

Are Municipal Bonds Safe Today?

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In the midst of today's financial crisis, when even the solvency of money market funds has been threatened, investors are questioning whether a rash of defaults lies ahead for the issuers of municipal bonds. But record shows that municipal bonds of any credit quality almost never default: From 1970 through 2006, the 10-year cumulative default rate for municipal bonds was 0.10%—versus a corporate default rate of almost 10%. After all, municipalities have to provide police and firemen, teachers, and social services—they can't just disappear.

Given the fact that we've experienced several unprecedented dislocations in the markets over the last year, some fear that something similar could happen with municipal bonds. While there's no doubt that municipal issuers are having financial problems, the bonds issued by municipalities are very different from the complicated securities that have caused so much trouble. These securities are essentially an open book if you take the time to research the fundamentals of the municipalities issuing them, and our analysis gives us every reason to feel confident about the municipal bonds we hold in clients' portfolios.

Although state tax revenue growth is definitely slowing, state officials know that changes in their tax revenues are economically sensitive, so they have traditionally built up reserves—or rainy day funds—to address these changes. Today's cycle is no different: State budget reserves as a percent of general fund spending are at 7.5%—which, in historical terms, is relatively high. In the past, states have used those reserves to get them through difficult times, and that's what we'll see again this year.

But while reserves are the first line of defense, states need to take action to keep their budgets in balance. To their credit, state officials have been slashing spending to forestall problems. For fiscal year 2009, the average projected increase in states' budgeted expenses is only 1%, the second lowest increase we've seen in the last 25 years.

Thus far, states do appear to be addressing the difficult times ahead prudently. But local governments, who are supported mainly by property taxes, represent the other primary issuer of municipal bonds. Since the current financial crisis began with a declining housing market and overextended subprime borrowers, investors worry that the property taxes of local governments will decline sharply, causing these governments to go bankrupt and default on their loans. It's true that local property values have fallen hard in an almost inevitable correction of the unreasonably inflated prices we saw at the height of the bubble in 2006, but does that mean that assessed valuations and property tax collections will also fall dramatically?

No. The assumption that property taxes will dry up overnight is false. Although property values can change dramatically in local markets, property tax collections have been quite stable historically for two reasons. First, the growth of assessed value tends to lag behind the growth of housing values, which means that the assessed value of most homes can continue to grow—or at least remain stationary—even if property values fall. Second, local governments generally have the right to raise property taxes to close budget shortfalls. Los Angeles, a market that experienced a significant drop in housing values over a prolonged period, provides a good example of the relationship between taxes and property values.

Housing values in Los Angeles rose sharply in the late 1980s, then dropped by over 5% a year for more than five years in the early 1990s. They rose again from the mid-1990s up until last year, when they again began a steep decline. But across all these time periods, including when property values were declining in the 1990s, property tax revenues continued to grow.

So despite the recent sharp drop in housing values across the country, property tax growth in the vast majority of municipalities is not likely to fall significantly, unless the

decline in housing values continues unabated for an extended period of time.

It's clear why there have been so few municipal defaults historically: If managed reasonably well, state and local governments have the resources to address their fiscal difficulties. Although a broad economic downturn will

require municipalities to adjust their budgets and spending, they have come through crises before—notably the 2002 to 2003 downturn in the aftermath of the tech bubble—and they have the means to do so again. The municipal market remains a safe marketplace. ■

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