



**Municipal Bond Market – Should we be concerned?
January 11, 2011**

While it is true that many states and local municipalities are experiencing budgetary problems, the more recent media stories of potential massive defaults appears to be overblown. With economic growth in the U.S. muted, revenues for local governments have been under pressure. It is important to note that many of these problems were evident before the recession and will remain when the economy regains sustainable strength. State and local governments do tend to lag coming out of a recession, and this time is no different. But overall, revenues in 2010 have improved over 2009.

The municipal bond market is very diverse in terms of issuers. Debt can be issued by states, state agencies, cities, counties and school districts. Bonds can also be issued for health care providers and educational facilities through conduit authorities. It would be inappropriate to apply a blanket statement of wide reaching defaults to the municipal debt market. Although rare, municipal defaults do occur, but are not limited to periods of economic stress. In 2009, defaults totaled 0.2% of total debt outstanding and the 10 year default rate is 0.1%. As for bankruptcy, states are not eligible to declare. Twenty-six states prohibit their localities from filing, which provides strong constitutional protection for bondholders. Municipalities are highly dependent upon access to the credit markets for financing and to jeopardize that would be a painful, costly and lengthy process to overcome.

While depressed revenues, pension fund shortfalls and health care costs have put pressure on states' financial health, it hardly seems credible to suggest that local governments could shut down essential services for their residents. Municipal governments simply cannot go away. Pension costs are a longer term problem that states have time but must address. With governments experiencing more fiscal conservatism, localities will be forced to look for innovative ways to balance their budgets. For states, their revenues are mostly derived from sales and income taxes. Localities' revenues are highly dependent upon property tax revenue and are likely to remain under pressure as long as the decline in home values takes time to unwind.

Problems do exist. There are states experiencing severe budget crises, Illinois and New Jersey to name just two. There is clearly a need for state and local governments to address their imbalances and strong steps need to be taken to

cut spending. The relationship between the states and the taxpayers and employees must go through the painful adjustment process. Help from the Federal government has pushed some of the more difficult decisions back, but raising tax rates and cutting spending will need to take place to get these houses back in order.

Careful examination of municipal credits is a must to avoid potential problems. Diversifying a bond portfolio across varying purposes helps mitigate risk. Focusing on high quality revenue bonds with stable, predictable income streams is one manner of avoiding potential problems. Strong general obligations of states and localities offer investors a secure alternative as well. There is always some interest rate risk associated with bond investing, however, unnecessary credit risk needs to be avoided.

Beth Swartz
Manager of Investor Services