Muni Bond Risks Mount, But Federal Bailout Unlikely

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Municipal bonds are usually boring, offering low-interest, tax-exempt returns for conservative investors. But with cities' finances in tatters, the muni market could roil Wall Street and spur new calls for bailouts.

Financial analyst Meredith Whitney recently warned that a muni bond crisis "is the largest threat to the U.S. economy." She is noted for predicting the 2008 Wall Street meltdown months in advance.

IShares' muni bond ETF (MUB) fell Wednesday, closing near the two-year low set in mid-December.

Municipal bonds, used to finance state and local government spending, are about a $2.8 trillion market.

But state and local tax revenues remain well below pre-recession levels, with some cities and counties flirting with bankruptcy. Emergency federal aid to the states runs out this spring. Public employee retiree costs are a fast-growing problem. And the federally subsidized Build America Bonds program expired Dec. 31, making munis a less attractive investment.

There's no appetite on Capitol Hill for yet another bailout, especially in the GOP-led House.

"Fifty to 100" counties and cities could default on their muni bond obligations this year, Whitney says, precipitating a crisis.

It's So Bad It's Good?

Other analysts are not convinced.

"Whitney may be a good bank analyst, but when it comes to public finance she doesn't get it," said Ed Reinoso, CEO of Castleton Partners. "Is there risk in the muni market? There is more than there was five years ago, yes. But it probably does not end in default."

The default risk — and media coverage of budget woes — may stiffen politicians' spine to make tough decisions.

"You've seen a trend of people coming into office who need to do something about (budget crunches)," said Craig Brandon who is a co-manager of the Build America Fund at investment firm Eaton Vance. "I think part of the upside of all the negative publicity you've had with the municipalities is that it gives a lot of governors and state legislatures cover to make the hard decisions they've never had to make before."

A few governors, like New Jersey's Chris Christie, have aggressively pushed budget cuts in the face of heavy union opposition — without suffering in the polls. On Monday, Calif. Gov. Jerry Brown released a budget that relies heavily on spending cuts to pull the Golden State out of its fiscal hole.

Markets Worried

It's not clear the market trusts politicians to step up. MCDX is an index referencing muni bond credit default swaps. The spreads on those swaps are up 87% to 107% since early November 2009.

"It does suggest that there are some investors who see a lot of downside in the muni market," said Brian Fraser, an attorney at Richards, Kibbe and Orbe. "The overarching concern is the cost of health care and pensions for (government) workers."

The pension plans covering about two-thirds of local government employees face an unfunded liability of $574 billion. The unfunded liability for state and local workers' health care costs is $1.4 trillion, according to the libertarian Cato Institute.

"There is also a growing concern that municipal issuers are not as afraid of defaulting as they once were," Fraser said.

When forced to make a choice between paying off bondholders and keeping services that voters need and want, local governments increasingly seem willing to choose the latter, Fraser says.

Since 2008, Vallejo, Calif., has declared bankruptcy while Harrisburg, Pa., and Jefferson County, Ala., came perilously close before being bailed out. Last year ratings services like Moody's and Fitch downgraded the muni bonds of seven cities to junk status, including Harrisburg as well as Littlefield, Texas; Detroit and Pontiac, Mich., Central Falls and Woonsocket, R.I.; and Harvey, Ill.

The Business Insider recently listed Central Falls and 16 other big cities that could face bankruptcy in 2011: Honolulu, Hawaii; New York City; Detroit and Hamtrack, Mich.; Camden, Newark and Paterson, N.J.; Los Angeles, San Francisco, San Jose, and San Diego, Calif.; Joliet and Chicago, Ill.; Cincinnati, Ohio; Reading, Pa., and Washington, D.C.

Cities and counties rushed to beat the year-end expiration for Build America Bonds. BAB was created as part of the stimulus to encourage infrastructure projects, and the federal government paid 35% of the interest on the bonds. New munis will be less appealing to investors without higher rates.

Safe As Houses

Adding to the pressure is that over $53 billion in stimulus funds to help stabilize state budgets will end this spring. It was supposed to last until state and local tax revenues normalized. A recent survey by the National Conference of State Legislatures found that 25 states do not expect a return to pre-recession levels until fiscal 2012 or later, while another 20 were unable to make a prediction.

Local governments are in even worse shape than the states. They are heavily reliant on property taxes, which continue to fall along with home prices and assessments. Many states are cutting aid and pushing responsibilities down to municipalities.

If the muni markets face a crisis, cities and their bondholders may not get help from Congress.

"We've just passed things like unemployment benefits that help states and local governments," said Sen. Majority Leader Harry Reid, D-Nev. "I think it's a little early to start talking about bailouts now."

House Budget Committee Chairman Paul Ryan, R-Wis., was more direct. "We are not interested in bailouts. This is a flat no. You're not going to get it here. Take it somewhere else."

Bailing out one city could implicitly put the federal government on the hook for all muni debts.

Rather than a rescue, some Republican lawmakers have signaled they will pursue legislation to let states file for bankruptcy, like local governments can.

Also, there's scant support for more bailouts among voters, especially in the Tea Party movement.

"We hate bailouts, period," said Billie Tucker, co-founder of the First Coast Tea Party in Florida. "Congress will come up with some sort of story about how life will end if we don't bail out the municipal bond market. But people are going to have to face up to the fact that we're broke."