Refuting Meredith Whitney

By Robert Huebscher
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Wealthy investors, seeking safe tax-free income, have historically centered their portfolios on municipal bonds. The fiscal problems faced by many states and local governments, however, are leading many to question that strategy, none more vocally than the analyst Meredith Whitney, who predicted "hundreds of billions" in municipal bond defaults in a recent *60 Minutes* interview.

Leading the challenge to Whitney's bold forecast is one of the organizations charged with monitoring the ability of states to meet their debt obligations – the ratings agency Standard & Poors. Robin Prunty, a senior director in S&P's public finance ratings group, exemplified the agency's standpoint while speaking at a luncheon sponsored by the Boston Security Analysts Society last week.

"We don't feel that US state and local governments are facing a debt crisis where we are going to see widespread defaults," Prunty told her audience.

I was reminded of a similar talk given by an S&P analyst several years earlier, assuring the audience that the housing market had stabilized and securitized mortgage obligations deserved their investment-grade ratings.

Everyone knows how that turned out. Nonetheless, I side with S&P over Whitney in this debate.

Munis will face many challenges this year, though – just not the defaults that Whitney predicts. I'll discuss the problems muni investors may face, but first let's look at what Prunty said about public finances.

Refuting Whitney

The clearest metric that indicates debt levels may be unsupportable is the ratio of debt service payments to revenue. On that score, state governments' debt burdens are modest, according to Prunty, averaging approximately 4%. That compares to 15% for sovereign governments rated AAA by S&P.

The comparison to sovereign debt is not fair, though, Prunty argued. She said that most municipal debt is amortizing, requiring regular payments of principal and interest. Sovereign debt typically pays principal at maturity.

Moreover, she said, most states have managed their budgets very effectively through the recessions and disruptive credit conditions, either by raising taxes, drawing on reserve funds, or issuing additional debt – in some cases at variable rates. "Overall," she said, "the states are pretty well positioned."

As a result, approximately 99% of US public finance debt is rated investment grade by S&P, and those ratings have been improving over the last two decades. Eleven states are rated AAA, and most of those have been for decades. Only two states, Illinois (A+) and California (A-), are rated single-A, and Illinois is the only state currently on negative credit watch. Arizona, California, Florida, Ohio, Maine, and Rhode Island are among the more troubled states, which Prunty attributed to their entering the recession earlier than most other states.

Connecticut has the largest debt burden of any state, with principal and interest payments representing 10% of its revenues. However, Prunty said, in the 1990s Connecticut faced a far worse budget crisis, and it did not default.

At the other extreme, Louisiana and North Dakota, which Prunty said had "breezed through" the recession without any material decline in revenue, have been upgraded. *New York Times* columnist Paul Krugman recently criticized Texas' financial health, but Prunty did not include it among the troubled states, since it has several billion dollars of reserves to weather adverse economic conditions. Wyoming may be the fiscally healthiest state, with no debt obligations at all.

The creditworthiness of states stems largely from their constitutional requirements for balanced budgets, according to Prunty. Some states, like Maryland, defaulted following the Civil War, and that began the movement to require balanced state budgets.

The last state to default was Arkansas, during the Great Depression.

Over the last several decades, Prunty said that total defaults for US public finance "might have gotten into the billions," but most of that defaulted-upon debt was tax-exempt and issued on behalf of corporations. In those cases, the corporation defaulted, not the public entity.

No state or local government defaulted on any rated debt in 2009, in the depths of the recession that began in 2008. Indeed, there were 15 ratings upgrades in fiscal 2008.

In 2010, there were three defaults by local issuers – none of which were for issuers with investment-grade ratings.

Over the past 25 years, there have been 42 defaults by local municipalities, according to Prunty, but this includes the housing sector – which has very different characteristics from other forms of public debt.

A couple of months after the Lehman collapse in 2008, Governor David Patterson of New York was quoted on the front page of the *New York Times*, saying that the state was insolvent. Prunty said that was inaccurate. Although New York faced major challenges at the time, it was "far from insolvent," and the governor was posturing for the passage of some tough budget choices.

Similarly, Prunty said current Governor Chris Christie accurately described New Jersey's acute budget problems on *60 Minutes,* several weeks prior to Whitney's appearance on that show. However, *60 Minutes* did not ask whether Christie expected the state to fail to meet its debt obligations. If they had, the answer would certainly have been no.

Even unfunded pension liabilities will not threaten the ability of states to service their debts. Prunty estimated those liabilities to be $1 trillion, although others estimate them to be two or three times as large. Using the $1 trillion estimate, Prunty said that states' debt-to-revenue ratios would roughly double if pension costs were included – well below the levels of high-credit sovereigns and not large enough to pose imminent danger.

The danger that remains

Although Prunty argued persuasively that states are fiscally solvent, default is not the only risk municipal bondholders face. Bond prices may suffer as overall interest rates rise, or if spreads widen because of a perceived risk of downgrades. Actual downgrades remain a possibility as well.

Prunty was careful to state that S&P does not use a model-based approach in its analysis, instead relying on a static analysis of the equivalent of income statements and balance sheets. As such, the potential impact of a spike in interest payments, and the resulting increase in debt-servicing costs, is not captured in S&P's methodology.

Over the longer term, shifting demographics will adversely impact state finances. Nearly a third of states' budgets go to cover Medicaid, and those costs will expand as the recently passed health care law takes effect. An additional share goes to the post-retirement healthcare costs of public sector retirees. These burdens will increase over time, creating perceived if not real risk in state debt.

One way states deal with budget problems is to "downstream" their costs, decreasing aid to local governments. It's much tougher to analyze the 90,000 non-state public debt issuers and, if there are to be defaults, expect them to be among local municipalities. It would be unrealistic to expect the ratings agencies to apply the same degree of scrutiny to those issuers as they do to state governments, and the result is necessarily heightened unsystematic risk.

Muni bond holders face another risk, to which Doubleline's Jeff Gundlach has called attention. Budget problems at the federal level may force a form of "polite default" by the

US government. This could take many forms, but one of them might be to impose taxes on municipal bond income.

Gundlach points to yet another risk. Unlike holders of other asset classes, muni bondholders are highly homogeneous – they are all wealthy and ultra-wealthy individuals. When all holders of an asset own it for the same reason – tax avoidance – it creates the danger that they could all decide to sell some or all of their holdings simultaneously. Such an event – which could, of course, be triggered by the sort of change in tax laws that Gundlach fears – would be catastrophic for muni bond prices.

Muni bondholders face risks unlike those they have faced in the past, brought on by budget pressures at every level of government. Defaults at the scale that Meredith Whitney predicts are highly unlikely, as states should be expected to successfully navigate their budget problems so as to avoid default at all costs. That does not mean, however, that munis will be the safe source of tax-free income that they have been in the past.