FENWICK ADVISERS

Municipal Meltdown

Over the past month, municipal bond funds in the US have suffered a meltdown on a par with the selloff in emerging market bond funds earlier this year. Unlike the exodus from EM debt that was exacerbated by the rush to unwind leveraged trades when the Fed announced its intention to taper its asset purchases, the catalyst for recent withdrawals from municipal bond funds clearly was related to deteriorating credit conditions in several visible cities. At the top of the list was Detroit's default, but in reality that credit event does not seem to have much spillover to other cities because its debt was neither large nor widely held. Indeed, Detroit's demise has been long seen as inevitable, so municipal bond funds avoided that risk. By contrast, the unraveling of Puerto Rico's finances has come as a surprise to most municipal bond investors who had no idea that their mutual funds owned the debt of this tax-privileged and now nearly insolvent, US territory.

As is the case with all indexed bond funds, the performance of US municipal bond funds is measured against that of an index weighted by the amount of debt outstanding. As a result, municipal bond fund managers tend to hold on average more debt of the largest issuers. Puerto Rico, as a large debtor comparable to that of an entire state as opposed to just a city, carries a large weight in the municipal bond universe. That fact tends to be unbeknownst to most investors who buy these funds. As an example, one aggressive fund that has seen huge withdrawals of late had an exposure to Puerto Rico of 15%. Needless to say, its performance also has been abysmal as Puerto Rico's credit ratings belatedly were downgraded. Puerto Rico also has always been a large debtor territory with access to US social welfare benefits and the attendant transfers from the US Treasury.

Detroit and Puerto Rico are the tip of the iceberg in terms of unfunded long term liabilities at the municipal level. Now the yields on municipal debt have returned to levels more commensurate with these risks, US cities will feel much greater pressure to enact another round of budget cuts in the year ahead. During the previous bout of budget cuts in 2009 to 2011, state and local governments laid off 10,000 to 15,000 workers per month in aggregate. The next round may not be a wrenching but the combination of municipal layoffs and local tax increases will take some toll on the US economy. The most likely candidate for the next shoe to drop is Chicago and the State of Illinois, which unlike Detroit would have spillover effects to the broader municipal market.

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