CITIES & STATES FEEL THE SQUEEZE....michael aneiro 11/28/08

Despite the federal government's continuing efforts to thaw frozen lending markets, states and municipalities are still feeling left out in the cold.

Municipal-debt issuance is down sharply in 2008, particularly during the past few months, as the credit crunch has elevated interest rates and scared away investors, making the floating of new bonds much harder.

Overall issuance of municipal bonds has dropped by 9.1% in 2008 to date. Since September, muni issuance has plunged by 41% compared with the same period last year, according to Municipal Market Advisors. Since investor demand has fallen sharply, the bonds' prices have sagged.

In an extraordinary development, yields for 10-year munis now hover around 4%, a full percentage point higher than comparable Treasury notes. Since munis have the advantage of being tax-exempt, which boosts investors' effective returns, they typically pay out less than Treasurys.

Every corner of the U.S. is suffering from the plummeting demand for munis. The state of Minnesota had originally planned to sell $450 million of general obligation bonds in October. It had to shelve the issue until sometime next year due to a lack of investor interest.

On Oct. 16, the Clark County Water Reclamation District in Nevada delayed a planned $250 million bond issue to fund expansion of the district's wastewater treatment facilities and repair its collection system, citing bad market conditions. Two weeks later the district returned to market but for slightly less than half the previous amount.

Similarly, the District of Columbia postponed until 2009 a $650 million income-tax bond deal that was originally planned for late 2008, hoping the outlook for new issuance will improve.

It is very bad news for state and local governments if they can't depend on a major fund-raising source amid rising unemployment, higher social-services costs and falling tax receipts. Many are left to choose unappetizingly between cutting services, raising taxes or both.

This week, New York Gov. David Paterson warned the state's school board presidents that deeper cuts in education spending will be needed to close the state's budget gap, which he said would be at least $1.5 billion this year and $12.5 billion next year.

Thus far, Washington hasn't moved to bail out states and localities, although President-elect Barack Obama has talked about some kind of help for them.

Citing growing pressures on city budgets and pension-plan losses in the stock market, mayors of three large cities -- Philadelphia's Michael Nutter, Atlanta's Shirley Franklin and Phil Gordon of Phoenix -- went to Capitol Hill this month to request $50 billion in aid to cities from the Treasury's bailout fund.

Last week, the state of California, along with 19 of its municipalities, sent a letter to Washington calling for a Federal Reserve program to inject liquidity into the municipal-bond market, through either the direct purchase of short-term municipal notes or loans to banks so that they may buy muni bonds.

The credit crunch has dried up demand all over the fixed-income realm. But munis have been especially harmed by ratings downgrades of monoline insurers, which used to bolster investor confidence that the bonds would be repaid.

Another negative factor: Cutbacks or outright disappearances of Wall Street banks that provide muni underwriting and secondary market-making. The collapses of Bear Stearns Cos. and Lehman Brothers Holdings Inc. and the sale of Merrill Lynch & Co. were huge blows. A special vulnerability is that muni underwriting brings in lower fees than other deals. Layoffs this month at banks like Citigroup Inc. and Goldman Sachs Group Inc. hit their muni desks hard. UBS <http://online.wsj.com/public/quotes/main.html?type=djn&symbol=ubs> AG has shuttered its muni-bond business altogether.

"One of the problems is that number of potential bidders is reduced because the number of broker/dealers has fallen," said Kathy Kardell, assistant commissioner for Minnesota's management and budget office. "When AG Edwards gets acquired by Wachovia , and Wachovia is acquired by Wells Fargo now you have one bidder where before there were three."

Meanwhile, the new scarcity of buyers is painful. Hedge funds, which used to buy long-term munis using significant leverage, now are shying away from debt-fueled deals. Mutual funds, beset by waves of investor redemptions, are selling munis to raise cash. Insurance companies, usually big buyers of muni bonds, also have backed away.

That leaves individual, or retail, investors to take up the slack, yet that often isn't enough. Historically, individual-investor demand tends to galvanize when yields on 10-year muni notes rise above 4%, according to Matt Fabian, managing director at Municipal Market Advisors. Yields peaked above 5% in September and October, bringing a surge of retail investors into the market, but have since receded to just below 4%.

Last week, the California Department of Water Resources tried to refinance $523 million of variable-rate notes by issuing new 10-year fixed-rate bonds, offering yields of 4.3%. When retail investors signed up for only $152 million of the new offering, the deal had to be downsized to $173 million, as the state said that institutional investor demand was close to nonexistent.

"We need to find a market bottom before institutions are able -- because they're willing now -- to return to the muni market," said Timothy Pynchon, a muni-fund manager at Pioneer Investments.

At least munis are cheap lately, which means this is a buyer's market. "It's a challenge to distribute all this paper, but I do think that generally muni credits are fine," said Ronald Schwartz, portfolio manager at StableRiver Capital Management. "Basically the muni market is a stable, conservative market and it will remain that way."

Indeed, defaults remain an extremely rare occurrence in municipal debt and are generally confined to smaller, special-purpose issuers like industrial development zones or sewer districts.

The $1.5 billion default of Orange County, Calif., in 1994 brought attention to the possibility of a large issuer collapsing into bankruptcy. This year, Jefferson County, Ala., has managed to skirt default on $3.2 billion of sewer debt, largely thanks to the forbearance of its creditors.

[Image Removed]