THE Weekly View
RIVERFRONT INVESTMENT GROUP
Asset Management • Investment Strategy • Advice

Rod Smyth • Bill Ryder, CFA, CMT • Ken Liu January 18, 2011

US Muni Bonds – Echoes of Europe

- Debt crises are rarely resolved until the debt is restructured, in our view. Already in the current crisis the housing market has experienced defaults, individual restructurings, and government forbearance. At the corporate level, aside from Lehman and General Motors, investment grade bond holders have largely escaped the crisis as bank bond holders were bailed out by governments, and low interest rates and strong profit growth have allowed corporate balance sheets to be repaired. In aggregate however, the cost of the Great Recession remains on the balance sheets of governments, states, and other municipalities. In the US and Europe, fears of systemic bank failure or sovereign default have led to more government debt and central bank subsidized interest payments.
- Like Greece and Ireland, US states and municipalities cannot print money, and so have no choice but to cut spending, raise taxes, or renegotiate the debt. Ultimately we expect a combination of all three. The uncertainty of this outcome has driven down municipal bond prices and is comparable to the European sovereign bond crisis, with the higher-risk state and local municipalities becoming increasingly differentiated from their better managed, more frugal counterparts. We recognize that the municipal market can become illiquid in times of uncertainty, leading to considerable price volatility, and are unwilling to step in at this time. Detailed credit analysis will be required, and the outcomes are still very uncertain.
- Last Friday's *Wall Street Journal* featured another problem for municipalities – maturing letters of credit that are not being renewed by banks, which themselves are facing tougher capital requirements. These letters of credit were issued during the height of the financial crisis. We believe that the severity of this problem has been overstated; while a reported $109 billion letters of credit are affected, this represents only about 3.8% of the municipal market. With the Municipal Market Data Curve (the benchmark AAA General Obligation municipal curve), now 0.42 percentage points steeper than the Treasury curve between 10 and 30 years, yields look tempting (see Weekly Chart), but we believe potential municipal bond investors should be wary of municipalities that are running large deficits and have large underfunded pension obligations. Federal Reserve Chairman Ben Bernanke has explicitly stated the Fed has "no expectation or intention to get involved in state and local finance," and that any bail out would have to come from Congress. For its part, we do not believe there is any appetite in Congress for further bail outs; thus state and local municipalities appear to be on their own. For current municipal bond holders, credit analysis now becomes paramount as price volatility will likely test investor confidence.
- We think budget problems in state and local municipalities help explain the recent US dollar weakness versus the euro. Whereas 'peripheral' Eurozone members are nine months into enacting austerity measures — budget cuts and tax hikes — to placate their bondholders, US municipalities are not as far along. As a result, the perceived risk of a state or local default in the US is the latest problem garnering the headlines and causing dollar weakness. With both economic blocks working through their debt issues, we think the euro/dollar exchange rate is likely to trade in a range of plus or minus 10% from current levels.
- Chinese President Hu Jintao visits the US this week, with economic discussion likely to focus on trade and the exchange rate. As we wrote last June, while there has been little movement in the *nominal* exchange rate, higher inflation — 5.1% in China versus 1.5% in the US —has caused an inflation-adjusted 3.6% *de facto* appreciation of the yuan through higher prices of goods and services. Thus the US' terms of trade with China have improved by more than the 3% nominal yuan/dollar gain since last summer. (Inflation has risen largely *because of* China's refusal to let its currency appreciate. In buying US dollars/Treasuries, China must print yuan, which has caused money supply growth to swell 20% in an economy growing 9%. We believe the excess money is driving prices higher.) We do not think that higher inflation is an ideal or sufficient method for adjustment in China. High inflation erodes consumers' purchasing power and has the potential to be economically and politically destabilizing (particularly with food prices

rising 12% annually). Additionally we think the US/China trade imbalance suggests that the yuan is sufficiently undervalued so as not to be meaningfully altered by a 6.5% adjustment, although further real reevaluation would help. China's recent policy decisions have done little to rebalance its economy more towards domestic consumption so far, but we recognize that the implementation of China's 12th five-year plan in March will likely set the tone for the future. China's central bank is pushing for greater currency convertibility, but is meeting resistance from exporters. We are hopeful that it will win this internal battle, because it seems to us that stable inflation is just as important to China as a stable currency. China clearly wants to become a dominant economic power and seems to recognize that goal is ultimately incompatible with an unconvertible currency.

The Weekly Chart: Beware the 'siren's call' of higher yields

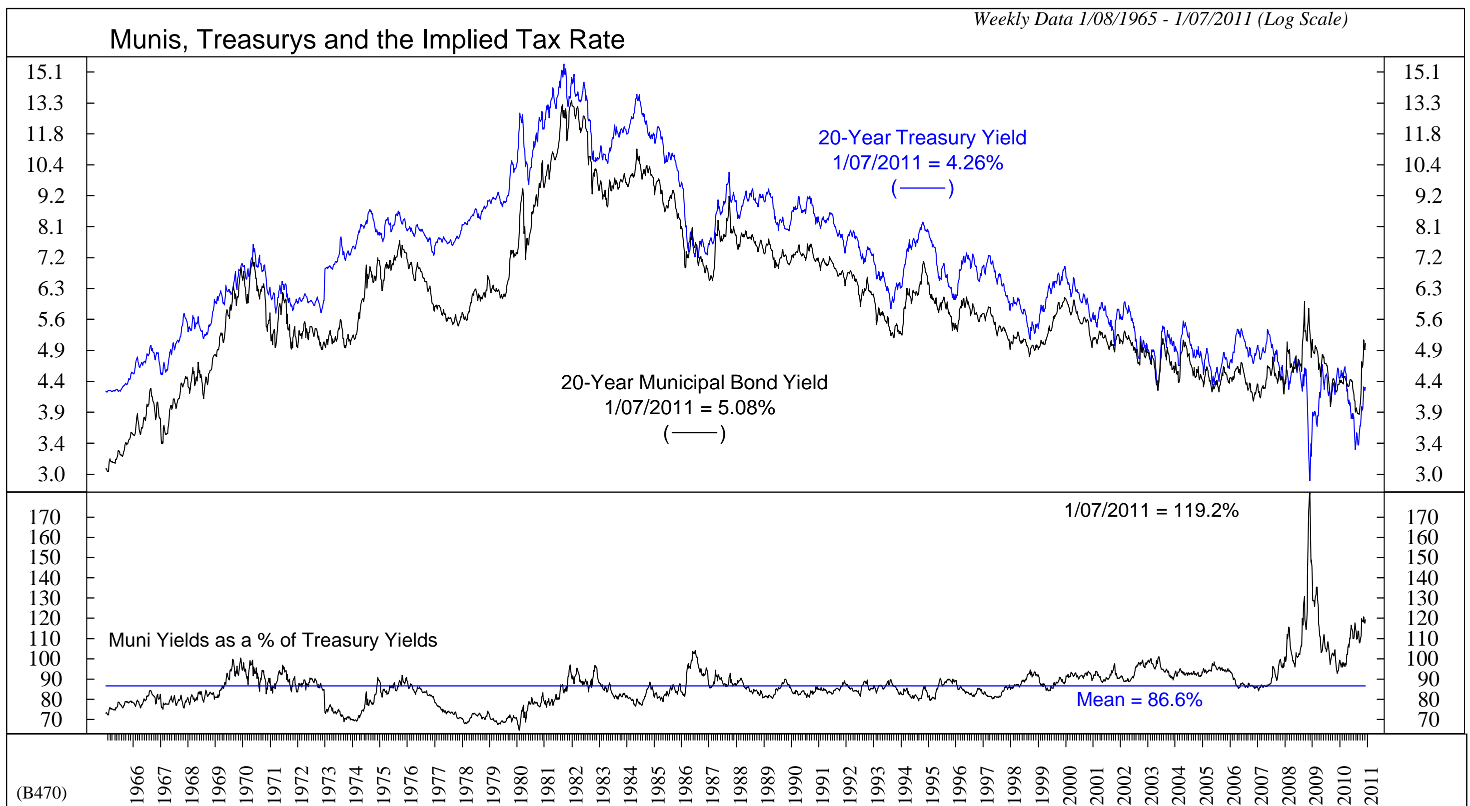

Chart courtesy of Ned Davis Research *Past performance is no guarantee of future results*

For the second time since the credit crisis began in 2008, 20-year municipal bond yields are significantly above those of comparable Treasuries, as illustrated in the chart above. Given the tax advantages and the relative historical rarity of municipal defaults, the ratio has averaged 86.6 since 1965 (bottom panel of the chart). We think it is crucial to recognize that the yield shown for municipal bonds is a blend and so reflects the wide differences in state finances. In our view, the reason for the current yield difference is that municipal finances in certain parts of the country are sufficiently dire that a 'default' premium is warranted in aggregate. Now is the time for municipal credit analysts to sort the sheep from the goats.

Rod Smyth, Bill Ryder, CFA, CMT & Ken Liu • 804-549-4800 • www.riverfrontig.com
Riverfront Investment Group, 9011 Arboretum Parkway, Suite 110, Richmond, VA 23236

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