



## Insights from Northern Trust

### Commentary from Katherine Ellis Nixon, Northeast Region Chief Investment Officer

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Concerns about the strength and stamina of the global economic recovery came to the fore last week, with investors viewing a myriad of earnings and economic releases through the prism of sustainable momentum. Unfortunately, this proved to be a disappointing exercise. Global equity markets lost steam and ended in the red for the week, particularly based on Friday's action which took the Dow Jones 30 index down 2.5% on the day and the Standard & Poor's 500 down almost 3%. Stocks across Europe and Asia also fell, capping a week that was characterized by emotional highs as BP met some success with temporarily stemming the oil flow from the Deepwater Horizon well and historic moments as the Senate passed the sweeping Dodd-Frank Wall Street Reform and Consumer Protection Act. Eyebrows arched over the Goldman Sachs agreement with the Securities and Exchange Commission to pay a \$550 million settlement in a lawsuit, and pessimism increased as various data points reinforced fears of a pending global economic slowdown.

The concern about the global economic recovery trajectory runs broad and deep at this point, clearly articulated in the release of Federal Open Market Committee meeting minutes that reflected a downward revision in economic activity, signaling there would be consideration of further stimulus if conditions deteriorated further. Economic releases from last week also ratified investor concern over the state of the global economy. With important data points on the U.S. consumer and business activity and confidence released, investors got a dose of growing concern. Consumer confidence, as measured by the University of Michigan survey, fell to 66.58 in July from June's level of 76 – this was worse than the most pessimistic expectation. The low confidence level is certainly an explanatory variable in looking at the anemic July U.S. retail sales figures, which also came in below expectations at -0.5%. Sentiment looks a bit shaky abroad as well, with the ZEW Indicator of Economic Sentiment, a leading indicator for the German economy, dropping to 21.2 in July from 28.

So perhaps corporate spending will come to the rescue? Both small business as well as general business confidence continue to deteriorate, and many economists fear that we are at the tail end of the inventory restocking cycle which propelled the economic recovery thus far. With waning consumer demand and continued deleveraging, it is a stretch to assume that activity will be robust.

Even the global growth engine known as China seems to be going through a well-controlled economic slowdown. Although at a still-enviable 10.3% second-quarter 2010 gross domestic product (GDP) growth rate, growth has slowed and may slow further as policies aimed at curbing speculation and stemming fixed asset investment (FAI, the biggest GDP driver) continue to take hold.

Under these circumstances it is not illogical that investors would be more risk averse, seeking the safer havens of fixed income and cash. Certainly we have seen this in the U.S. Treasury market, where two-year yields fell to a historic low of 0.569% last week, a level lower than that reached during the height of the Lehman crisis. The 10-year note has been holding solidly below 3% as well. With little concern about inflation, investors are willing to accept these low absolute yields in return for the high relative security of these bonds. As investors



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have continued to focus on safety and security in their portfolios and have relied heavily on their fixed income portfolios to provide that, we have begun to hear more negative news in other areas of the bond market, particularly in municipal finance.

With tax-paying entities, municipal bonds tend to represent core holdings in fixed income portfolios. With historically low default rates and a tax-advantaged status, munis have historically provided predictable cash flows, diversification benefits and lower volatility to investment programs. Unfortunately, the current economic climate is one that is extremely challenging to state and local entities, and this has called into question the overall creditworthiness of various municipalities as investors worry about the “next Greece” here in the United States. With income, sales and real estate tax receipts falling – in addition to a decrease in federal aid – finances at the local level are stressed. We have seen various articles in the popular press that highlight the growing concern, and this has created some understandable anxiety as clients tend to view their municipal bond allocation as their low-risk asset.

Given the environment, we thought we would take this opportunity to provide an update on our views of the \$2.8 trillion muni bond market, highlight some positive secular trends and articulate how we are managing through the challenges for our clients.

We agree that there are areas of the broader municipal market that are challenged; however, many of the vulnerable credits were made not so much by the current economic conditions as by poor overall planning before the financial crisis hit. The poster child for this is Harrisburg, Pennsylvania, where the \$288 million in debt incurred for the incinerator project was going to be onerous regardless of the economic climate, as various analyses show that it is an impossibility for that facility to process enough waste to ever service the debt load, even when running at peak efficiency and capacity. The Harrisburg situation highlights the importance of credit research and due diligence, something that we have always considered a crucial step in the investment process. With dedicated resources focused on in-depth credit research, our municipal bond team assesses each offering carefully based on rigorous analysis. Even before the dislocation in the municipal bond insurance market, we relied only on this fundamental analysis to support bond purchases.

Credit research is all the more critical today, given generally deteriorating budgetary forecasts. It is important to note that state and local finance is a lagging indicator – budgetary improvements hit the local balance sheet well after the economic recovery has taken hold. For this reason, we tend to favor only certain types of municipal bonds with secure and more predictable cash flow streams right now in this market:

**Pre-Refunded Municipal Bonds** - These are the result of an issuer’s refinancing of older, higher- coupon debt with today’s lower-coupon debt. The IRS says this is fine, but issuers are only allowed to refinance this way once, if the older debt is escrowed to maturity. The older debt remains in the market, now backed by U.S. Treasuries as collateral versus the original credit features of the issuer. With the Treasury collateral, these bonds now have a top credit profile, but due to the high coupon nature these can demand a large premium dollar price over par.

**Unlimited Tax General Obligation (GO) Bonds** - These bonds are backed by the full faith and credit of the issuer. The issuer has unlimited ad valorem taxing power (taxes placed on real property) to re-pay the bonds. These come in varieties like state, city, county and school district GOs.

**Dedicated Essential Service Revenue Bonds** – These are bonds with revenue streams from essential services like water/sewer, public power and transportation. These bonds can also be backed by sales taxes or personal income taxes. Revenues flow directly to bondholders, and we look for those that have very high debt service coverage ratios.



We believe that this “belt-and-suspenders” approach to credit quality serves our clients well in this uncertain environment. Conversely, we are avoiding certain revenue bonds linked to specific projects and for which there needs to be annual appropriation. These bonds require a legislative act to authorize the expenditure of funds to pay debt service. Many of these bonds can be for small project- specific-type financing. Our view is that due to the slower economy and the resulting lower fund balances across state and local governments, the available discretionary dollars used to appropriate/ pay these types of bonds will be fewer than in years past, creating challenges for the annual appropriation decision. That being said, however, we believe it unlikely that municipal finance will become the next “Greece” for investors. To put things in a bit of perspective, Greece’s debt to GDP stands at approximately 120% while California’s – a state often mentioned as fiscally vulnerable – is around 10% of its state GDP.

Alongside the challenging cyclical trends, we observe some very positive secular trends in the municipal bond market. With the expiration of the Bush tax cuts, and with the stresses on local finance resulting in increased state income and sales taxes, the tax benefits of municipal bonds may become only more valuable. Further, the Build America Bond (BAB) program has resulted in lower traditional supply of municipal bonds. The BAB program was initiated as part of the American Recovery and Reinvestment Act of 2009. It was intended to provide federal support to “shovel-ready” state and local infrastructure projects, in effect enabling municipalities to issue taxable bonds and receive a federal tax subsidy of 35% of the coupon payment. As the interest paid by these bonds is fully taxable, it is a different class of investors – typically institutions like life insurance companies and pension funds – interested in purchasing these bonds. Institutional investors have welcomed this program, and nearly \$120 billion in BABs have been issued since April 2009. This is more than 25% of the total muni issuance during this period, so clearly the ability to issue these bonds has reduced traditional supply. A great example of the success of the program was last week’s issuance by Illinois of \$900 million of BABs with a taxable yield of approximately 3.4% over treasuries, appealing to non-traditional investors including investors in Europe and Asia. The BAB program will be extended beyond 2010, although the federal subsidy will be lower, and there is discussion about making the program permanent.

With increased demand for traditional municipal bonds being driven by increased tax rates and decreased supply being driven by the BAB program, we continue to believe the inherent value of traditional municipal bonds is enhanced. There will be credit challenges, to be sure, but those can be managed through dedicated credit research and active oversight.

Katherine Ellis Nixon holds designations as a Chartered Financial Analyst and Certified Investment Management Analyst.

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