painful cuts by raising taxes and draining budget reserves, but there is more work to do and the political environment has changed.

The influx of Republicans into federal and local government has changed the tenor of discussions regarding additional federal support of state (and thus local) budgets. Although Democrats were able to extend the Bush-era tax cuts, Republicans and especially Tea Party members have indicated reluctance to further increase the federal deficit. If their resolve continues, states will be forced to implement further spending cuts and tax increases which could further slow the economic recovery underway.

While this political shift has heightened concern that a federal bailout is not available for needy states, Wells Fargo Securities notes that a bailout has never been a realistic option. A feature of our federal system is that money regularly moves between the various levels of government to meet the shared responsibilities of programs like unemployment insurance. States often borrow from the federal government but those loans are expected to be repaid, and it is highly unlikely that the traditional borrowing function would be circumvented to relieve states of obligations.

Investors find California's budget situation of particular interest to the default discussion. Since shifting the financing for many services and education from property tax to the more volatile income and sales tax base in 1978, California has run deficits in 58% of subsequent years. Budget adoption prior to the most recent election required a supermajority vote of the legislature (it has now been changed to a simple majority), so observers have raised concerns that a negotiation stalemate could result in default. Standard & Poor's analysis reveals that the high priority of debt payments in California's budget would require revenues to fall 45% (annualized) to place material pressure on its ability to meet debt payments. That level of decline would be roughly 2.5 times the average deterioration of state revenues during the Great Depression, and thus unlikely.

The Deficit Challenge Should Not Become a Default Crisis

Municipal bonds significantly underperformed Treasuries in the fourth quarter of 2010 as supply increased and investors became increasingly concerned about credit quality in the municipal market. While investors are wise to investigate the potential for deteriorating fundamentals of the state, county and local issuers in their portfolios, there are many reasons to think fears are overblown and to seek opportunities in municipal bonds.

1. Municipal defaults are rare, especially when compared with corporate defaults. Moody's Investors Service found the average five year annual default rate of investment grade municipal debt from 1970 through 2009 was only 0.03%, compared with 0.97% for corporate issues. In addition, average recovery rates on municipal debt are substantially higher than corporate debt.
2. Municipal bankruptcy is not always an option. There is no legal provision for states to declare bankruptcy, and municipalities in many other states can file only under circumstances that normally end in state intervention rather than bankruptcy.

Changes Made to Public Pension Plans in 2010

Reduced Benefits	Increased Employee Contributions	Both
<i>Arizona</i>	<i>Louisiana</i>	<i>Colorado</i>
<i>California</i>	<i>Wyoming</i>	<i>Iowa</i>
<i>Illinois</i>		<i>Minnesota</i>
<i>Maryland</i>		<i>Mississippi</i>
<i>Michigan</i>		<i>Missouri</i>
<i>New Jersey</i>		<i>Vermont</i>
<i>New Mexico</i>		<i>Virginia</i>
<i>Rhode Island</i>		
<i>South Dakota</i>		
<i>Utah</i>		

Source: Pew Center on the States

3. Defaulting on municipal debt may not significantly improve an issuer's budget situation. Debt service accounts for less than 5% of most state expenditures and less than 10% of most local expenditures. These debt burdens are relatively small compared to the tax bases supporting the debt, and debt service costs are typically spread out evenly over time such that few issuers face large refinancing needs in any given year.

Municipal Bond Opportunities

Municipal budget woes will continue to make headlines and some marginal issuers may default on payments for marginal projects issued during the heyday of surpluses. However, municipal bond investment strategies focused on high quality issuers in a well-diversified portfolio should fare well.

Essential purpose revenue bonds look especially attractive in difficult budget environments as even troubled households are likely to stay current on water, sewer and electric bills. These bonds typically generate revenue streams that are dedicated to repaying the debt and may offer higher yields than general obligation bonds which are supported by taxing authority. General obligation bonds of high quality issuers with strong, stable tax bases are also attractive as they have cushion to raise taxes to meet budget shortfalls. The potential for federal and state tax rates to rise as government deals with a slow-growing economy also makes tax-exempt municipal bonds attractive.

Miles Capital manages over \$870 million in municipal bonds for clients. The Municipal Income strategy provides clients with high quality tax-exempt income from a laddered portfolio with a maximum maturity of ten years. The strategy targets issuers with ratings of AA or better, and limits exposures to individual states and issuers to diversify the sources of risk in client portfolios.

For more information, contact:

David Jackson
djackson@miles-capital.com
515.226.7014
800.343.7084

Jake Anonson
janonson@miles-capital.com
515.224.2709
800.343.7084