

Day of Reckoning or Business As Usual?

The December 19, 2010, *60 Minutes* segment, “The Day of Reckoning,” raised some valuable points, but the information touted by equities analyst Meredith Whitney was largely inaccurate. The segment focused on a looming crisis in municipal debt across the nation, and one has to wonder about the timing of the broadcast, which took place during a volatile time in the municipals market. The current volatility in the municipals market has been based on an abundance of oversupply, political unrest regarding taxes, and the forthcoming cessation of the Build America Bonds program—not on a credit or funding crisis.

One accurate prediction does not a seer make

During the past two years, Whitney has made one important accurate call—and a fairly obvious one at that. After the failure and subsequent bailout of Bear Stearns and several other banks, in a CNBC interview, she boldly predicted that banks were in trouble and that Citigroup would cut its dividend. She was correct; however, many analysts believed the same thing at the time—and some predicted this, though they didn’t announce it on CNBC.

Whitney has struggled with her forecasts since 2008, when she made the prediction referenced above. On May 17, 2010, again on CNBC, she warned to “avoid financials at all costs.” Since then, and through December 15, 2010, financials have gained 3.89 percent, a decent return. When she made her prediction on May 17, the market had taken a serious downturn and the flight-to-safety trade was well on its way. One could argue that Whitney used the uneasiness in the markets to garner attention, by promoting her new company and referencing a 600-page report prepared by her team and available only to her clients.

Whitney also mentioned in her May 17 comments that the big banks would not perform well. Since then, Goldman Sachs has climbed from 143.47 on May 17 to 169.60 as of December 15, an 18-percent gain; and JP Morgan, which opened at 39.93 on May 17, moved to 42.29 on December 15, a 6-percent return over six months. In addition, Citigroup, the one bank that did not fail or get acquired during the entire crisis—and that was arguably affected most—has gone from 4 at the open on May 17 to 4.7 as of December 15, a more than 17-percent return. Finally, Whitney commented that “the markets would be bleak” going forward. The S&P 500 Index has gained more than 10 percent since the day she appeared on CNBC last spring.

In a three-strikes-and-you’re-out scenario, in that very same May 17 interview, Whitney also called for a double-dip in the real estate market during the second half of the year. To be sure, housing has a way to go, and we could very well see somber days through the next 12 to 18 months, but sales of existing homes, as reported in mid-December, were up 5.60 percent month-over-month in November, and the House Price Index was up 0.70 percent in October.

State debt and unfunded pension liabilities

Let’s look at two other significant issues discussed in the *60 Minutes* piece:

1. Debt liabilities currently held by the states and the likelihood of a spike in defaults
2. Unfunded pension liabilities

In 2010 alone, we've seen close to 100 defaults. There were 204 in 2009 and 162 in 2008. The total number of assets affected was \$2.52 billion for 2010, \$7.2 billion in 2009, and \$8.1 billion in 2008. How many of these did we hear about in the national news? Did we hear about Jefferson County, Alabama's \$3.8 billion default, the single largest default in the last few years by more than \$2.1 billion? What about Main Street Natural Gas, another big one, at \$700 million? And, finally, did we read about Vallejo, California's, Chapter 9 filing in May 2008, which was worth approximately \$279.8 million?¹ Other California municipalities that had issued similar debt were not affected by the Vallejo default, as the debt was backed by a dedicated revenue stream and not funded by state or local governments.

Whitney predicted 50 to 100 or more defaults next year, affecting hundreds of billions of dollars in assets. That's quite a range and quite a vague prediction. Actually, to our way of thinking, 50 defaults would be an improvement. But, for the sake of argument, let's imagine a \$200 billion default, which would be significantly higher by a long shot than anything we have ever seen and still only a fraction of the \$3 trillion municipals market.

In "Kaminsky's Call: Muni Market May Be Great Buy Opportunity," published on December 21 on the CNBC website, Ben Thompson pointed out that, if the 10 largest cities in the U.S. defaulted on their debt at the same time, the affected assets would equate to \$85 billion. Such a circumstance would be highly unlikely, but it would still be only a fraction of the municipals market and come nowhere close to Whitney's hundreds billions of dollars in defaults assertion.

Taking things a bit further, on December 22, in "Meredith Whitney Overreaches With Muni Meltdown Call," which appeared on the *Bloomberg News* website, Joe Mysak commented that Whitney had admitted that she didn't believe state governments would default. By law, they can't. So that leaves local governments and authorities. Mysak said that \$5 billion to \$10 billion in assets could go under next year, but that estimate would be on the high-end and mostly in nonprofit borrowings, nursing homes, housing developments, and bio-fuel refineries. Moreover, in a report published in November 2010, Fitch Ratings commented, "Debt levels for U.S. local and state governments are relatively low, with annual debt service representing a relatively small part of budgets." So, Mysak asks, why would states decide to default on debt? It's a very small portion of their obligations.

Finally, in "U.S. State and Local Government Bond Credit Quality: More Sparks than Fire," published on November 16, Richard Raphael, a specialist in the municipals arena with 31 years of experience, said, "The tax-supported debt of an average state is equal to just 3 percent to 4 percent of personal income, and local debt roughly 3 percent to 5 percent of property value. Debt service is generally less than 10 percent of a state or local government's budget, and in many cases much less." The report continued, ". . . debt service is a relatively small part of most budgets, so not paying it does not do much to solve fiscal problems (particularly as compared with the costs of such an action)."

The *60 Minutes* piece also covered unfunded pension liabilities. This is no doubt a big problem, and one that should be dealt with sooner rather than later; however, it is a problem that we believe won't truly rear its ugly head for many years down the road (rather like the social security problem). It is really a matter of current state funding. A solution may be to simply

reduce the level of financial support that states dedicate to pensions. Though extremely unfortunate for people relying on these benefits, this does represent a way out of the difficulty.

Municipals market going forward

Some municipalities will struggle this year and in years to come. In 2011, defaults will remain close to current levels, and, yes, we could see some major cities reach critical levels. Detroit comes to mind. But, we believe if you stick to quality investments and strong credit obligations and shorten up on duration, you can limit volatility and decrease the possibility of being affected by any defaults considerably.

Troubled states and entities include Arizona, California, Florida, Illinois, Michigan, New Jersey, Nevada, and Puerto Rico, and stick to stronger states like Massachusetts, Texas, and Virginia. We think that if you must have exposure to troubled states, it's better to keep to essential services and GOs in states that are doing better. We'll keep these guidelines in mind as we invest in the municipal market.

¹*Distressed Debt Securities Newsletter*, December 2010.

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