AllianceBernstein

How Safe Are Municipal Bonds Today?

Summary

- Reports about the poor financial condition of state and local governments make the headlines every day, but municipalities continue to take prudent action, including cutting expenses and raising taxes, to balance their budgets
- State governments are facing particularly difficult situations because of their dependence on economically sensitive tax revenues for the bulk of their budgets; revenues are likely to stabilize and begin to grow when recovery takes hold
- Our analysis points to selective credit rating downgrades rather than a meaningful increase in defaults

States Are Facing Financial Pressures

Although we are starting to see the first signs of economic recovery, bond investors continue to be bombarded by reports in the media about the poor financial condition of state and local governments. Some forecast the near-collapse of municipalities weakened by low tax collections and unsustainable cost structures due to overly generous retirement and health benefits. However, our analysis shows the municipal market should not collapse under the weight of these shortfalls, and we don't even foresee a significant increase in municipal bond defaults.

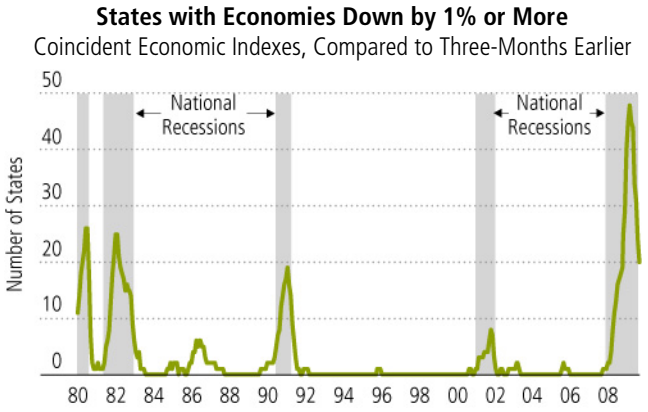
There is no question that these are difficult financial times for states and their local governments, and that financial pressures are likely to persist for some time. According to the Center on Budget and Policy Priorities, state governments closed a combined budget gap of $178 billion in fiscal year 2010 and are likely to face another gap of $180 billion in fiscal year 2011. These gaps clearly reflect declining state economies. But the economies of most states have historically declined during national recessions and grown in times of plenty. Today the number of states with economies that have declined by more than 1% over the past three months has dropped sharply, and we believe the worst is over (*Display 1*).

Furthermore, municipal bonds remain highly rated because the vast majority of municipalities have a long history of taking the necessary steps to balance their budgets and pay their debt service, even in hard economic times. They are once again doing this: making difficult choices and relying on the traditional tools of tax and fee increases, spending cuts, and drawing down reserves. They have also been helped by a substantial flow of federal stimulus funds, which will continue through the first quarter of 2011.

Elected officials make these difficult choices because most municipal governments must pass balanced budgets: Forty-nine of the 50 states require this. But, like making sausage, the process by which state legislatures reach political consensus and adopt balanced budgets is not a pretty sight.

Display 1

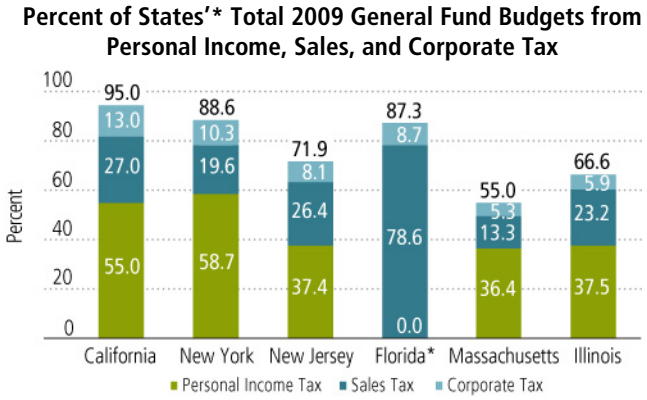
State economies decline during recessions



Historical analysis does not guarantee future results.
As of September 30, 2009
Source: Federal Reserve Bank of Philadelphia, National Bureau of Economic Research, and AllianceBernstein

Display 2

State budgets are dependent on economically sensitive tax revenues



Historical analysis does not guarantee future results.
*States shown have the greatest debt outstanding. Florida has no personal income tax.
Source: State budgets, Moody's 2009 State Debt Medians Report, July 2009, and AllianceBernstein

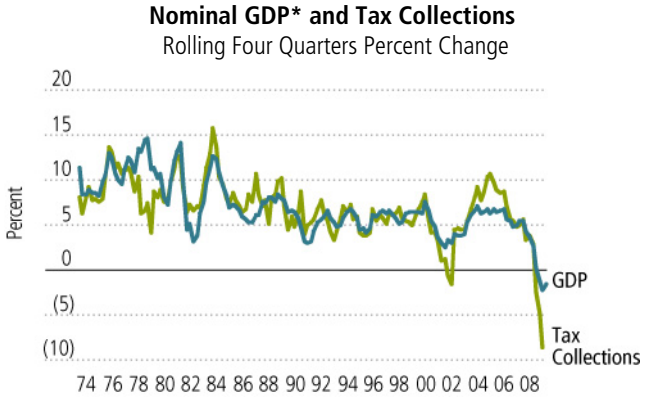
Economically Sensitive Revenues

Not surprisingly, state governments are facing particularly difficult situations today because of their dependence on economically sensitive tax revenues for the bulk of their budgets (*Display 2*).

In fact, for the largest states, personal income, sales, and corporate income taxes constitute a minimum of two-thirds of their tax revenues. But just as the revenues from these sources shrank as the economy contracted, they are likely to stabilize and begin to grow when recovery takes hold. As *Display 3* shows, historically, changes in tax receipts reflect economic growth or retrenchment. Thus, every downturn results in weak state tax revenue performance, and every upturn results in stronger performance. During each such period, governments have ultimately responded with balanced budgets.

Display 3

Tax receipts reflect economic growth



Historical analysis does not guarantee future results.
As of September 30, 2009
*Nominal GDP is gross domestic product not adjusted for inflation.
Source: Bureau of Economic Analysis, All Tax Receipts

And while the most skeptical critics claim that municipalities will stop paying their debt, that simply doesn't make sense: Governments need to safeguard their continued access to capital to operate. If they failed to pay bondholders they would be shut out of the credit markets or would pay a substantial penalty in the cost of capital. In addition, debt service is a small part of most budgets.

Actions to Solve Fiscal Difficulties

Although the economy has stabilized since mid-summer and we should begin to see improvements in state tax revenues, financial challenges remain for state and local governments. Let's look at a few typical examples of what states are doing now.

California has faced extreme pressures in the last two years—partly because the percentage of its tax revenues that is economically sensitive is higher than other large states', and partly because any potential solutions are hampered by the two-thirds majority required before the legislature can approve a tax increase or pass a budget. As it confronted delays in achieving a balanced budget, the state issued IOUs to conserve cash, thereby ensuring that it had the resources to meet its two highest constitutional priorities—education and repayment of its general obligation debt. State officials made sure debt service was paid not only because it was a legal requirement but also for the more pragmatic reason of maintaining a default-free record and thereby ensuring financing for the construction of roads, bridges, schools, and other critical infrastructure. Debt service makes up

7% of California's fiscal year 2010 budget, which we view as quite manageable.

The state's Legislative Analyst's Office has recently released a new gap figure totaling $21 billion for the remainder of the 2010 fiscal year and the 2011 fiscal year. This was not due to the continued decline in tax revenue collections, but to the realization that some of the state's earlier planned actions to close its budget gaps were not realistic. Once again, we expect a round of difficult budget negotiations, including wrangling over tax increases and spending cuts, but ultimately a budget resolution will be reached.

New York State's enacted budget eliminated an $18.5 billion gap for fiscal year 2010 by relying on similar sorts of measures, including federal stimulus funds and a temporary income tax increase. To address the newly opened multibillion-dollar budget gap for the remainder of this fiscal year and next, the state is attempting to reduce spending growth, but will have to take additional measures. The state is also advancing some of next year's federal aid into this fiscal year, which will exacerbate next year's budget gap.

Virginia, a state known for its strong and conservative financial management, was not immune to slowing revenues. However, it responded by cutting education aid, laying off staff, closing facilities, and partially drawing down its fiscal stabilization fund.

Nevada, one of the epicenters of the ruptured housing bubble, has seen its sales-tax- and gaming-tax-dependent budget weaken considerably. The state responded by implementing across-the-board cuts, including employee furloughs, as well as selective tax and fee increases; it still has a 5% budget reserve available.

Mounting pension and healthcare costs are often cited as a significant factor that will lead to the so-called financial collapse of states and municipalities, but there is no evidence to that effect. For most, pension expenses remain a very moderate burden on their budgets. Among the largest state bond issuers, pension expenses range from a high of 10% of budgets to a low of 1% (for fiscal year 2008).[1] Municipalities have seen their pension fund levels drop before in previous weak economic and investment markets, but they have the ability to stretch out the required contributions over a multiyear period to restore the health of their pensions. And recent improved investment performance should mitigate some of the pressures in this area. In our view, the pension issue is a far greater challenge for the long term than it is for the short term.

A Municipal Bankruptcy Is Different

There are almost 90,000 units of local government in the United States. Experience suggests the vast majority will respond to current fiscal pressures in a prudent way and on a timely basis. Nevertheless, given the severity of the recent recession, some will likely falter. Even so, filing for Chapter 9 bankruptcy protection is not an easy route for municipalities to take. States are not permitted to file, and many states do not allow their municipalities to do so. Even Vallejo, California, the most recent example of a large community filing for bankruptcy protection, has not sought to repudiate its debt; it recognizes its need to have future market access. A more typical route for a distressed community is to be placed under state control, with debt service payment continuing to be a high priority.

In our view, state and local governments will almost universally weather this sharp recession and continue to pay debt service on their general obligation (GO) bonds, which are backed by their full faith and credit. However, it is important to note that debt backed by a general obligation pledge makes up only a quarter of the municipal bond market. So the range of municipal securities available to investors is far broader than GOs and includes many that are secured not by weakened tax pledges but by other, more stable forms of revenues—revenues derived

[1] Estimates are based on the Comprehensive Annual Financial Reports from the 10 largest states by debt issuance.

from essential municipal enterprises such as water systems, sewer systems, electric utilities, and airports. These have continued to generate levels of revenues that not only provide for both ongoing system operation and maintenance but also provide more than adequate coverage of debt service.

No Meaningful Increase in Defaults

Anyone who closely follows municipal governments and their finances fully expected tax-supported bonds to register the impact of this deep recession. However, we see selective credit rating downgrades rather than a meaningful increase in defaults, particularly for the larger. ■

A Word About Risk

Municipal Market Risk: Debt securities issued by state or local governments may be subject to special political, legal, economic and market factors that can have a significant effect on the portfolio's yield or value.

Interest Rate Risk: Fixed-income securities may lose value if interest rates rise or fall—long-term securities tend to rise and fall more than short-term securities.

Credit Risk: A bond's credit rating reflects the issuer's ability to make timely payments of interest or principal—the lower the rating, the higher the risk of default. If the issuer's financial strength deteriorates, the issuer's rating may be lowered and the bond's value may decline.

Inflation Risk: Prices for goods and services tend to rise over time, which may erode the purchasing power of investments.

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