SmartMoney

Longshot by Dave Kansas

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Why Muni Bond Fears Are Overblown

There's no shortage of chatter about the challenges facing the municipal bond market. Headlines about deeply indebted states and cities – combined with the Federal Government's own soaring debt – have provided ample ammunition to muni bond bears.

Meredith Whitney, an analyst who made her name forecasting trouble for banks ahead of the financial crisis, began arguing last September that big defaults are ahead in the $3 trillion muni bond market. Her comments rocked the market, led to outflows from muni bond funds and sent various muni bond ETFs reeling.

Video: Are Muni-Bond Fears Overblown? [1]

With many cities and states facing dire financial situations, WSJ's Dave Kansas talks with SmartMoney's Janet Paskin about the risk of investing in muni-bonds and the likelihood that some municipalities could default on those bond

Should investors be concerned about all the heavy breathing? Mostly, the answer is no. Muni bonds remain a relatively safe way to invest and earn money in a tax protected fashion. It's not sexy, but sometimes slow-and-steady wins the race.

There are, of course, caveats and investors should always pay attention – the financial crisis has taught us that the seemingly sacrosanct can surprise. Even seemingly super safe money funds got caught in that inferno.

Much of the muni bonds "safety" reputation stems from investment-grade ratings. If a big state, say California or Illinois, gets downgraded below investment-grade, that will certainly be a red flag for that locality. But shrewd muni bond investors always remember that, like real estate, munis are a highly localized market and a broad downdraft in the wake of such a move (which remains speculative) would present opportunities elsewhere.

Here are three additional things to bear in mind when thinking about all things muni.

• **History** . The stories of past defaults aren't always explained. The term default has many meanings.

• **Variety** . There are many flavors of muni bonds, and some are safer than others.

• **Interest rates** . The rate environment is shifting, which may overtake all the talk about defaults.

First, history. As you've no doubt read elsewhere, the history of muni bond defaults is incredibly small. According to Moody's Investors Service the average default rate for investment-grade muni bonds is 0.03% – sharply lower than for similarly rated corporate bonds. In the four decades before 2010, Moody's said 54 rated bonds defaulted.

Default, of course, means many things. At first glance, one would think a default would mean the investor got hosed. But usually, that's not the case.

In one of the highest profile defaults, the Orange County, Calif., 1994 bankruptcy, muni bondholders were ultimately made whole. More recently, Harrisburg, Penn., "defaulted" in Sept. 2010 when it missed a bond payment. Days later, the state stepped in and the bond holders were made whole.

One of the more famous bond defaults is the Arkansas default in 1933 during the Great Depression. After much haggling between bondholders and the state, eventually the bondholders were paid off after Arkansas raised taxes to fund the bonds. (Joe Mysak, the maestro of all things muni*chronicled this moment in history* [2] .)

Now, of course, the default rate isn't zero. In the 1970s, the Washington Public Power Supply System defaulted on $2.25 billion in bonds when its plan to build five nuclear power plants went a cropper. Investors recovered between a dime and 40 cents on the dollar.

But the WPPSS bonds were tied to a specific plan – the building of power plants. And therein lies the next lesson.

There are many types of muni bonds, and those tied to a specific, prospective thing, such as building nuclear plants, tend to be among the riskiest. Here are the main types of munis:

General Obligation (or "GO") bonds . These bonds are backed by the issuing government's full faith and credit. In other words, they are promising to pay back the bonds no matter what. Governments have a lot of tools to make this happen. The biggest, of course, is raising taxes, which is what Arkansas did back in the 1930s. Given the power to raise taxes, governments are in a strong position to honor their GO bond obligations. These are considered the safest of the historically safe muni bond environment.

Assessment bonds . These are based on taxes, usually property taxes, collected to make general improvements (street lighting, road works, county parks). Given that these are based on the issuing authorities ability to raise and collect taxes, this is also considered a safer muni bond.

Revenue bonds . These bonds are based on the specific revenue streams of an entity. Here the researching of a bond becomes much more important. For instance, bonds tied to the Triborough Bridge & Tunnel Authority are generally considered a good bet because the TBTA has a long track record. Moreover, it can raise tolls on its bridges and tunnels to meet future obligations. But not every project is so clear-cut (see WPPSS above). Generally, however, revenue bonds tied to projects with a track record and the power to raise money through increased pricing are considered safe-ish bets, even if not as safe as GO bonds.

A key element to all the above bonds is the investment rating. If the bonds have investment-grade ratings, the odds of the bonds paying off for the bondholder are quite good. Below investment-grade, the betting is more unpredictable. In this environment, there's wisdom in sticking with investment-grade bonds.

Lastly, we come to the elephant in the room that too few are discussing: interest rates. As with all fixed-income assets, as interest rates rise, the price of the asset declines.

This is not an issue for muni bond investors who buy their bonds and hold them to maturity. And this covers most investors. They are buying muni bonds for the tax benefit, the preservation of capital and the predictability of the interest rate payment over time.

But for muni bond investors, a rising interest-rate environment will have a downward impact on prices.

After years of lower interest rates and current record-low short-term rates, expectations are that rates will start to rise this year. The Federal Reserve is expected to start raising short-term rates later this year or early in 2012. Most economists also expect long-term rates, or yields, to rise. The 10-year Treasury yield is at 3.35%, already well above the 2.8% yields of last fall.

So, while defaults grab all the headlines, the bigger risk ahead for muni bonds will likely come from rising interest rates.

Dave Kansas blogs at at The Wall Street Journal's Marketbeat[3] .

[1] http://www.smartmoney.com/video/asset/news-hub-are-muni-bond-fears-overblown/BE5FB08E-5D8C-4D4E-9ED7-B3D6A6FF4705
[2] http://www.bloomberg.com/news/2010-07-21/bond-default-means-too-much-debt-too-little-time-commentary-by-joe-mysak.html
[3] http://blogs.wsj.com/marketbeat/

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Bonds by Jilian Mincer and Jonnelle Marte Published February 7, 2011

5 Ominous Signs the Bond Bubble Is Breaking

Despite their calm words , bond managers can't be sleeping well—what with their worries about interest rates and inflation, the housing market and municipal bankruptcies keeping them up at night.

So just when will this bond bubble burst? Treasurys are as expensive as they've ever been; bond king Bill Gross, manager of Pimco Total Return, the world's biggest bond fund, called the end of the 30-year rally in bonds way back in October; and the Federal Reserve's program to snap up Treasurys in hopes of reviving the economy could end in June without further government action. And still nothing catastrophic has happened. But smart financial advisers and fund managers are diligently watching for signals that the end is near and so should you. Ironically, good economic news--such as an improved housing market or increased consumer spending--could be disastrous for your bond portfolio. Here then are five key signs too look for that could signal the bond market is taking a turn for the worse.

1. A rise in interest rates.

Let's face it: Interest rates can't get much lower after falling steadily for the past three decades, so a hike is coming sooner or later--and that's bad news for bonds, especially Treasurys. If employment and consumer spending improve, the Federal Reserve is likely to lift interest rates to control inflation, says Greg McBride, a senior financial analyst at Bankrate.com. Higher rates could decrease the value of existing bonds because investors would likely flock to newer issues with higher yields.

Another reason higher rates are bad for bonds is they would likely mean more competition from insured bank products, which have been earning next-to-nothing in recent years. An upward tick in rates would suddenly make certificates of deposit, money market accounts and high-yield savings accounts more attractive to older and risk-averse investors.

Longer term bonds, especially U.S. government bonds, and bond funds, would see the biggest hit if interest rates rise because over the long-haul the higher rates would diminish the value of the bonds. Something as small as a one-percentage-point hike would send the average 10-year Treasury bond down about 8%, says McBride. "If interest rates go up two percentage points, that's a 16% loss."

Investors should stay tuned to the Federal Reserve monetary policy meetings, which occur eight times a year and often reveal news about rate changes and Fed policy on Treasury buybacks. The next meeting is scheduled for March 15. And beware: Interest rates could rise even if the economy remains sluggish, experts say.

2. Signs of inflation or deflation.

Concerns about deflation have eased in recent months as consumer spending has improved, but if the economy continues to heat up, it could stimulate inflation as more dollars go toward buying clothing, food and other products. Economists are particularly concerned that this buying spree could come from abroad – especially developing countries – in the form of higher prices for oil and commodities.

"Inflation is to the bond market what kryptonite is to Superman," says McBride, because it erodes the value of a bonds' fixed payment.

Rates on longer term Treasurys – such as 10-year and 30-year bonds – are more driven by inflation expectations, says Steve Huber, manager of the **T. Rowe Price Strategic Income Fund** (*PRSNX* [1]) . At the end of 2010, for example, rates climbed as investors became more worried about inflation. On the other hand, deflation makes Treasurys more attractive, but could be bad news for non-government bonds because issuers may have trouble making payments. Even when businesses earn less because of deflation, they have the same bond obligations, notes McBride. Investors should keep an eye on the Consumer Price Index, released each month by the Bureau of Labor Statistics.

3. Delayed bond payments.

Many states and major cities are facing a financial crisis and an enormous deficit, especially those hardest hit by the recession, including California, Illinois and Florida. Many governors and mayors are eager to slash spending, rein-in pension benefits and in some cases raise taxes. While states currently cannot declare bankruptcy and avoid paying bonds, many cities could, and some states are even litigating to avoid pension obligations.

The good news is that municipalities are unlikely to renege on bond obligations because that would make future borrowing difficult, says David C. Leduc, chief investment officer, active fixed income for Standish. More likely, they could delay payments or up the ante on future bonds to get anxious investors to invest in debt-laden states and cities. That means those with older bonds would see their values decrease as newer bonds offer better terms to attract investors.

To stay on top of the muni crisis, investors should watch for news on the housing market and unemployment, and also check credit ratings from Standard & Poor's, Moody's and other agencies. Elizabeth Fell, fixed income strategist for Barclays Wealth Americas, says to consider only bonds with an A Rating or better before investing. Also, understand the quality of revenue funding the bond. Is it backed by tax revenues, or by services that are less dependable such as public housing or a rural hospital?

4. More home sales.

No one expects a recovery in the housing market anytime soon, but when it does come it will certainly have an impact on bonds. Any uptick in home values and occupancy rates would provide additional revenues to cash-strapped states and cities, says Michele Gambera, head of quantitative analysis at UBS Global Asset Management. He says he keeps tabs on federal statistics on whether banks are lending and Conference Board numbers on durable goods. An improving housing market could lead to higher interest rates because it would be a sign that the economy is improving and the Fed – which has kept rates artificially low since the recession – would want to increase rates to limit inflation.

In the meantime, home loan defaults continue, and that negatively affects mortgage-backed bonds, says Leduc. Under some circumstances, bondholders lose some principle. Agencies like Fannie Mae that back bonds are on the hook for the credit losses, but individuals could also receive cash back sooner than they wanted—especially because savings rates at banks remain low. Professionals keep a close watch on housing starts, existing home sales and the S&P/Case Shiller home-price index for increases.

5. Higher government or corporate debt.

Another thing to watch out for: U.S. and corporations piling on more debt, experts say. Investors feel safe right now with their investments in high-quality corporate bonds, but that can change quickly if those businesses decide to increase their stock value by buying back stock or borrowing to buy a competitor. "Those things are not bondholder friendly," says Leduc. Publicly traded companies are required to disclose information about their debt and share repurchases in their financial statements.

All eyes will also be on the U.S. government's handling of its soaring debt load. Investors – especially those abroad – could lose confidence and pull out of Treasurys if the U.S. doesn't soon address the more than $14 trillion deficit. While unlikely, "if the appetite for U.S. government debt begins to wane that would be a catalyst for a meltdown in the bond market," says McBride.

For signs that the creditworthiness of Treasurys in on the decline, institutional investors typically look at the pricing of credit-default swaps, insurance contracts that bet against government debt. A rise in their prices would signify a loss in confidence in U.S. debt, says Anthony Valeri, a market strategist specializing in fixed income for LPL Financial. But with little information on swaps publicly available to retail investors, experts recommend regularly checking guidance coming out of the credit rating agencies.

[1] http://www.smartmoney.com/quote/PRSNX/

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