After a Weak Week; Where Are We? 11/15/10

In the past two decades, historically, the municipal market has witnessed at least one disturbance per year. In 2010, that time is now.

Weekend Articles in NY Times and Wall Street Journal Entitled "Muni Bond Market Shudders" and "Credit Fears, QE2, Elections Prompt Muni Selloff"

- The media's weekend frenzy of bad news contained much "misinformation," and the items that they got right were well known by professional investors, and already built into current market prices.
- Many of the articles suggested that credit fears were largely responsible for last week's decline in municipal bond prices.
- While credit concerns are relevant in a weak economic recovery following a severe recession, they are not new.
- ***The real reason for the surge in yields and ugly week…*** was price weakness in the US Treasury market, which spilled over to other fixed income sectors, combined with a high level of new-issue municipal supply that overwhelmed the tax-exempt market.
- ***This happens almost every fall season….***to some degree or another, and persists during the fourth quarter through mid-December, as traditionally there is a rush to issue new municipal bonds prior to the upcoming holiday season. This seasonal or technical spike in new issue supply typically reverses itself during the first quarter of the subsequent year, resulting in an ensuing bias or return to higher bond prices, notwithstanding other fundamental factors.
- Does this mean that credit concerns are exaggerated? No.
- We have never shrugged from our ***responsibility to tell it like it is. This is especially relevant in the new post election environment.***

Post Election: New Uniforms, New Team, But Game Is Unchanged
The result of this mid-year election is essentially unprecedented. Republican gains in Congress are well publicized. On the grass roots level, the GOP gained approximately 700 seats in the various state legislative houses, and a majority (29) of governorships. Republican state legislators are at the highest levels since just prior to the Great Depression 80 years ago.

Tax increases on the federal and state levels are an anathema, as an anemic economic recovery follows on the heels of the worst US recession since 1929. This is especially relevant, as in fiscal year 2009 more than half of the states raised taxes to the tune of $28 billion, while recurring deficits remain to be resolved.

The challenge remains how to address state and local fiscal ills with tax increases off the board, and with the demise of the federal stimulus program which transferred billions to the state and municipal governments during the course of the recession.

Expenditure reductions should not prove to be a total panacea. Shortfalls of $500 billion have already been addressed by states since the start of the recession, the majority of which consisted of spending cuts and deferrals. Additional cuts will be right to the bone, and could subtract from short-term economic growth prospects.

Looking Ahead

- Elements do not appear to be in place for interest rates to sustain elevated levels.
- Considering the weak economic backdrop, spikes in Treasury bond yields do not appear sustainable as the Federal Reserve is scheduled to purchase roughly two-thirds of the Treasury's overall debt issuance over the next 12 months.
- There will be "headline risk" for many major bond issuers going forward.
- The pace of credit downgrades will accelerate in 2011. Approximately a dozen states have negative credit outlooks.
- Defaults are not an issue at the state level. But we perceive there to be little value in investment in weak states in a low interest rate environment.
- Local governments will continue to be stressed as states have the ability to "download" pressures.

At RSW

- Given the current and anticipated supply-to-demand imbalance, it seems likely that the municipal market will continue to experience further price pressure into mid-December.
- Since we think this price pressure is temporary in nature, we would view this yield increase as an opportunity to extend our average maturity and call structure, to capitalize on the higher rates.
- ***We distinguish*** between issuers that have longer term structural imbalances, and those credits that have better prospects for recovery and fiscal integrity.
- ***We remain vigilant*** *as the expiration of the federal stimulus program, the lack of any appetite for tax increases, and the still $140 billion of shortfalls that states are confronting for the next fiscal year, approximately 20% of spending,* ***demand that we keep our pencil sharp.***

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