

Investment Focus

2010 Municipal Bonds Update



Recent news reports have highlighted extreme cases of financial hardships for cities, towns and states across the country. However, upon a broader, more reflective examination, the majority of municipalities are weathering the current economic conditions and we continue to believe that the municipal bond market holds opportunities for investors.

A few rare circumstances notwithstanding, we expect municipal bond issuers to remain sound financial entities with reliable debt-servicing capabilities.

When assessing the muni bond market, an important bellwether is Moody's upgrade-to-downgrade ratio. For the full year 2009, Moody's rating agency reported that the municipal credit upgrade-to-downgrade ratio was at 0.7:1 (seven upgrades for every 10 downgrades). The decline from 2.4:1 in 2008 illustrates the effect of the weak economy on government finances. Still, the ratio is not drastically below 1:1, a reasonably favorable performance relative to recent doomsday media headlines. In addition, most of the downgrades were incremental from a high rating to one only marginally less strong, such as from AA- to A+. There is no question that municipal governments must work harder to become more cost efficient. Improved cost effectiveness combined with creative revenue solutions will eliminate the downgrade trend, though we expect the ratio to remain below 1:1 in upcoming quarters.

What is S&P's view? In its 11/6/09 report, S&P "believes public issuers will manage through the strain. What we consider strong fiscal management has buoyed our credit ratings to date, particularly state and local governments, which accounted for 95% of the upgrades."

For both revenue bonds and general obligations, there are many options open for ensuring timely debt service payment. Massachusetts earlier this fiscal year decided to

raise the sales tax to close its gap between ongoing revenues and expenditures. Sales tax revenue for the state increased in the second half of 2009, a period in which we read a blizzard of negative news articles on the retail industry. On the cost side, California has implemented involuntary worker furloughs. Not only have these furloughs saved cash, but their frequency has led some unions to consider giving up certain pension benefits in exchange for reducing the frequency of the furloughs. The point is that governments facing an imbalance have many ways to correct the problem. Another important consideration is that most revenue bond issuers have full rate-setting ability. This enhances their ability to pay debt service.

What has changed in the past year? While the debt-servicing abilities of municipalities remain in very good condition, some troubling fundamental trends emerged. Things will improve, but not before they get worse in some cases. We believe it will take multiple quarters until upgrades outnumber downgrades again.¹ Still, the key point is that many of these credits are rated very highly. Some downgrades will occur, but except in rare circumstances those downgraded credits will still be fully able to meet contracted debt-service payments. We remain very confident in the debt-servicing abilities of the majority of municipal bond issuers and vigilant in searching for opportunities while avoiding the few true problem spots.

¹In the first quarter of 2010, Moody's upgrades vastly outnumbered downgrades. However, this was due to a singular adjustment made to their ratings methodology. It waone-time event that was not related to current trends in municipal credit quality. The information provided is as of July 2010. BNY Mellon Wealth Management services are provided by bank subsidiaries of The Bank of New York Mellon Corporation, primarily BNY Mellon, N.A. This is not intended to serve as investment advice. The information contained in this paper is based on sources believed to be reliable, but its accuracy is not guaranteed. © 2010 The Bank of New York Mellon Corporation.