

MUNICIPAL BONDS: Sizeable Deficits and Expenditure Pressures Hamper State and Local Governments



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Many clients maintain an allocation to municipal bonds due to the lower risk profile and tax benefits of the asset class. Given the stress on local and state budgets, both in terms of lower revenue generation and higher expenditures, we believe active management will be key to navigating potential minefields. Further, today's low interest rate environment may present challenges and opportunities for fixed income investors going forward, as higher rates in the future can erode prices of existing bonds. Active portfolio managers can position client portfolios with awareness of the creditworthiness of holdings, as well as duration and interest rate exposure.

Jeffrey Lipton and James Iselin are members of Neuberger Berman's municipal investment management team, which navigates this sometimes inefficient marketplace and seeks to preserve capital, maintain sufficient liquidity and deliver competitive tax-efficient returns.

In the fourth quarter of 2009, we saw GDP growth of 5.6%, a real surprise to the upside. In your view, is this level of economic growth sustainable through 2010?

JEFFREY LIPTON: We don't believe so. A number of factors converged during the fourth quarter and contributed to that unusually high GDP number. Certainly inventory realignment played a role, as did the spending of federal stimulus money by state and local governments. The Federal Stimulus Plan, which was passed in February 2009, allocated approximately \$135 billion of "discretionary aid" to state and local governments. Much of it was distributed in 2009 and 2010. In 2011, we anticipate there will be very little money for the states.

However, while I think we're seeing indications of improvement, states are grappling with very sizeable deficits. Further, we continue to see troublesome unemployment levels. For example, the U.S. Department of Labor shows the California unemployment rate for January 2010 at 12.5%. When combining total unemployed with part-time employment and other marginally employed individuals, the unemployment rate for 2009 in California stood at 21.1%. We have ongoing expectations for revenue dislocation, both at the state and local levels; in certain states, we are still confronted with real estate dislocation and mounting foreclosures. Given these factors, we're likely to see upcoming GDP numbers coming in below Q4 2009 numbers.

What are your thoughts on deficits and cash flows at the state and local levels? How are you addressing this within your municipal bond separate account portfolios?

LIPTON: We closely monitor state and local budget deficits and believe they are likely to persist throughout the near term. Across the board, all types of revenue sources are decidedly down — personal income tax receipts, corporate income tax receipts and sales tax collections, for example. At the same time, expenditure pressures, especially at the state level, continue to grow exponentially, particularly in the areas of social services, corrections, unfunded pension liabilities and other post-employment benefits.

One of the ways we address risk in our municipal bond separate account portfolios is through diversification. Issuer, sector and geographic diversification are imperative. For New York and California residents, there really is no reason to avoid out-of-state municipal securities. For out-of-state bonds, which may be subject to in-state taxation, we seek out bonds in which the yield has the ability to offset or exceed the effects of the state taxation.

Another way we look to diversify risk in today’s uncertain municipal marketplace is through bond type. We have increased allocations to prefunded bonds and escrow-to-maturity bonds, which are essentially secured by an irrevocable escrow of U.S. government obligations that is a byproduct of municipal defeasance. When these bonds are properly structured, they can offer triple-A credit quality.

FISCAL YEAR 2010 BUDGET ISSUES FACING U.S. STATE GOVERNMENTS	
Number of states that cut 2010 budgets up to 5%:	19
Number of states that cut 2010 budgets more than 5%:	24
Number of states with lower-than-expected 2010 revenue projections:	41
Total U.S. state budget gap for 2011:	\$55.4 billion

Source: National Governors Association.

What are your thoughts on the path of interest rates this year? How are you positioning portfolios given the outlook for a rising interest rate environment?

JAMES ISELIN: Ben Bernanke testified in Congress in mid-March that the Fed will continue its accommodative stance for the foreseeable future. I think it’s extremely unlikely that the Fed funds rate will increase in the first half of this year; and any increase in the second half of 2010 will likely be contingent on a material improvement in the U.S. labor markets. The national unemployment rates probably understate the true level of joblessness in this country. With the national average for unemployment hovering around 10% — and significantly higher in certain areas like Michigan and California — there is substantial political pressure on the Fed to be accommodative. Mid-term elections this fall are also likely to be a factor in keeping rates low.

The municipal yield curve is at historic levels of steepness right now and we believe it is unlikely to further steepen. We’ve been positioning portfolios with a barbell bias in advance of an increase in the Fed funds rate and a flattening of the yield curve. For example, for our Core strategy separate accounts with a 1–15 year maturity focus,

we have been overweighting the 1–3 year and 10–15 year parts of the curve and underweighting 5–7 year bonds. A barbell bias doesn't really cost us anything—we're not giving up much, if any, yield as we wait for the curve to flatten.

Of late, deflation has been a bigger concern than inflation. What are your thoughts on inflation going forward and how are you positioning portfolios should inflation return?

ISELIN: We're not overly concerned about inflation in the near term, but our investment style could play well in an inflationary environment. Our core strategy targets an overall portfolio duration of roughly four years with a 1- to 15-year maturity focus. This type of duration positioning, in our view, presents a more conservative amount of interest rate risk and has the potential to capture the bulk of the steepness in the current yield curve.

In addition, we are currently taking some precautionary measures in our separate account portfolios in two ways: We currently are avoiding the 20- to 30-year section of the yield curve, where a hyper-inflationary market could cause prices to fall sharply, and are focusing on higher coupon issues in the 10- to 15-year duration range. In the event that rates rise, they could be less likely to trade at deep discounts.

What is your general sense of investor sentiment for municipal bonds today?

ISELIN: Municipal bonds tend to be one of the lower risk allocations of an overall investment portfolio, so higher risk allocations tend to go to other asset classes. Given the fact that the Fed has kept interest rates so low, and the yield profiles on money market funds and on the shorter end of the yield curve are at historic lows, some investors could start looking further out on the risk spectrum in order to seek a higher yield profile, perhaps towards lower-quality issues or longer-dated bond maturities with higher interest rate risk.

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