CREDIT MARKETS

Pension Payments in Stockton Case Could Have Ramifications in Muni Market

As we reported in the April 2013 APA commentary, a California Judge has granted permission to the City of Stockton to remain under court ordered Chapter 9 bankruptcy protection. As part of the bankruptcy protection, Stockton has begun working on a restructuring plan for its various debt obligations. The California Public Employees Retirement System (CalPERS) has raised questions regarding what constitutes a debt obligation in Chapter 9. Stockton is arguing that CalPERS is a creditor and therefore the City may reduce or suspend payments while working through its bankruptcy. CalPERS argues that the California State Constitution and various court rulings forbid any state or local government from being able to lower the pensions or payments to retirees or current employees once they are enrolled in CalPERS. Additionally, CalPERS argues that federal bankruptcy law, which allows a judge to end contracts, should trump state law. City officials have stated that they do not intend to reduce pension benefits, but they have reduced health benefits for retirees. The California State Supreme Court will decide the issue in the next few months, with many legal analysts believing the Stockton case may end up in the U.S. Supreme Court. Should the Courts rule in favor of CalPERS, this would be unprecedented as in recent Chapter 9 cases courts have forced cuts to pensioners while honoring payments to bond holders.

In yet another California city bankruptcy, San Bernardino is in state court arguing that its CalPERS obligations should be treated as debt and therefore the city should be allowed to make reduced payments to CalPERS in the same way they may be able to force haircuts to bondholders and other stakeholders. A judge has yet to rule on the petition. In January 2013, the Florida Supreme Court ruled that public employees' pension contracts can be adjusted. In that case, the Florida Education Association had sued the state arguing that required contributions to the pension system equated to a pay cut and thus should be subject to negotiations as part of the Association's collective bargaining agreements. The court ruled that any restriction on the state's pension structure by subjecting contributions to labor negotiations could lead to fiscal irresponsibility. In August 2011, the city of Central Falls, R.I. declared bankruptcy after failing to renegotiate various pension and labor contracts

that would have prevented insolvency. The city then filed for bankruptcy and went to court to reduce the amount owed on its various debt, eventually reducing its pension obligations by 55%. Both cases illustrate that legal precedent provided state and local governments the right to modify any obligations during bankruptcy.

Chapter 9 Bankruptcy: How Common?

The three California bankruptcies last summer leads to the question of how common a bankruptcy filing is by municipalities. Currently, municipalities can file for Chapter 9 bankruptcy protection under the federal bankruptcy code. However, states cannot file for bankruptcy. According to the Pew Charitable Trusts, a municipality is legally eligible for Chapter 9 bankruptcy if it is:

- Insolvent.
- Has made a good-faith attempt at negotiating a settlement with its creditors.
- Is willing to devise a plan to resolve its debts.

Additionally, municipalities must also have permission to file for Chapter 9 from their state governments. Currently, only 15 states have specific laws granting their respective municipalities the legal right to file for bankruptcy. They are Alabama, Arizona, Arkansas, California, Idaho, Kentucky, Minnesota, Missouri, Montana, Nebraska, New York, Oklahoma, South Carolina, Texas and Washington. The remaining states required some sort of state oversight in the bankruptcy process, with only the State of Georgia not allowing a municipality the legal right to file. Filing for bankruptcy by a municipality still remains a rare occurrence. The Pew Charitable Trusts reports that since 1937, when Congress added Chapter 9 to the federal bankruptcy code, approximately 620 municipalities have filed for protection. In comparison, there were 12,000 corporate bankruptcy filings in 2012.

A Chapter 9 filing can have short term advantages by giving a municipality a reprieve from creditors and the ability to renegotiate its collective bargaining agreements. But it often has long term ramifications as well. Vallejo, California, filed for Chapter 9 in May 2008 and spent three and a half years in legal proceedings. The City has not been able to issue any municipal debt since filing Chapter 9 due to lack of market access. After emerging from bankruptcy the City still faces a structural deficit of $3.8 million in its 2012 budget. Furthermore, the city reports it has been unable to maintain its infrastructure and has reduced its police and fire protection personnel by half. This is an example as to why APA believes municipalities will use Chapter 9 only as a last resort.

Past performance is not indicative of future results. Please see attached disclosures.
www.assetpreservationadvisors.com

Defaults and Downgrade Trends

Despite predictions of "Armageddon" and "hundreds of billions of defaults", the actual number of Municipal defaults and downgrades reported from January through April 2013 remained at historic levels. Municipal Market Advisors (MMA) reports that through April, there have been a total of 19 muni issuers reported to have defaulted with a total outstanding debt of $4.97B. According to MMA, this is down from the 22 first time defaults recorded for the same time period in 2012, with a total outstanding debt of $41 billion. There were 30 first time defaulters for the comparable period in 2011 with total debt of $62 billion. The increase in the actual dollar amount in debt outstanding for 2013 was the result of the large defaults of San Bernardino and Stockton, CA. Standard & Poors rated muni portfolios shows there were eleven defaults (non-housing) in 2012, which was higher than S&P's annual mean of 2.1 and median of 1 since 1986. Only four of the eleven defaulted issues in 2012 held an investment grade rating prior to defaulting while seven had speculative grade ratings. APA does not typically trade speculative rated issues. Bank of America Merrill Lynch reported $573 million in missed payments for quarter 1 of 2013 or approximately 0.6% of the $3.7 trillion of munis outstanding, compared with 1.01% for all of 2012.

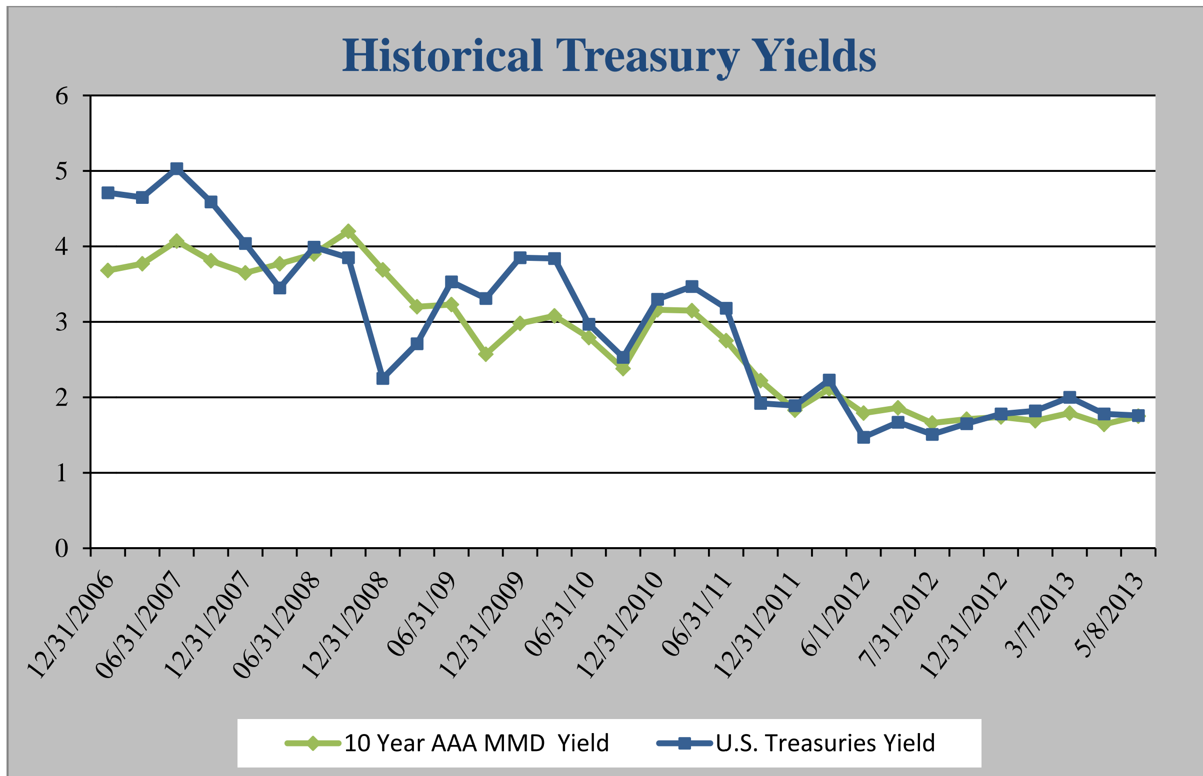
Moody's Investors Service reports that in the first quarter of 2013, downgrades comprised 87% of its public finance rating actions. While downgrades may not necessarily predict default, they are considered an early indicator of issuer performance. The total amount of downgraded debt declined from $95b in 4Q2012 to $27B 1Q2013. This was the lowest amount of defaulted debt since 4Q2011.

Past performance is not indicative of future results. Please see attached disclosures.
www.assetpreservationadvisors.com

TRADING MARKETS

Treasury Yields

With better than expected job growth numbers and positive economic news out of Asia and Europe, Treasury yields have remained relatively flat from last month with 2-year Treasuries at 0.22% on May 7, the same as the April 5 level of 0.22%, yet down slightly from 0.25% on March 7. The benchmark 10-year note yield has declined as evidenced by the 1.76% level on May 8, down slightly from the 1.78% level on April 5 and down from the March 7 yield of 2%. The triple A-rated muni bond spread to comparable Treasuries hit one of its highest ratios since 2007 at 121% on June 1, 2012. Current spreads are 99.4% as of May 8, 2013, compared to the historic spread average of 85%. A ratio over 100 indicates that Munis are less expensive relative to comparable Treasuries. The yield on 10 year AAA Munis also showed decreases over the past few months. A May 8, 2013 yield of 1.75% was 1 basis point lower than the April 5, 2013 yield of 1.76%.



Source: MMD and U.S. Treasury Department

Past performance is not indicative of future results. Please see attached disclosures.
www.assetpreservationadvisors.com

GLOBAL OVERVIEW

European Central Bank Rate Reduction

Euro-zone fiscal troubles, which we have highlighted numerous times in previous commentaries last year, have continued into the spring of 2013. On May 3, the European Central Bank (ECB) reduced its key lending rate by one-quarter percentage point to a record low of 0.5%. This was in an effort by the ECB to provide relief to southern European banks that generally borrow heavily from the ECB and continue to experience financial stress since the 2008 economic downturn. The ECB also hinted at additional and more dramatic stimulus measures to spur private-sector lending in an attempt to provide relief to the more depressed economies in southern Europe. ECB Officials also stated they will provide unlimited funds to commercial banks in the stressed economies at least through mid-2014. The Euro-Zone economy has yet to recover from the effects of the 2008 global financial crisis.

Past performance is not indicative of future results. Please see attached disclosures.
www.assetpreservationadvisors.com

Disclosures:

Past performance is not indicative of future results. This material is not financial advice or an offer to sell any product. The actual characteristics with respect to any particular client account will vary based on a number of factors including but not limited to: (i) the size of the account; (ii) investment restrictions applicable to the account, if any; and (iii) market exigencies at the time of investment. Asset Preservation Advisors, Inc. reserves the right to modify its current investment strategies and techniques based on changing market dynamics or client needs. This is not a recommendation to buy or sell a particular security. There is no assurance that any securities discussed herein will remain in an account's portfolio at the time you receive this report or that securities sold have not been repurchased. The securities discussed may not represent an account's entire portfolio and in the aggregate may represent only a small percentage of an account's portfolio holdings. It should not be assumed that any of the securities transactions, holdings or sectors discussed were or will prove to be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance of the securities discussed herein.

APA is an investment adviser registered with the U.S. Securities and Exchange Commission. Registration does not imply a certain level of skill of training. More information about the advisor including its investment strategies and objectives can be obtained by visiting www.assetpreservationadvisors.com. A copy of APA's disclosure statement (Part 2 of Form ADV) is available without charge upon request. Our Form ADV contains information regarding our Firm's business practices and the backgrounds of our key personnel. Please contact APA at 404-261-1333 if you would like to receive this information. APA-13-134