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Municipal Bond Market Update

Commonwealth Bank & Trust Company

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Our investment team meets regularly to review the cyclical (shorter-term) and secular (longer-term) outlook for the municipal bond market and other asset classes. Given the recent media attention on the many challenges facing the municipal (muni) markets we wanted to share our thoughts on the current conditions and outlook for those markets.

In general, investment-grade municipal bonds have played an important role in our taxable clients' fixed-income allocations, leading us to always consider the tax implications of investment decisions made on our clients' behalf. However, tax-exempt income alone is not a reason to invest. Default rates for all municipal bonds have averaged 0.01% annually since 1970 (versus 1.57% for all corporate bonds), according to Moody's, and over the same time period, the depth and breadth of state and local debt has grown. That has given us and other active managers a larger universe of investment-grade securities to choose from and (in our opinion) more opportunities to produce higher total returns.

That being said, risks have clearly increased. The percentage of muni bonds currently backed by insurers has dropped from about 50% to 10%; some bond insurance companies like Ambac and MBIA forayed into businesses like mortgage-backed securities insurance and have struggled to stay afloat following the housing meltdown. State and local municipalities face budget shortfalls brought about by the economic downturn and longer-term structural challenges due to unfunded pension and health care liabilities. A PIMCO study conducted in late 2008 reviewed U.S. municipal defaults as far back as the early nineteenth century and it found default rates ranging from 1.4% to 7.3% during economic depressions. While the contributors to the rising default rates varied across time periods, there were some familiar-sounding developments mentioned: large increases in debt, real estate booms, and the collapse of many banks.

All of that has led to our concern that defaults in the investment-grade muni bond market will increase above their historical average rate in the years ahead. While there is still debate about whether the U.S. economic recovery will sustain itself or undergo a "double dip," there is little debate about the health of the states. In fiscal 2009, states saw a 16.9% drop in corporate income tax collections, an 11.2% decrease in personal income tax receipts, and a 6.2% decline in sales tax revenue, according to a report by the National Governors Association and the National Association of State Budget Officers. Despite enacting almost $32 billion in tax, fee, and other revenue increases in 2010, additional declines of 5.8%, 2.8%, and 1% in corporate, personal, and sales tax receipts, respectively, are estimated for fiscal 2010. Overall, that amounts to an almost 12% decline in states' general fund revenue from 2008 to 2010.

Moreover, even if the U.S. economy avoids a double dip and sustains its recovery, an improvement in state and municipal budgets can lag overall economic improvement by years. State spending needed three years to recover following the nine-month downturn of 2001, according to the report cited above. And while sales and income taxes reflect economic volatility pretty quickly, property

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tax receipts generally exhibit a two-year lag versus changes in property values due to the time it takes for assessed valuations to change. That will have ongoing consequences for municipalities in states with large property-value declines like Florida, Arizona, Nevada, and California.

However, we do not anticipate wide-spread defaults at the state level (general obligation debt) for several reasons:

- Most state constitutions protect GO debt holders above all other claims and states do not have the option of filing for Chapter 9 bankruptcy
- Debt service on GO bonds as a percentage of revenues is generally in the single digits so defaulting on payments does not have the benefit of producing much savings relative to cuts in education, prisons, or health and human services programs
- It does not serve the issuers' interests. Defaulting or delaying payment on GO debt ultimately damages credibility and raises an issuer's cost of borrowing, the last thing an issuer needs when funds are tight.
- The underlying trend of economic growth and state revenues has improved off a low base

Although we don't expect widespread defaults will occur, general price risk (higher yields) remains that could impact the entire market. Any risk of a ratings downgrade to GO debt may cause investors to sell in favor of higher-quality bonds, increasing the risk premium. Generally, however, a ratings downgrade is usually reflected in bonds' pricing well before the actual downgrade occurs and we think we are capable of navigating this type of risk.

In terms of revenue bonds, the risk of default is much more dependent on how the state of the economy directly impacts the individual issuer and the health of the revenue stream backing the bond. Unfortunately, because of the idiosyncratic nature of this market and the wide variety of issuers and backing we believe that there is increased risk of default. But while revenue bonds will continue to present credit risk, we do not see as much potential here for contagion risk. It will be hard to make comparative assumptions across issuers given all the differences among them. That said, it is an environment that requires more time spent looking "under the hood" at various revenue bond allocations and we anticipate that will continue to be the case going forward.

Unfunded Pension and Helath Care Liabilities Are Structural Issues That Will Have a Longer-Term Impact on State Spending

The near-term budget woes cited above are cyclical problems brought about by economic weakness. But states and municipalities also face longer-term structural issues due to huge, looming unfunded pension and health care liabilities. A well-publicized report earlier this year from the Pew Center on the States estimated a $1 trillion funding gap between the $3.4 trillion pension and health care obligations of the states and the funds on hand to pay for them in mid-2008. Because the report did not include the severe investment declines experienced in late 2008, that calculation

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was likely optimistic. The University of Chicago's Robert Novy-Marx and Northwestern University's Joshua Rauh estimate a higher range of $1.3 trillion to $3.3 trillion in underfunding. They note that state funds use a long-term annual investment return of 8% to calculate the present value of future payments, a rate that may dramatically overestimate the funds' actual investment outcomes.

There's no question that unfunded pension and health care liabilities will impact state spending priorities going forward and there will be an increasing tug-of-war between civil servants wanting to protect their retirement benefits and the taxpayers called upon to finance those benefits. Solutions to deal with the problem include tax hikes, benefit cuts, a movement toward defined contribution rather than defined benefit plans, and the issuance of taxable pension obligation bonds. None of these solutions, however, should threaten debt service on GO bonds. In most states, these remain first claim on a state's general fund revenues (and relative to other state spending, a small claim in percentage terms). American Century's director of municipal research David Moore believes general obligation debt would even be honored above pension benefits in a situation where a pension fund ran out of money. "Pension benefits are a strong contractual obligation," he notes. "But a GO bond is a full faith and credit pledge in which the state irrevocably pledges its taxing power."

The poster children for this kind of test will most likely be Illinois and New Jersey, according to DWS's Flynn. But while the two states debate the appropriate level of current contributions to their pension funds, a number of years remain before their pension expenses reach a truly significant level. Flynn says the earliest estimates she has seen are for 2017 or 2018.

The impact for muni bond investors in the near-term will most likely be felt via ratings because states' actions to address underfunding in the coming years will determine how far state bond ratings can sink. Illinois' cumulative underfunding of pensions rose to $19.2 billion at the end of fiscal 2008, up 59% from $12 billion three years earlier. That was a significant factor in the state's April 2009 ratings downgrade. More recently, Moody's revised the outlook on New Jersey GO debt from stable to negative due to mounting pension obligation pressures. The state's funded ratio for pensions fell from 101% in 2002 to 70% in June 2008. (State pension systems have averaged funded ratios of about 85% in recent years.)

Yet positive outcomes are also possible: Moody's cites San Francisco's well-funded employee retirement system as one of the key strengths supporting its strong rating. And in August 2009, Moody's revised the outlook for West Virginia from stable to positive after the state increased its overall funding level on five retirement systems to 80%. The state had been one of the lowest funded states in the nation for years.

Conclusion

The more we dig into the fiscal problems facing many muni bond issuers, the more potential pitfalls we see for investors. We don't disagree with media commentators and traders who say that we are

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likely to see an increase in default rates and headline risk going forward. That said, we believe we have the ability and experience to navigate those risks. Here are some of the things we are doing and will continue to focus on in this environment:

Watching Kentucky fundamentals closely – Due to KY's tax on out-of-state municipals, most of our KY residents prefer a diversified in-state portfolio. We continue to believe we can get adequate diversification within the state, but our opinion could change on deteriorating fundamentals. Note that KY does not issue state-level GO's and relies mostly on appropriation based debt.

- We remain confident that a default on appropriation-based debt (Aa2/Aa3, A+ & AA-) is unlikely. Most important would be the ramification of future borrowing costs.
- We are comfortable with the credits of our school district enhancement (KSDE) and public university intercept programs (Aa2). Education tends to be a priority politically.
- Portfolios can be anchored with these credits and then diversified with county & city general obligations (GO's), utility revenues such as water, sewer & electric (essential services) and a few positions within healthcare.

Knowing and understanding the underlying security and source of payments will be important. Reading the official statements, rating agency reports and financial disclosures can provide helpful insights both positive and negative. For instance, a red flag we look for is low or declining debt coverage ratios. A positive example would be pledged collateral such as a building which is not the norm for municipal credits.

Overall, we are keeping portfolios in the higher rated tiers and focusing on GO's when possible. For example, most of our portfolios end up being AA-rated in aggregate. We do our homework on each bond and do not solely rely on the rating agencies and/or third-party insurance providers. For example, viable AA-rated municipal insurers still exist, but the underlying rating or lack thereof is what is important.

For our most conservative clients, we do focus on the escrowed-to-maturity (ETM) or pre-refunded marketplace. This is where a municipality has refinanced prior debt and purchased collateral, usually U.S. Treasuries, which will create the cash flows necessary to mature the bonds. For a given maturity however, ETM bonds tend to be the lowest yields, as one would expect. This is one consideration in purchasing within the secondary market. How likely is an issue to be refunded? How much could the price appreciate if it is refunded? If you have any questions on the above or would like to discuss your portfolio please give us a call.

—CB&T Investment Team (1/11)