Seeing Past the Headlines - June 8th, 2010

Warren Buffett, in various recent statements and public testimony, has made specific references that express his concern over the state of the municipal bond market. Specifically, Warren said "there will be a terrible problem and then the question becomes will the federal government help". Citing ballooning pension-benefit liabilities he generalized that this predicament will become a massive issue in "five or ten years from now".

As we at RSW have often said, there is no question that state and local government fiscal operations have been severely impacted by the worst economic downturn since the Great Depression. State tax collections in 2009 declined year-over-year by 11% - the worst on record. There is also no doubt that governmental obligations regarding pensions and other retirement health benefits are like a "Sword of Damocles" hanging over many issuers. With that said, municipal market investors should be wary of looking at the municipal market with a "broad brushed" doomsday scenario. While we do not make light of the global issues facing public finance, we do not envisage an "apocalypse now" or in five to ten years.

We agree with Buffett in his assessment that, if left unchecked, unfunded benefits can be ruinous to state finances. However, many states have already begun the process of altering their retirement benefits. Across the country there is a growing public and bipartisan recognition that the level of financial promises that have been made to retirees is not financially viable. New Jersey's governor Christie in his February 2010 declaration of a fiscal emergency cited an example of a 49 year-old retiree who contributed during his career $124,000 toward pension and health retirement benefits. His estimated retirement benefits over his projected lifetime total $3.8 million. New Jersey's future pension and health benefit obligations are estimated to be $ 90 billion. At least a dozen states have taken or are introducing significant reforms to reduce pension costs and future liabilities. These reforms are no longer "around the edge" but are being designed to fundamentally address the unsustainable growth in future liabilities that are one of the leading causes of budgetary structural imbalance.

States have enacted or will enact with the adoption of the fiscal 2011 budgets strong measures to reduce pension costs and future liabilities. Michigan and Alaska have closed pension plans and have moved to defined contribution plans. Utah has just closed its defined plan to new employees and implemented a hybrid alternative. Illinois has raised the retirement age for new hires from 62 to 67. Wyoming will join other states in no longer paying the full pension costs for state workers.

Excluding post retirement benefits, the projected budget shortfall for the states combined for fiscal year 2011 is $112 billion. Budgetary shortfalls persist as fiscal recovery lags a still weak economic recovery. In other words, the magnitude of the problem could be the equivalent of an "AIG squared". However, this is not an insurmountable situation, as the states are empowered with the ability to raise taxes and cut expenditures. While the federal stimulus program is set to expire, states are lobbying for an extension of the program. We suspect that if additional federal stimulus funds were approved than its application would be limited to specific programs and not be available as a substitute for state cash.

Summary and Conclusion

We are not trying to see the world or the municipal bond market for that matter through rose colored glasses. States have suffered a mild heart attack, however recovery is the prognosis. Greece, Portugal, and Spain provide a terrific road-map as to where not to go. Many U.S. citizens now understand the financial quagmire and are concerned about mushrooming deficits. This is where the process has to begin for solutions to occur.

It remains our opinion, that despite the economic weakness, budget gaps, pension shortfalls and expiring federal stimulus, that most municipal entities remain creditworthy. Prudent jurisdictions are more than aware of the environment and are addressing fiscal concerns. Issuers that either do not demonstrate the political wherewithal and that are hampered by structural imbalances are credits that should be avoided as the environment does not support investment in issuers that are banking on non-recurring actions including an uncertain extension of the federal stimulus program . As always, we continue to adhere to a rigid discipline with respect to our fundamental credit analysis.

Sincerely,

Robert S. Waas
Managing Member

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Supporting Facts for Consideration

Aggregate budget shortfalls that the states are confronting with the adoption of fiscal year 2011 budgets (for most states commencing 7/1/2010) are $112 billion, or 16.9% of fiscal year 2010 budgets.

- ◊ We note that most states are implementing budgets with combinations of budget cuts, select tax increases or revenue enhancements and reserve drawdowns that seek to maintain balanced budgets.
- ◊ Specific states and other municipal jurisdictions are confronting political impediments and structural imbalances that make fiscal discipline difficult to address. These credits while highly visible still remain the exceptions in a still challenging environment.

Pensions- The fiscal year 2011 state and local unfunded actuarial accrued liability for pensions is estimated to be $1 trillion as compared to $355 billion in 2005.

- ◊ While the number is large it should be noted that, on average, state and local funding ratios were still estimated to be a healthy 78% for 2009, declining from 84% in the previous year as a consequence of the declines in the equity market.
- ◊ It should also be noted that, on average, pension plans reported that a still healthy 82.5% of the ARCs (annual required contribution as defined by actuaries) were funded in 2009 as opposed to 86.4% in the previous year.

Federal Assistance- Mr. Buffet's comments infer that the creditworthiness of state and local governments will, in large part, depend on additional future federal support. We note that approximately 70% of federal capital spending consists of grants and loans for transportation and water and sewer spending. Additionally, in response to the recession the federal government provided $787 billion in additional federal stimulus funds to state and local governments. These amounts include approximately $140 billion in state funds for Medicaid and fiscal stabilization- or between 30 and 40% of state budgetary shortfalls.

- ◊ The federal stimulus funding is set to expire by December 2010.

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