



## The Current State of the Municipal Bond Market

*Many investors may be worried about how the difficult times facing many municipalities will affect their fixed income holdings. The following addresses those fears.*

As the credit crisis has unfolded, the credit profiles of corporations and governments around the world have deteriorated, and states and municipalities have not been spared. State and local income tax, sales tax and property tax revenues are down, and liabilities (in the form of pension obligations and other post-employment benefits) are up.

Nationally, one study estimated that state and local pension plans were underfunded by about \$4 trillion as of December 2008. (That is, the value of pension plan assets was about \$4 trillion less than the value of pension plan liabilities.) And this does not include any post-employment benefit plan underfunding.

Several states are also running significant budget deficits. Add on to this that outstanding municipal debt is in the neighborhood of \$3 trillion, and there is reason to pay attention to the fiscal status of states and municipalities.

Before getting too carried away with these statistics and recent press on the municipal market, it is worth reiterating a few key aspects of the historical data for municipal bonds:

- s Of the issuers that Moody's rated over the period 1970–2009, only 54 have defaulted. The vast majority of these defaults occurred in the health care and housing project finance sectors.
- s Of these defaults, only three have been on general obligation debt.
- s The historical cumulative five-year default rate for investment-grade municipal debt is 0.03 percent, compared with 0.97 percent for corporate issuers.
- s Recovery rates (that is, what the investor ultimately gets back after a security has defaulted) on municipal bonds have typically been higher than the recovery rates on senior unsecured corporate bonds (roughly 60 percent versus 38 percent).

So as bad as the current state of some states and municipalities may be, municipal bonds have historically been a safe place to invest, especially when compared with corporate bonds.

Also, yields on high-quality taxable municipal bonds are typically lower than the yields on high-quality corporate bonds. This indicates that the market is pricing in lower credit risk for these bonds than for corporate bonds.

It is also worth noting just how difficult it is for a municipality to file for bankruptcy. States are not even eligible to file for bankruptcy. (Many states also don't allow their municipalities to file bankruptcy, either.) Also, those that do file for bankruptcy may be cut off from the capital markets in the future.

### Summary

High-quality municipal bonds have experienced lower default rates than high-quality corporate bonds. However, a number of states and municipalities are currently experiencing more fiscal distress than they have historically, indicating that the municipal bond market may be riskier in the future than it has been.

It is also worth noting that Treasury bonds are the only fixed income securities generally considered to be free of default risk. All other types of fixed income securities have some degree of credit risk. To the extent possible, this risk can be mitigated by investing in high-quality sectors of the fixed income market (Treasuries, CDs, agencies and municipal bonds), but credit risk cannot be avoided by any means other than investing exclusively in U.S. Treasuries.

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