The Investor's Edge

C.W. HENDERSON & ASSOCIATES, INC.

Investment Managers Specializing in Tax-Exempt Securities

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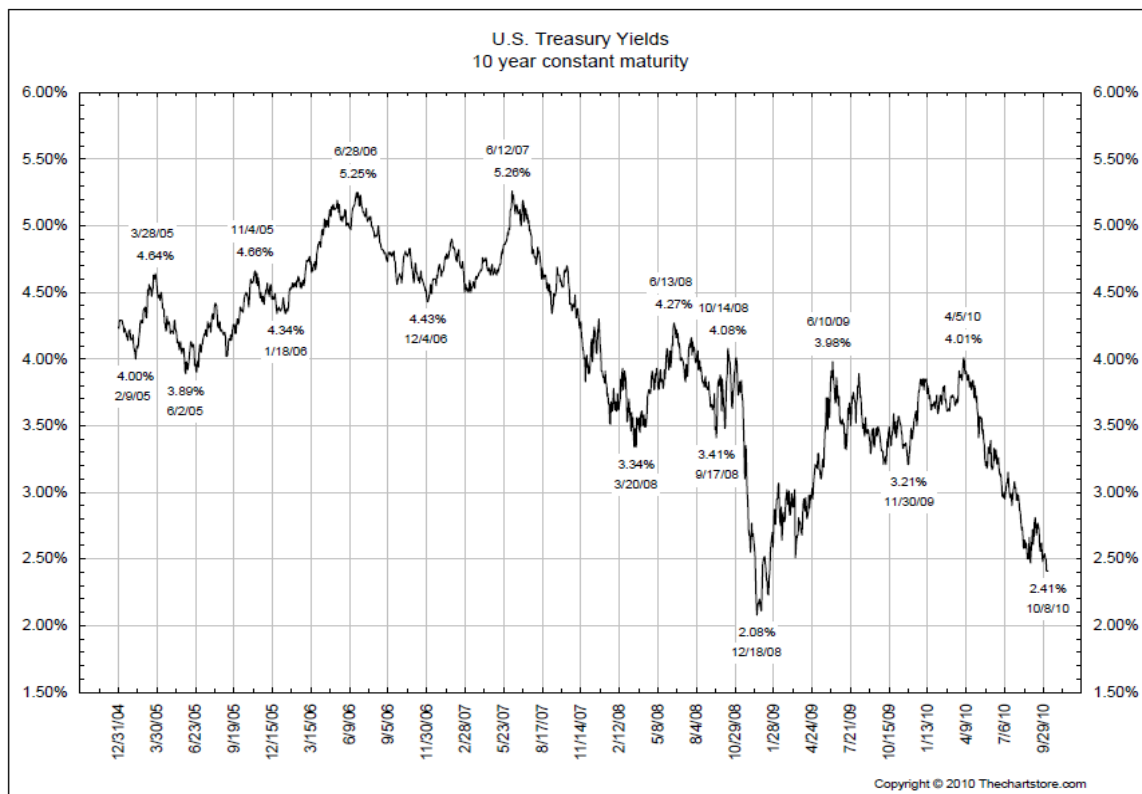
Background and Outlook

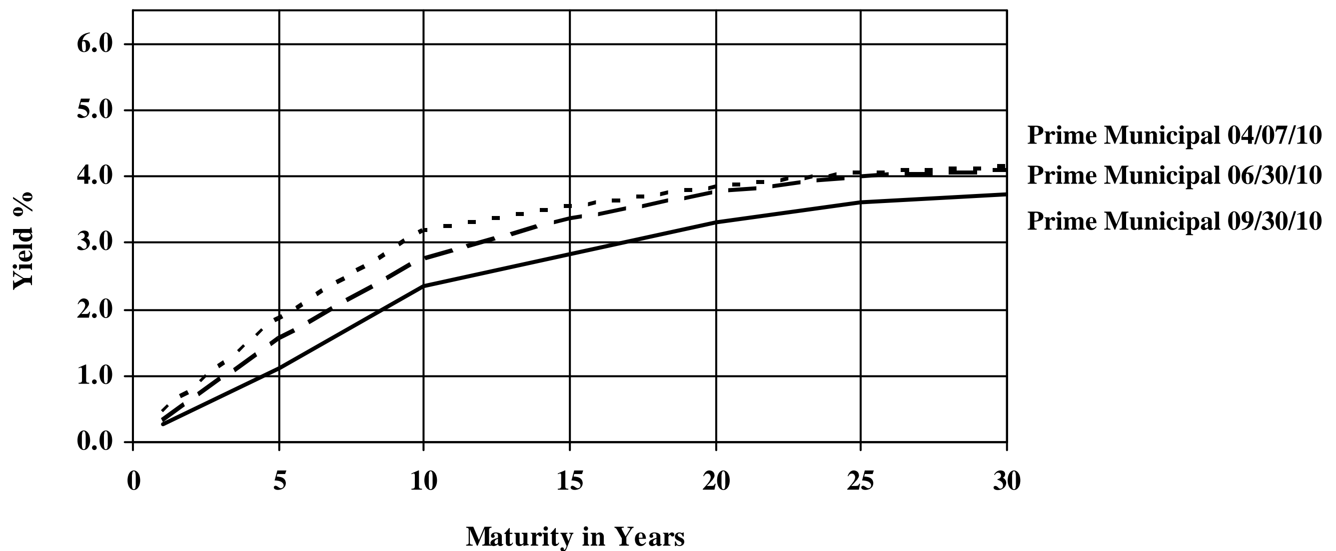
Fears of a double dip recession and deflation caused interest rates to fall dramatically during the spring and summer. As shown in the chart below, the ten year Treasury yield dropped from over 4% in early April to under 2.40% currently. Are these low yields justified? Probably over the near term.

The recession officially ended in mid 2009 but high unemployment, limited wage gains and deteriorating housing prices continue to impact consumer sentiment and spending. In turn, corporations are hesitant to expand and hire while demand remains uncertain. Undecided tax policy and increasing regulatory burdens are producing additional recovery headwinds. We expect that growth will continue but at a moderate, less than 3%, pace as the economy struggles to overcome the burdens of high unemployment and asset value erosion. Limited pricing power and modest, if any, wage demands should keep near term inflation rates subdued. This is not an environment where interest rates are likely to be pressured significantly higher.



New fiscal stimulus programs to spur growth appear unlikely given federal deficit concerns, but monetary policy remains very accommodative with short rates locked at close to zero for the foreseeable future. A second round of quantitative easing (i.e. additional purchases of long Treasuries by the Fed) now appears likely which could act to further contain interest rates. Dollar weakness and rising commodity prices, which have been fueled by monetary ease, may continue for some time.

As shown in the following yield curve chart, tax-exempt rates also moved lower over the past several months although not to the same extent as in the Treasury market. Ten year prime municipal yields dropped by eighty basis points from early April to the end of September as investors continued to exit money market funds in search of yield. Their quest for tax-exempt securities has been hampered by the heavy issuance of taxable Build America Bonds which have captured over 30% of the new issue market this year. New issue supply through September totaled $294.3 billion which included $93.5 billion taxable municipals.



In contrast to the Treasury market, municipal investors have shown some resistance in recent weeks to blindly chasing rates to ever lower levels. Nominal rates remain very low, but the tax-exempt sector is now extremely cheap on a relative basis due to the surge in Treasury prices. As shown in the following table, prime municipal yields exceed Treasury rates on the short end of the yield curve and are essentially the same in longer maturity segments.

	Municipal	Treasury	Ratio
1 Yr	0.29%	0.20%	1.45
3 Yrs	0.67	0.52	1.29
5 Yrs	1.10	1.11	0.99
10 Yrs	2.35	2.37	0.99
30 Yrs	3.75	3.72	1.01

Bubble Concerns?

Although we don't feel that there is an imminent threat, we are concerned that interest rates will surge higher at some point. Risk aversion and deleveraging are the current predominant forces in the economy and the markets, but with liquidity abounding any pick up in monetary velocity could dramatically alter growth projections and inflation forecasts. This concern has been intensified by recent comments from Federal Reserve officials that higher than normal inflation targets (greater than 2%) should be a policy objective. The obvious fear is that if the Fed is successful in ratcheting inflation higher, they will not react quickly enough to counter building price pressures after they take hold. The resultant impact on bond prices could be dramatic. For example, should the ten year Treasury yield return only to the 4% level of last April, a bond purchased at the current 2.37% market yield would suffer a price decline in excess of 12%. Municipals could experience even larger principal declines as bond prices drop below par and pierce de minimis thresholds. We are maintaining modestly defensive portfolio constructions in response to low prevailing nominal rate levels. Account durations continue to be targeted at 3.8 years, about ten percent below neutral. Durations will be reduced further if signs of stronger growth or building price pressures emerge.

Will There Be a Tax Bill?

We expect that Congress will take action after the November election to forestall the sunset provision that would cause personal tax rates to revert back to the levels that prevailed in the early years of the decade. Our working assumption has been that the highest marginal rates would move back to the 39.6% level while middle income families would not be impacted. There is now growing sentiment that the economy is too fragile to allow any tax increases. It remains to be seen if a tax bill will emerge from the lame duck Congress after the election. Marginal personal tax rates are important and will have an impact on the demand for municipals, but macroeconomic forces (GDP growth, inflation, etc.) will continue to be the main drivers of interest rate levels.

The future of Build America Bonds is likely to be a more significant factor for the municipal market than marginal tax rates. There is a year-end sunset on this program unless Congress acts. We continue to expect that the program will be extended for a year or more in conjunction with an overall tax package but with BABs rebate rates reduced below the current 35% level. As we pointed out in our July newsletter, lower rebate rates decrease the attractiveness of BABs to issuers. The expectation of reduced rebates after this year is prompting the current large supply of these instruments. If it appears that BABs could be eliminated, an additional supply surge could be forthcoming.

Underfunded Public Pensions

The Pew Center on the States estimates that public pension funds are underfunded by at least a trillion dollars and possibly much more due to overly optimistic return assumptions, inappropriate discount rates and insufficient annual contributions. Assuming we are in a "new normal" investment environment with lower long term returns, reestablishing the integrity of these plans will require that changes be made. Larger contributions by municipalities funded by higher taxes are unlikely to be accepted by taxpayers who have seen their salaries stagnate and retirement plans ravaged. As a result, contract restructurings for new, and in some cases existing workers, that reduce benefits, raise retirement ages, eliminate double dipping, etc. are all being discussed. Shifts from defined benefit to defined contribution plans appear less likely.

This problem has been highlighted in New Jersey where Gov. Christie indicated that the State's unfunded pension obligations total $46.8 billion and could grow to $181 billion in thirty years unless changes are made. Proposed plan adjustments for new and existing workers would increase the normal retirement age from 55 to 65, require thirty years of service for early retirement, roll back a 9% increase in pension benefits authorized in 2001 and eliminate cost of living adjustments. New Jersey's unfunded post-employment health care benefit liabilities are estimated at $56 billion. Gov. Christie has proposed that employee contributions increase from 8% to 30% to rein in health care costs. New Jersey is not unique. Most states and many local governments are facing similar funding challenges.

How all this plays out in New Jersey and across the country remains to be seen. It is clear that current trends are unsustainable and changes are necessary to maintain the solvency of these programs. Ultimately we expect that necessary changes will be made although the negotiating process is certain to be difficult and, in many cases, contentious and litigious. It was recently pointed out in a *Wall Street Journal* article that state and local governments employ close to 19.5 million workers, more than the manufacturing and construction sectors combined. The political influence of these workers is considerable and will add to the challenge of restructuring plans to assure long term solvency.

Our credit review process at C.W. Henderson & Associates examines the funding status of pension funds and other post employment benefits. Significant underfunding is viewed as a serious negative.

Municipal Bankruptcy Developments

Periodic articles continue to suggest that a growing number of municipalities could opt to choose bankruptcy as a way to resolve budgetary imbalances. As discussed in our March credit memo, we do not expect a surge in filings. States cannot declare bankruptcy nor can local governments in twenty-six states. In those states where bankruptcy is allowed, permission is often required from state authorities and oversight boards may intervene to impose resolutions on local governments. Municipalities need access to the financial markets for short term liquidity and for long term capital project financing. Bankruptcy seriously jeopardizes municipalities' ability to raise needed funds. Unlike corporations, state and local municipalities are ongoing entities that must continue to provide services to their constituents.

Harrisburg, PA is burdened with $288 million G.O. debt that financed a solid waste disposal incinerator and threatened to default on a $3.3 million September 15 debt service payment. The state intervened with $4.4 million of expedited funds and grants due the city which allowed the bond payment to be made on time. The immediate crisis was averted, but a long term solution to the city's financial challenges has not been developed. Some city officials have suggested bankruptcy, but this action is opposed by the Mayor and by the state.

A recent memo from the law firm of Chapman and Cutler reviewed a decision rendered by the Bankruptcy Court for the Eastern District of California regarding the Chapter 9 (municipal) Sierra Kings Health Care District bankruptcy case. Specific ad valorem taxes were pledged to support the bonds sold to raise funds to construct the Sierra King medical facility. It was determined by the court that specifically earmarked revenues, be they fees or taxes, are "special revenues" and must be paid on time on their scheduled payment date without interference from the bankruptcy proceedings. In other words, bond holders are protected in bankruptcy proceedings if specific funding sources have been designated to support outstanding municipal obligations. Good news for bondholders!

Craig W. Henderson **Thomas L. Mallman CFA**

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