Scarsdale Investment Group, Ltd.

All Bond Portfolios

Vol 2, number 2, 2010

The Municipal Bond Market: *Take II*

Summary:

2% and 3% tax-exempt municipal yields are the result of lack of supply and increased demand.

Municipal governments must bite the bullet and reduce spending to improve credit quality.

Overview:

High Demand for Tax-Exempt Municipal Bonds: Despite the continued worry about inflation, prices of tax-exempt muni bonds have continued to rise. Reductions in supply have resulted in price increases, lowering yields on high quality tax-exempt municipal bonds.

Muni Rating Upgrades: As a result of upgraded ratings of municipal bonds, the security pool of high quality bonds will expand in April 2010. The upgrades are not due to improvement in the underlying credit-worthiness of the bonds. Credit evaluation will become more important.

Pre-refunding of Munis: Pre-refunded bonds are bonds backed by escrowed funds that will be retired on the bonds' call date. There is often significant appreciation. You might consider selling the bond to take the gain.

High Demand for Municipal Bonds

Prices have increased and yields have decreased for most municipal credits in recent months. While investors still worry about inflation, yields are declining in spite of a drop in state revenues due to the Great Recession.

The essential problem is not less revenue, but a lack of spending restraint. There has been a mutually beneficial partnership between the politicians and the municipal unions; the unions get increases in salaries and benefits and the politicians get the union votes. This partnership is unraveling as costs increases and revenue declines demand fiscal restructuring.

The media is drawing attention to the fiscal problems of the states. We view this publicity as favorable to the health of the states and municipal bonds in general. It puts pressure on politicians and municipal unions to recognize that it is not business as usual.

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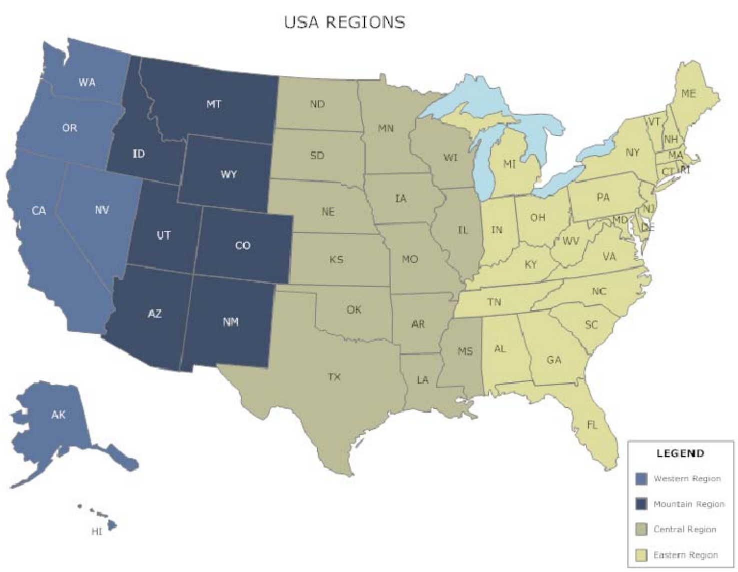
Summary:

Muni bonds will be exempt from the Obamacare 3.8% flat tax on high earners that begins in 2013.

For someone in the highest tax bracket, "a yield of 3.8% would be worth 5.8% this year, perhaps 6.3% next year, and 6.7% in 2013, or even more if it is exempt from high state taxes as well."[1]

There are some hopeful straws in the wind regarding state spending. In some states, like New Jersey, the teacher's union has 'voluntarily' forgone raises so that the teaching staff would not be decimated by cutbacks. In Los Angeles, it has been suggested that the unions may have outlived their usefulness. The North Penn school district in Pennsylvania is taking a teacher strike rather than see a 17 percent increase in costs. Though the state economies have improved marginally since the depths of the Great Recession, the states are not out of the woods. Revenue recovery will not be enough to continue to sustain past spending habits. Pension and health care costs are significantly underfunded in many states and overall state spending must be reduced. This drama will play out over many years.

Despite municipal budgetary problems, the prices on high quality municipal bonds have risen and yields have dropped. Issuers have chosen to issue taxable municipal bonds called Build America Bonds (BABs) in lieu of tax-exempt munis. Supply for retail buyers has been further diminished by rule changes that enable banks to purchase more municipal bonds without negative tax consequences.



Demand for tax-exempt municipal bonds will only strengthen. Municipal bond interest will be exempt from the newly enacted 3.8 percent flat tax on investment income for high earners in the Obamacare legislation. This new tax is slated to begin in 2013. For someone in the highest tax bracket, "a yield of 3.8% would be worth 5.8% this year, perhaps 6.3% next year, and 6.7% in 2013, or even more if it is exempt from high state taxes as well."[1]

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[1]Laura Saunders and Daisy Maxey. "Munis: Riskier Than You Think," The Wall Street Journal, April 17-18, 2010. http://online.wsj.com/article/SB10001424052702304180804575187973704815244.html?KEYWORDS=laura+saunders

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Summary:

The global ratings place municipal bonds on the same footing as all other bonds in their likelihood of default.

Moody's lifts the ratings of 34 states.

Moody's raised the ratings of California to A+ and Puerto Rico to A- in April 2010.

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To increase your security we recommend diversifying your municipal bond portfolio among many states and counties, despite the possible increase in your state taxes.

Rating Changes

The states have been objecting for many years to the rating systems employed by Moody's, Standard and Poor's and Fitch . Until recently there have been two separate rating systems, one for corporate bonds and another for municipal bonds. Since municipal bonds have historically defaulted less frequently than corporate bonds, state representatives claimed that their issues should receive higher ratings. Rather than lower the ratings on corporate and sovereign bonds, which would move many more corporates to junk status, the rating agencies decided to increase the ratings on municipal bonds. Standard and Poor's has done this over time; Fitch and Moody's completed their re-rating in April 2010. The global ratings now reflect the likelihood of default for all types of bonds instead of the "distance to distress" formerly used for municipal bonds.

As a result of re-ratings, bonds that were previously avoided by buyers of high quality bonds will now be part of the high quality pool. This may increase yields some as the security pool expands within a given rating. As a result of Moody's re-rating, five new states ascended to triple-A ratings: Indiana, Texas, Tennessee, New Mexico, and Iowa. States previous rated Aa1 were raised to stable from negative watch. The biggest beneficiaries were bumped up three grades: California is now rated A1 and Puerto Rico is rated A3.This is a new act for municipal bonds. Previous rating scales will have to be recalibrated noting the seismic shift.

Pre-Refunded Bonds

When you look at your brokerage statement, you may find a "(p)" next to some of your high coupon bonds. This marker indicates that this bond has been pre-refunded (prf). Pre-refunding removes the bonds from an issuer's balance sheet. The maturity date of the bonds becomes the call date. Pre-refunding replaces the issuer's collateral by placing U.S. Treasury or agency bonds of equivalent value into an escrow account. The escrowed funds pay the pre-refunded bond's semi-annual interest payments and the principal on the call date.

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Summary:

Pre-refunding shortens the maturity to the call date.

Pre-refunding may substantially increase the value of your bonds.

A pre-refunded bond may be re-rated to reflect the higher quality of the escrowed bonds, but it does not have to be. The shorter maturity and the possible increase in quality of the security backing the bonds may result in an increase in the bond's value. For example, on October 23, 2008 we purchased $50,000 Harris County Texas bonds with a 5.625 percent coupon due October 1, 2022. In March, 2010 the bonds were pre-refunded. The original cost of the bonds was $49,945 and the current value is $60,351, a difference of $10,406 on April 16, 2010. Though some of the appreciation is the result of an increase in bond prices generally, the big boost to the price was the result of the pre-refunding. If there has been substantial appreciation you might consider selling the bond and taking the gain.

Important Disclosure Information

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