

## **NOW MORE THAN EVER, CREDIT QUALITY MATTERS**

*Maintaining a diligent credit process is key to investing in tax-free municipal bonds*



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*Northern Trust  
manages over  
\$300 billion  
in fixed-income  
assets as of 6/30/11  
and the municipal  
marketplace is  
a core area  
of expertise.*

The years since 2008 have been unusually turbulent for municipal bonds. Volatility increased sharply during the 2008 global financial crisis, then spiked again during the fourth quarter of 2010. The finances of many state and local governments are strained, causing concern that default rates on municipal bonds will rise above historic norms.

Given the sluggish economic recovery, Northern Trust believes credit issues will remain a significant concern for tax-exempt bond investors during the foreseeable future. In this challenging environment, we believe a disciplined approach to credit quality review and evaluation is critical.

### **VOLATILE ENVIRONMENT**

Owning high-quality municipal bonds has generally been rewarded over time. Muni bond default rates have historically been much lower than those in the corporate sector. Still, credit issues at the state and local levels do arise even in the best of times, and these are most assuredly not the best of times. Volatility in what is usually a placid sector of the fixed-income market has been high since 2008, and we expect municipal bond credit risk to remain elevated, relative to historic norms, as the economy struggles to fully emerge from the worst downturn since the 1930s.

The current, tepid recovery is atypical of post-war economic experiences, and thus the investment climate is distinctively challenging as well. The recent recession was caused by the rapid deflation of a massive credit bubble in residential housing, the main store of wealth for many families.

The economic landscape after this credit bubble's demise bears little resemblance to that following the typical recession and Federal Reserve-engineered recovery. Deleveraging among households, corporations, and state and local governments is imparting economic and financial stresses that are unique among recent business cycles. These stresses, in turn, have promoted volatility and boosted credit risk, both real and perceived.

### **FEDERAL STIMULUS WINDING DOWN**

Though many municipalities have made significant progress in addressing short- and longer-term budgetary shortfalls, and some tax revenues have started to rebound from the depths of the Great Recession, it would be naïve and irresponsible to minimize the importance of risk management in the credit area.

“State finances? They’re still a mess,” *The Kiplinger Letter* reported in a recent edition<sup>1</sup>. According to Kiplinger, a significant part of the problem is the looming drop in federal stimulus money from \$51 billion in 2011 to just \$3 billion in fiscal 2012, which began on July 1, 2011. As states receive fewer federal dollars, there could be “more problems for local governments ... as the cutbacks move down the money pipeline.”

Now more than ever, credit quality matters.

<sup>1</sup> *The Kiplinger Letter*, June 10, 2011; Volume 88, No. 23



## MICRO AND MACRO

Our municipal fixed income credit analysis process encompasses both a top-down and bottom-up focus. In fact, we view one type of analysis as incomplete without the other. Macro and micro factors interact to form a composite of national and local economic conditions, a portrait that helps us assemble high quality, creditworthy tax-free bond portfolios even in an undeniably challenging environment.

**Big-picture.** Top-down considerations form the foundation of our credit analysis. Municipal governments and the projects they finance do not operate in an economic vacuum, as has been made clear during this financial crisis. State and local revenue streams are closely tied to broader, national economic trends. A weak labor market, for instance, usually affects sales tax receipts and revenues generated by nonessential service projects. When stock prices are falling, capital gains tax payments are lower as well. Falling real estate prices eventually can reduce property tax revenue, which hits county and city finances hardest. In that sense, municipal credit quality often may be considered to lag changes in general economic conditions.

Northern Trust managers take into account proprietary and public forecasts for a variety of critical macro-economic factors, including:

- National and local economic activity
- Monetary and fiscal policy
- Official (benchmark) and market interest rates
- Labor market conditions
- Capacity utilization
- Headline and core inflation
- Credit growth
- Geopolitical risk

**Location, location, location.** We also recognize that these issues do not affect all locales equally, because the mix of income, sales and property tax revenues can vary widely. A few states do not have an income tax, for example, which may put added pressure on sales and property tax revenues and, by extension, the bonds that depend on those sources of income for the timely payment of interest and principal to creditors. States with resource extraction taxes may benefit if demand for commodities increases. We carefully scrutinize the differing effect of revenue sources on various government issuers' finances and projects as part of the credit review process.

**Fine print.** Because of the importance we attach to credit quality, we weigh the particular details that comprise the issuer and specific loan covenants of each municipal security we consider for purchase.

Although government regulations have increased public access to filing data (see the Municipal Securities Rulemaking Board website at [emma.msrb.org](http://emma.msrb.org) for more information), the size of the municipal market (nearly \$3 trillion), the number of issuers (roughly 50,000) and the volume of information regarding each offering (offering statements often run at least 100 pages, with much of it couched in legalistic language), the credit review process is not one in which most investors might be expected to excel.

*For most clients, repayment confidence is a much higher priority than extracting a few extra basis points of current yield.*

## **OTHER CONSIDERATIONS**

Our teams also analyze where bondholders stand in an issuer's lien structure, whether interest payments must be reauthorized by a governmental entity — a potential red flag — and what additional obligations (including underfunded pensions liabilities) an issuer has outstanding, as factors that could affect the ability to meet future debt obligations.

Often we choose to own dedicated essential service bonds backed directly by revenue whose economic vulnerability is low, such as water, sewer and other utility-related projects. Although those types of bonds may offer a slightly lower interest rate than their higher-risk cousins, repayment confidence is a much higher priority to most clients than extracting a few extra basis points of current yield. Some general obligation bonds also can be attractive, though we do not automatically accept the “full faith and credit” feature of general obligation debt as the ultimate litmus test for determining credit quality.

Finally, we realize that “things change.” Issuers that once may have been dicey credits can and do reform their ways, while others that historically have been good credits could abandon their fiscal discipline. Meanwhile, the pension liability clock might be ticking. That's why it is always important to ...

## **TRUST BUT VERIFY**

While we respect the work of the various credit rating agencies, Northern Trust does not rely on outside sources to provide the definitive word regarding the creditworthiness of a municipal issuer. We do our own proprietary credit homework, which often includes talking directly with the appropriate local authorities about the arcane aspects of a bond offering that might lack sufficient transparency for our purposes. We have never depended on municipal bond insurance, even when it was a major part of the industry, because the reliance on insurance could serve as a shortcut in the credit review process and provide a rationale to hold a security that we otherwise would consider less than creditworthy. Our mantra has been, “If we would not buy the bond without insurance, we won't buy it with insurance.”

## **OUTLOOK**

Looking ahead, we anticipate a prolonged period of heightened volatility for fixed-income assets, including those in the municipal sector. Whether the perspective is from the top down or from the bottom up, economic conditions have not yet normalized, and may not do so for some time. In this environment, skilled credit analysis is especially critical. Yet, we do not believe the economic outlook is sufficiently foreboding that it should dissuade investors from considering munis as a potential part of their overall asset allocation.

It's all about giving credit where credit is due. And only where credit is due.

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