ASSET PRESERVATION ADVISORS

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AN OVERVIEW OF U.S. STATE CREDITWORTHINESS

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The severe financial pressures facing many state and local governments continue to garner much media coverage, as evidenced by the December 19th episode of the CBS show "60 Minutes." In a segment entitled "State Budgets: The Day of Reckoning", correspondent Steve Kroft examines the current fiscal stress at state and local levels, and the arduous measures being taken by governments across the country to combat the "great recession" and close substantial budget gaps. Steve Kroft unveils the ugly truth that within the past two years, states have collectively spent nearly half a trillion dollars more than they collected in taxes, and are facing a trillion dollar hole in their public pension funds.

With regard to these current fiscal challenges, the most common misconception is the notion that budgetary pressures will drastically impede the ability of state and local governments to meet debt payment obligations. In actuality, debt service is a relatively small percentage of state and local revenues, accounting for a mere 3% to 5% of their annual budgets on average. Moreover, municipalities have demonstrated a strong willingness to pay debt obligations in order to maintain access to capital markets. Current budget problems should not be construed as a debt crisis, but rather a consequence of decades of financial irresponsibility, reckless spending and unsustainable benefit packages for public employees. Over the past two years, dwindling tax revenues and unrealistic investment returns have exposed massive budget deficits and forced state and local governments to publicly address these financial issues.

Also appearing on the show was Meredith Whitney, CEO of Whitney Advisory Group, who continued to paint a dim and gloomy future for municipalities nationwide. Whitney predicted that 50 – 100 municipal issuers could default on their debt over the next 12 months. She forecasts the muni default level could top $100 billion, as the billions of dollars of federal stimulus money that has helped state and local governments trudge through the "great recession", runs out in the Spring of 2011. Her prediction is based upon a two year study that her research firm spent analyzing the financial condition of the 15 largest states. Whitney sees frightening parallels between the current fiscal condition of states/municipalities and that of banks during late 2008.

Hasty Generalizations in the Municipal Bond Market

While APA recognizes the fiscal challenges facing many state and local governments and the stress they will put on municipal finances, we feel it is important to dispel the generalizations that view the entire municipal marketplace as a single vast and troubled sector. In addition:

- There are nearly 100,000 individual state and local governments, districts, authorities and other issuers active in the municipal bond market today, with $3 trillion in debt outstanding.
- In general, the majority of problems or risk associated with state and local credits are confined to the non-rated, speculative type issuers. In particular, real estate oriented credits such as land-secured bonds, tax increment financings, multifamily housing loans, retirement projects, hotels and casinos.
- According to a recent report by Municipal Market Advisors (MMA), the amount of bonds in default at the end of November 2010 totaled $8 billion – or less than 0.2% of the current market – and involved 279 issuers. The majority of defaults have occurred in the non-investment grade sectors, with issues that were initially non-rated accounting for over 80% of all payment defaults. As a sector, land-secured bonds represent 112 of the 279 issues in default and account for about a quarter of the principal associated with default.
- With respect to the so-called “safe sectors” of the municipal market, which include issues that, historically, have seen very little default activity, there were only three payment defaults involving $47 million in principal. These three include Menasha WI’s appropriation-linked steam facility bond anticipation notes and Warrens, WI’s appropriation and water bonds.
- States are willing and able to take decisive action including reducing expenditures, increasing taxes and spending reserve funds, in order to honor their debt obligations and maintain access to capital markets. Moreover, general obligation (GO) bondholders have a claim over pledged revenue and are generally well protected versus other interested parties such as taxpayers, service recipients, employees and vendors.

- In our view, the immediate operational stresses at state and local levels stem from program and service expenditures, not debt. Most governments are making the necessary painful expenditure cuts and are bringing public employees back to the bargaining table to confront new fiscal realities.

- Importantly, states are not banks and the leverage used by governments is not comparable to that used by banks. Even though states have greatly increased debt borrowings over the last five years, it appears that most outstanding municipal debt is self-amortizing. In other words, principal is paid down regularly via level annual debt service payments funded through tax receipts. In general, municipal issuers do not borrow as do international sovereigns or corporate issuers: via large short maturity notes that can only be refinanced with more debt, creating a crippling reliance on market acceptance for solvency. As recent history showed during the 4Q of 2008, an extended primary market "closure" did not result in widespread municipal defaults. States simply stopped funding new infrastructure until rates declined enough to justify the cost. We believe this is distinct from money market funded banks that fell quickly into insolvency when investors turned risk averse and short-term funding by Sovereign issuers.
- State and local government tax receipts grew modestly in the second quarter of 2010, as acceleration in consumer spending boosted sales tax revenue. According to the Census Bureau, municipalities in the U.S. collected $318.15 billion in taxes in the second quarter of 2010, resulting in a year-over-year increase of 1.7%.
- The stock market decline in 2008 left states with significantly higher unfunded pension liabilities. According to the U.S. Bureau of the Census, public pension funds lost on average over 25% in 2008. This reduction in pension funding ratios resulted in higher actuarially calculated required annual contributions, bringing more budgetary pressure to states that traditionally try to meet the required level of funding. The recent recovery of stock market values could ease some pressure on funding levels for most states, although the easing is not likely to be apparent until an update in actuarial tables is taken, which may not occur in 2011.

- States are acutely aware of their responsibility to fund growing post-retirement benefits. States like California and New York have continued to pay into their pension trusts even as their revenues have declined, either because they are required to or because they believe it is a basic financial discipline. Many states including New York, New Jersey and Illinois have adopted pension reforms, primarily reducing benefits for new employees, requiring higher employee contributions to pension plans and increasing the age at which a retiree can collect his pension.

APA's Approach to State Credit Quality

We believe that Illinois, California and Arizona are three states with the most challenged financial outlook and we are not recommending new purchases of bonds from these states. Furthermore, we think that careful credit analysis can significantly reduce the risks involved in municipal bond investing to a very manageable level. With respect to the types of municipal bonds APA currently favors, two main areas are in focus: unlimited tax general obligation bonds and dedicated essential service revenue bonds. General obligation bonds are backed by the full faith and credit of the issuer, which has unlimited real property taxing power and generally represents a high credit profile. Additionally, essential service bonds are supported by dedicated revenue streams from projects like water or sewer, public power or transportation.

Summary

While Meredith Whitney is one of the top bank analysts in the country, she can be challenged for "overreaching" in comparing municipalities to banks and declaring the municipal market as the next systemic fault line comparable to the financial crisis in the fall of 2008. As states have struggled with the fall-off in tax revenues from the financial crisis and ensuing recession, they have experienced very difficult budgeting processes. Despite these difficulties, almost all the states began the 2011 fiscal year with improving budgets. Nearly all the states are cutting spending; some are raising taxes and as many as 20 states have begun to tackle their massive pension problems by modifying program terms.

During the “60 Minutes” episode, Steve Kroft sat down with New Jersey’s new Governor, Chris Christie, to discuss the rigorous measures he has taken to address the state’s substantial budget gap and unfunded pension and healthcare liabilities. Since taking office in January 2010, Christie has slashed New Jersey’s budget by 26 percent, including a billion dollars in cuts to education, laid off 1,300 state workers and drastically reduced funding to local governments throughout New Jersey. He also has initiated significant pension and infrastructure cutbacks in order to correct the state’s budget shortfalls and improve its credit rating. And while others, such as California, reached difficult budget compromises and avoided issuing government IOUs, the fact remains that municipalities historically are solvent, have very low debt to revenue ratios and can scale back expenditures in short order unlike corporate bond issuers or banks who borrow short term in the public markets.

We are reminded that the historic default rate for Municipalities from 1970 through 2009 according to Moody’s Investors Services was 0.09%. During the same period Corporate Bonds registered a default rate of more than 11%. As a Barron’s columnist recently advised however, regulators cannot guarantee protection…”the best strategy, then as now: Find yourself a muni expert. Only a fool would count on Congress.”

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