



Municipal Defaults Rates: The Untold Story

We have been working on our 2009 commentary (to be released next week), with one section slated to deal with the increase in credit risk in all markets. However, now that Bloomberg has released an article quantifying the rising cost of default insurance (the amount an investor will pay to insure against a particular issuer's default), it seems timely to offer our views on credit risk today.

It is now fashionable to talk about the Great Depression and the resultant escalation of municipal defaults that will occur. With lightning speed, the market is trying to price-in this perceived risk and yes, this even includes U.S. Treasuries. For an example, please see the chart below which depicts an amount that an investor will pay for default insurance (expressed in basis points: 1/100th of 1%). The greatest untold story is that traders are not only betting that states will miss their coupon payments but that the U.S. Government will as well. This is shown below by the 400% increase in insurance premium that investors / speculators are willing to pay.

10-Year CDS Spread Data

	<u>4/1/2008</u> <u>Spread</u>	<u>12/9/2008</u> <u>Spread</u>	<u>%</u> <u>Change</u>
U.S. Government 10-Year CDS	15	75	400%
California Municipal Market Index 10-Year CDS	70	289	313%

Source: Bloomberg, LP

While we do not seek to minimize this perceived risk, we merely find it more instructive to look at the actual occurrence of municipalities defaulting during the worst period in our nation's history, the Great Depression. The facts about the history of defaults during that unique period will astonish both layman and market pros. Professor Hempel of Washington University conducted a study analyzing municipal bond defaults during the period 1929 through 1937. A summary of those findings is as follows:

- 4,800 issues defaulted, representing 2.7% of all issuers
- Total debt involved was \$2.8 billion
- A large number of special assessment districts defaulted on their obligations

This brings us to the very essence of what we believe differentiates municipals from non-Treasury fixed income securities. The first is a lower default rate and the second is a higher "recovery rate." While defaults attract the headlines, the bondholder should be more concerned about the amount of principal and interest that is actually lost. Of the \$2.8 billion (mentioned above) bonds in default, only \$100 million or about 0.5% (50 basis points) of the average state and local debt outstanding during this historic period remained unpaid to bondholders. Using a modern example of a "headline" default we could examine the Orange County California crisis (1994). Here, bondholders recovered 100% of their principal and interest.

Understanding the sectors to avoid as much as the issuers credit rating has been a key determinant of the probability



of default. As we have often said: hospitals, nursing homes, regional airports, land secured deals, etc. is where the majority of the defaults have resided. We will continue to tread lightly in these segments going forward.

Bottom line: As the economic climate continues to weaken, spectacular headlines will become more commonplace (along with Depression references). Let us be mindful that Traders were very recently forecasting \$200 per barrel for oil, no recession (a soft landing), hyperinflation, credit derivatives helping to diversify risk, etc. The point here is that we are not trying to sound like “know it alls” but what we are saying is that Wall Street and investors price in a lot of events that just don’t occur.

Sincerely,

Robert S. Waas
Managing Member



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