

Municipal Bombs: The Parlous State of State/Local Governments

With Federal Government debt generating such low returns, many investors have embraced the purchase of municipal debt. Such debt often has a higher interest rate made higher still by potential tax-exemption if properly issued and purchased by qualified citizens.

What many investors are doing is making the same mistakes made by investors in the debts of Enron, WorldCom and Lehman Brothers bonds. They are letting their choices be dictated by yields and bond ratings. The reality is that while much has been said about the state of US Government finances, state ledgers are under as much pressure with one additional factor. The Federal Government can print money and does not need to balance its books. State governments cannot issue currency and need to come up with a way to make income equal outgo.

Most state governments operate chiefly on some combination of property, sales and income taxes. Property taxes are a function of real estate values. When they go down tax collections follow. Sales and income taxes track the economy. Thus states have seen their revenues decline across the board as real estate deflation makes the normal business cycle that much more severe.

On the other hand state services such as state pensions, unemployment payments, schools, roads, etc. are sensitive to cycles that are at a minimum counter to the economy or even disconnected from the economic cycle. Schools are a function of demographics and population. Pensions are a function of prior promises and the current number of retirees. Unemployment payments go up when the economy goes down.

Most states set up “rainy day” funds to address the counter-cyclical nature of their spending in recessions. The problem this time is that real estate’s decline has made the decline in state revenues more severe than normal. In addition, the underfunding for pensions makes their amount grow regardless of the economy.

One factor investors tend to overlook is that the SEC, the agency that polices financial reporting of the private sector, has no jurisdiction over municipalities. Thus there is no uniform accounting of municipal finance and no easy way to compare municipalities to each other. Thus one state may set aside funds to meet pension payments while another indulges in “pay as you go” accounting.

There are two broad types of municipal debt. The first is the so-called “general obligation” debt, backed by the taxing powers of the municipality. The second type is “revenue” debt which is backed by the income from the associated government entity. For example if a revenue bond was backed by a toll road and the road did not get sufficient use the bond could default. The state would not be obligated to make the bond good. A general-obligation bond, on the other hand, could in theory call for the municipal government to raise taxes to whatever level necessary to make the bond whole. Generally the general-obligation debt has a higher rating and lower interest rate than a revenue-backed debt.

However, if a municipality were to default it would be the general-obligation debt that would stop paying. The revenue debt would not be directly affected unless the economic circumstances adversely affected the income of the associated venture. The point of this illustration is to show that municipal debt is not the panacea that some investors and brokers make it out to be.

The health of these and all bonds is driven more by the circumstances and management skills of the issuer and less by the bond rating. Unfortunately municipal managements typically do not have the restructuring skills or flexibility of the private sector. For example, a municipality cannot reduce its pension liability by filing for reorganization like a private entity can. It can reduce the amount owed municipal bond investors.

Since this recovery is not expected to be consumer-driven, the participation of state and local governments will be more muted than in the past. While the travails of such states as California are well known, there are any number of states whose finances differ only by degree. Many states are looking to the Federal Government to throw them a lifeline and underwrite their obligations. Countering this is the demand that the Federal Government reduce its own deficit. It appears that either taxes will go up, services will be reduced, or some municipalities will take a trip to the bankruptcy court. The third option is the one muni investors need fear most.

The Economy

Economic activity was strong in the fourth quarter of this past year. More moderate economic growth is expected for 2010.

A growth rate of 5.6 percent in late 2009 should be closer to 2.5 percent in 2010. Much of the growth in late 2009 came from businesses restocking their shelves after letting inventories get too low. There are also the comparisons to a year ago when the economy was in free-fall.

In 2010 it is expected that growth will continue at a more moderate pace. Consumer demand will not provide the leadership of past recoveries. Instead exports and business investment will be the chief drivers. Those companies that serve international markets will be better positioned than those whose orientation is primarily domestic.

Interest Rates

The Federal Reserve has strongly hinted that its program to support low interest rates by buying securities on the open market will begin to wind down in March. The net effect will be to make some interest rates higher such as mortgage rates.

It would seem that the Government is laying the groundwork to bump up interest rates before the year is out. How much of an increase will depend on the state of the economy but it looks like money market fund rates of 1-2 percent by year-end will be in the cards.

Inflation

Inflation has received a setback with the stronger dollar sending commodity prices lower. Until wage pressure exerts itself inflation is not believed to be a material factor going forward. This will probably not happen until sometime after the economy rebounds. Discussing inflation without the presence of wage pressure is like discussing the potential of a hurricane without the presence of wind.

The Stock Market

The stock market, which rose almost 70 percent since its March 2009 lows, is now in a holding pattern waiting for additional validation before moving higher.

This is not unusual. In a market upturn there is often a first stage driven by cheap money and a relief that things are not as bad as the pessimists forecast. The second stage is driven by profit growth from increasing revenues.

The first stage tends to be a broad advance while the second stage becomes more selective. Many of the industries that tend to do well in the second stage will be absent this time around due to the reduction in the growth of consumer borrowing. Corporations by contrast are in the best financial shape in 50 years. Foreign consumers as a group have less debt and more spending power.

Warren M. Barnett, CFA
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Jonathan Emanuel Joins the Firm

We are pleased to announce the appointment of Jonathan Emanuel to Barnett & Company in the capacity of Portfolio Manager.

Jonathan served as a pilot in the US Air Force before joining the financial industry. We are pleased to have him as an important addition to the firm.

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