



## **Will Municipal Bonds be the Next Disaster?**

By Dennis Gibb  
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It has been an article of faith that municipal bonds are safe investments, but this complacency about the safety of munis may soon be proven unwise.

The last time there was a serious problem in the muni markets was during the Depression, when numerous states and municipalities defaulted. In my 40-year career, I have found that problems often occur in markets that are not subjected to continuous rigorous scrutiny and are given a pass because of a record of safety. Prior to 2008, for example, the last sustained national drop in residential real estate was in the 1930's. The Black Swan is an unpredictable but monumentally important event, and it always comes from the area you least expect.

In this case, the potential black swan is a huge one. The three biggest categories of debt in the United States are the debt of the federal government and its agencies, mortgage-backed debt and municipal bonds. Over the past decade, the municipal markets have moved from being the safe haven of widows and orphans to a \$2.5 trillion active market, complete with its own indices, ETFs and credit default swaps. The size and sophistication of the muni market masks the following sources of instability:

1. The states have for years been underfunding their pension plans, while at the same time adding to their rolls. There are large gaps between the present value of the future promised benefits and the value of the assets available to pay them. This is a structural problem that will not go away without a number of years of extraordinary investment returns, a reduction in benefits, increased taxes, or a combination of all three. At the same time, other state-mandated spending (schools, medical support, and public assistance) has increased to more than 50% of the revenues states take in via taxes. This higher mandated spending has not been matched by the politically unpopular solution of increased taxes. Instead, it has been addressed in large part by issuing bonds
2. In the current economic downturn, the main sources of state revenues – property, income and sales taxes – have all taken a hit. If a home has declined in value, then, with some delay, the property tax assessment will also fall. Houses that stand vacant often do not pay taxes, and homeowners in default on their mortgages are unlikely to pay property taxes. Tax receipts will not recover until house prices get back above their pre-crisis levels. Does anyone want to predict when that will happen?



3. The legal framework for redress of defaults on municipal bonds is obscure. There is a legal provision (Chapter 9) for a city to go bankrupt, but there is no such provision for a state to file for bankruptcy. The terms and conditions of a municipal bankruptcy are difficult to execute and require virtual liquidation of all of the municipality's assets. Bondholders should be concerned by this lack of transparency. Ultimately, the decision to pay interest on bonds is made by politicians who are immune from lawsuits, which means the risk of an unsound decision increases in direct proportion to the number of votes to be gained.
4. Over the years, states have received more and more transfer payments from the federal government. A prime example is in Medicare, which is administered by the states but funded by transfers from federal coffers. But while states are getting more money, the funds they do receive go to benefits, not administration, which means that states have had to bear the increased administrative burden of expanding programs without being compensated for those increased costs. Build America Bonds are in effect a transfer payment and a perfect example of federal dollars going to lower the interest costs of unsound borrowers. Issuing these bonds was supposed to be a temporary program, but now there is talk of making it permanent. "Solutions" like these are essentially cosmetic – they mask but don't change underlying problems.
5. Under the laws of most states, all revenues collected within their borders go to the state general fund, from which the budgeting process distributes those funds to the state's various needs. Since the budget process is highly politicized, there is little assurance that revenues for a specific bond are set aside in an account for that bond. In more cases than anyone will admit, revenue bonds are really subordinated debentures of the state.
6. The advent of municipal bond ETFs and the continued inflow of money to open- and closed-end muni funds have created a continuous bid under the prices of the bonds, preventing any serious price correction and encouraging states to issue bonds to capture lower interest rates. In many cases this borrowing is new debt, not refinancing of existing debt. As such, the overall interest burden of the states is still increasing, just at a slower rate than it otherwise would have.
7. The mono-line insurers, such as MBIA and AMBAC, already reeling from the mortgage mess, cannot withstand a mass default of bonds. So the security of bond insurance might not be what it appears.
8. Forecasts of state revenue and income are essentially a moving target. California went through a prolonged and acrimonious debate over its recent budget. The debate focused on every way to raise or save money; nothing was spared. Finally a budget was approved, but 45 days later the state "discovered" \$6 billion more in un-



derfunding. Can you say Greece? If the states ever had to properly reserve for workman's compensation insurance pools, high-risk auto insurance pools, or hurricane or earthquake insurance, current deficits would appear minuscule.

9. The cost of insuring against a default of muni bonds with credit default swaps is large, as the chart below shows:

Issuer	10 year CDS levels
California	299
Illinois	304
Portugal	380
Spain	250
Ireland	478
Iceland	253

Iceland is bankrupt, Spain is leaning that way, and the EU is forcing Ireland to accept a bailout. California and Illinois are judged to be equally risky!

10. Finally: In recent years, there has been a change in our national understanding of the sacred nature of contracts. We have seen untold numbers of homeowners default on mortgages with the justification that the bank should never have lent them the money. We have seen the banks improvidently speculate with other people's money and then justify it by saying that they were only doing what the customer wanted. This same mentality is evident in municipal government. Harrisburg, Pennsylvania councilwoman Susan Brown Wilson exemplified the ominous trend when she said recently, "By no means should the citizens of Harrisburg (alone) be strapped with the debt created eight years ago by a prior administration." Are we not responsible for what past administrations have done? Isn't that principle what secures any bond issuance? If Ms. Wilson's is becoming the prevailing attitude, muni bonds are nothing more than colorful paper.

The number of muni bonds on dealer desks wanting bids is as large as at any time in history. Maybe this is dumb money getting out, creating a golden opportunity. But it could also be smart money running from a market that has a lot of the characteristics of the pre-2008 mortgage markets: lack of transparency, legal obscurity, inflated values and deteriorating economics. That's a risk investors can no longer afford to ignore.



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