

# Muni Market in the News

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In the last few months, the news media has published numerous articles on municipal credit risk. The harshest critics predict that some high profile issuers will default on their obligations to repay principal and interest in a timely fashion. Generally, the thesis is that declining revenues, combined with unfunded pension fund liabilities, will make it impossible for issuers to service debt. The articles typically repeat the same three examples of actual recent defaults: Vallejo, CA; Harrisburg, PA; and Jefferson County, AL.

There are approximately 1.3 million municipal bonds outstanding, and every year a handful default. The bad apples are often non-rated bonds issued to fund real estate development, low income housing, health care, and toll roads. We may see a small elevation in defaults but we don't expect a tidal wave, and currently, Thornburg owns no defaulted bonds. We're avoiding general obligations (GOs) in specific places like Detroit and Puerto Rico, and we're avoiding revenue bonds for projects with weak financial results. We do expect there will continue to be newspaper articles with inaccurate forecasts of widespread collapse in the bond market.

When a newspaper reporter or analyst wants to write a

"defaults are coming" article, he or she often fails to mention the following:

- Data from the Rockefeller Institute shows that state and local revenues have increased for the last three consecutive quarters ending September 30, 2010.
- The National Governors Association projects a slow recovery for state revenue beginning in 2011.
- For most states and cities, the debt burden remains modest as measured by debt per capita (\$936 in 2009), debt-to-state gross domestic product (GDP) (the average is 2.78% in 2009), and debt as a percent of personal income (median is 2.5% in 2009).<sup>1</sup> Debt-to-GDP ratios in Greece, Ireland, and Spain are 113%, 65%, and 53%, respectively.
- In California, which receives a great deal of the attention, in the 2011 fiscal year, general fund revenue will be approximately \$89 billion. The first \$36 billion will go to education, leaving \$53 billion to cover \$6.6 billion in debt service.<sup>2</sup> We believe there's a low chance of a default on state GOs in California or any other state.

We do agree that unfunded pension fund liabilities are a

serious issue, though not yet a cash drain on taxpayers. Fortunately, there is some progress being made toward reducing these obligations, such as proposals from the mayors of Philadelphia and San Diego to move to a 401(k) defined contribution plan for future employees. 2010 saw the beginning of legislative changes in many states - changes in employee contributions, lengthening service requirements, COLA (cost of living allowance) reductions, and anti-spiking rules to limit final average salary calculations.

At Thornburg, we utilize a multi-pronged approach to credit analysis. Our goal is to screen out bonds with a material chance of default. We use quantitative fiscal distress indicators such as declines in assessed value of real estate, general fund reserves as a percentage of expenditures, and debt as a percent of taxable property value. We examine operating data such as declining enrollment in school districts and apartment vacancy rates. We monitor lists of fiscally distressed local governments that are assembled by state government agencies. We use common sense tests of whether a project is essential, economically sound, and cash flow positive. After we purchase a bond, we monitor its financial statements, and

occasionally, based on what we find, we may sell bonds prior to maturity. ■

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**General Obligation Bond** – A municipal bond backed by the credit and "taxing power" of the issuing jurisdiction rather than the revenue from a given project.

**Revenue Bond** – A bond on which the debt service is payable solely from the revenue generated from the operation of the project being financed or a category of facilities, or from other non-tax sources.

<sup>1</sup> Source: Moody's Investors Service

<sup>2</sup> Source: California Legislative Analyst's Office