

# Municipal Market Comments



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## Municipal Market Issuance Picks Up, Though Still Lagging 2010; 2012 Forecasts See More Growth

October saw the highest level of new municipal issuance to date in 2011, with issuers selling approximately \$32 billion of bonds. Even so, October's issuance was more than 23% lower than October 2010 figures, and 2011 year-to-date issuance in the municipal market remains well below 2010 levels. Most market observers currently project full year 2011 issuance will total between \$260 billion and \$300 billion, or between 32% and 40% lower than last year's \$433 billion of issuance.

The overall decline in municipal issuance volume has been one of the fundamental factors supporting the strong performance of municipal bonds this year. Short supply coupled with healthy demand for high quality municipal bonds has been one of the factors supporting historically low yield levels for munis. Among the factors driving the supply dynamics in the market are:

- *The elimination of the Build America Bond (BAB) program, which has resulted in a 77% drop in taxable municipal bond issuance in 2011 (versus 2010 year-to-date).*
- *The related BAB's "hangover." Many municipalities accelerated borrowings into 2010 to take advantage of federal tax credit programs before their Dec. 31, 2010 expiration. Consequently, issuance that would have been expected in 2011 was artificially shifted into 2010.*
- *Financial pressures on municipalities. Many municipal issuers have been forced to scale back borrowing plans due to budgetary pressures. Voter resistance to tax increases has also depressed some issuers' ability to pass bond measures.*

Looking into 2012, many municipal observers predict issuance will grow by approximately 15% to 20%, with combined municipal issuance projected to total between \$310 billion and \$350 billion. The outlook is fueled by expectations that the economy will continue to

slowly expand and the housing market will stabilize, which should support modest revenue expansion at the state and local level. Other factors expected to drive supply include the natural demand for funding by municipalities and low yields, which will continue to support refunding issuance as long as they persist. A substantial uptick in issuance levels could begin to pressure prices in the municipal market generally, though the general level of interest rates and the dynamics of the U.S. Treasury market will continue to be the main drivers of municipal yield levels over the long-term.

### **Municipal Ratings Fall Further in Third Quarter as Property Values Pressure Municipal Budgets**

The third quarter of 2011 saw further weakening of municipal credit quality. For the first time since the start of the financial crisis and recession, S&P's ratio of upgrades to downgrades turned negative in 3Q2011, with downgrades outpacing upgrades by a ratio of 1.23-to-1. Moody's downgrade ratio, already negative, accelerated further during the quarter, to a figure of 5.3-to-1 (downgrades to upgrades) from a level of 3-to-1 in 2Q2011. (These rating figures do not include the housing sector, which experienced thousands of downgrades from S&P in the second quarter due to downgrade of the United States to AA+ from AAA, and the resulting rating impact on bonds guarantee by Fannie Mae, Freddie Mac, FHA and other U.S. government agencies.)

Notably, while ratings for general governmental issuers at both the state and local level received more downgrades than upgrades by S&P in the quarter, utility revenue bonds (water, sewer, electric, gas and combined utilities) saw 24 upgrades during the second quarter against only 5 downgrades. Why the substantial disparity in ratings performance between utilities and general governments? Utility bonds are almost always secured by revenue pledges of the utility system issuer. These revenues are collected through periodic billing for utility service and are among the most stable and dependable revenue streams collected by municipal governments. Even in tough economic times, people pay their electric and water bills and revenues flow to the utilities to service their bonds. For local governments – cities, counties, school districts, etc. – the full impacts of the housing market collapse that started in 2006 and 2007 are just now becoming fully reflected in tax collections. As we noted in our August 25, 2011 Municipal Market Comments, the financial performance of municipalities lags the national, state and/or regional economy by as much as two years. Consequently, cyclical lows for municipal finances occur approximately two years after the depths of an economic downturn. This is due in large part to the fact that property values are assessed on a multi-year cycle in most states. The resulting assessed values form the basis for municipal

tax bills the following fiscal year. So it may be three or more years after housing prices begin to decline before those declining values are reflected in the tax collections of local municipalities. That is exactly the dynamic we see in place today. Most municipal issuers only began to show tax base declines in FY2009 or FY2010. The resulting property tax revenue declines then become apparent in FY2010 or FY2011 financial results.

Following the onset of budget pressures, the rating cycle may take another 12 to 18 months beyond that to reflect the full impacts of financial deterioration and reductions of reserve levels used to offset revenue shortfalls and to balance budgets. As we observed in August, for local issuers, the impacts of declining real estate values will continue to weigh on their budgets and credit quality for some time to come. Absent a significant upturn in the national economy in the near term, we would expect that municipal ratings generally will continue to remain under pressure well into 2013 and possibly beyond.

While municipal credit quality is under pressure generally, investors should not make investment decisions based on broad generalizations of market health. More than many other sectors, munis are an extremely diverse universe of issuers, each with unique characteristics that may react very differently to broad economic trends. As we noted above, essential purpose utility revenue bonds continue to show strengthening credit quality. Likewise, we have seen multiple rating upgrades and outlook changes for some states and local issuers in recent months. Attention to fundamental credit quality remains the key to constructing portfolios that will exhibit high and stable credit quality across economic cycles.

A handwritten signature in black ink, appearing to read "B. Tournier", with a long, sweeping horizontal line extending to the right.

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