

Product Focus

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John Cummings, David Blair and Bob Fields Discuss Recent Market Stress and the Outlook for Municipal Bonds



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The continuing financial crisis has had dramatic consequences for the municipal bond market. In the following interview, John Cummings, executive vice president, portfolio manager and head of the municipal bond desk; David Blair, senior vice president, credit analyst / portfolio manager and head of municipal bond research; and Bob Fields, senior vice president and product manager for municipal bond strategies, discuss recent developments in the municipal bond market. Muni investing has taken a fundamental turn back to a credit-driven model while liquidity in the market has decreased sharply. Although PIMCO has a guardedly optimistic market outlook (including potential effects of federal stimulus programs), there are still challenges that face municipal bond issuers despite their historically low default rate.

Q: What are the key trends and factors affecting the municipal bond market today? How has the market changed as a result of the financial crisis?

Cummings: In 2008, the municipal bond market essentially transitioned to a credit market from a rates market, in part due to the loss of the big bond insurers who guaranteed the AAA rating on many municipal bonds. Issue selection is now of primary importance, unlike in the rates market of the previous few years, when all munis were viewed as equally prudent due to the insurance wrap. This return to a focus on muni credit selection may be nostalgic for long-time muni traders like me, but really it's indicative of the tremendous stress the market endured over the past year or so.

Also, many of the large institutional buyers that supported the municipal bond market and kept it liquid, such as property and casualty companies and the big banks, are no longer profitable and do not have room on their balance sheets for munis. Price-setting in the market shifted from the levered buyers – such as single-strategy muni hedge funds and large global hedge funds and bank portfolios who had become the marginal buyers in the period from 2005 to mid-2007 – back to retail high net worth investors, the traditional marginal buyer in the two prior decades.

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As the financial crisis intensified in 2008, the muni yield curve steepened dramatically, even more so than it did during the bear market in 1994. More recently however, the attractive prices are enticing buyers back in to the market. In fact, in February 2009 we saw a split along the yield curve as investors put money to work in longer maturities even as demand for shorter maturities declined. Overall flows are positive, but still not large enough to make up for the significant outflows at the end of 2008.

Q: You mentioned that large institutional buyers fled the muni market in 2008; how did this affect the market's liquidity?

Cummings: The loss of a number of major dealers in 2008 caused liquidity to dry up dramatically: we lost Bear Stearns, which was folded into JP Morgan; Lehman Brothers failed completely, and while parts of the investment bank were incorporated into Barclays, it is a much smaller presence in the market; the combination of Merrill Lynch and Bank of America removed another distinct player; and UBS has withdrawn from the institutional municipal market. And as the remaining dealers continue to delever, they are reducing their positions in the municipal bond market. The loss of the big bond insurers has also hurt liquidity because some investors can only hold the highest-rated securities.

While liquidity is better today than it was three to six months ago, it is still not what it was several years ago, and that period is probably a better benchmark because back then we had more dealers, insurance companies and arbitrage accounts involved. Liquidity comes and goes in the financial markets with increasing irregularity these days, and that means an increase in the liquidity premium, and higher transaction costs as well. In December, when yields on long AA munis hit 6.40%, two times comparable duration Treasuries, it nearly felt like the muni market world was ending. But now there are days when the market is very liquid, even though there are still days when it isn't – it's continually changing.

Q: What is your outlook for the municipal bond market in 2009 and beyond?

Cummings: While 2008 was a horrendous year for municipal bonds, and some feared the market might actually disappear, it has since come back to life after appearing to be moribund at the price lows it hit in December. Dealers appear to be slightly more comfortable taking on incremental risk, and some municipal issuers are now able to come to market once again. We expect significantly lower volatility in the municipal bond market in 2009 compared to 2008.

Some of the recent federal policy decisions also bode well for better days in the municipal bond market. The stimulus package is expected to directly send \$135 billion in federal dollars to municipal issuers, which would help patch up a lot of budget deficits, especially in New York and California. In addition, the package will provide financial assistance for infrastructure, Medicaid and the alternative minimum tax. The federal government also may help municipal issuers to the bond market: Congressman Barney Frank has floated the idea of a federally backed independent municipal bond insurer, and he's also working on a federal insurance program for muni bonds.

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Q: How are municipalities faring at this stage in the financial crisis? Is federal intervention from the stimulus program likely to be helpful?

Blair: In late 2008, states and local governments faced a daunting economic situation. To be fair, most municipalities came into this environment with very strong balance sheets. Over the last several years as the economy boomed, they'd built up their reserves and were generally well positioned. Municipal bonds have a reputation for being a prudent investment, as municipalities have a long history of fiscal restraint – they simply aren't able to paper over their debt or issue their way out of deficits; they are legally required to balance their budgets.

In the fourth quarter of 2008, the economy took a big turn for the worse and as a result the outlook is very challenging for a lot of municipal issuers, particularly for some high-profile issuers such as the State of California – that's where a lot of the headline risk comes from. The news tends to focus on the one or two issuers who are having the biggest problems.

The very nature of their fiscal restraint actually leaves municipalities with fewer options for dealing with crises: they may increase their progressive income tax rates, user fees and other types of taxes, but the dramatic cost-cutting actions they would need to take in an effort to counteract the effects of a severe crisis would be painful and unpopular, and would also exacerbate the economic downturn. To help forestall that consequence, a large portion of the federal government's stimulus package will be aimed at municipalities. For example, much of the federal aid is expected to go to education, which can amount to 50% of a state's budget – in turn, the federal aid may alleviate some of the stress on school districts, cities and counties. Municipalities are also likely to benefit from funds that flow through to Medicaid and other social services.

In the next few months, we will see some federal money start to flow through the states. This may substantially reduce or eliminate their budget deficits in the coming fiscal year, though the deficit in the State of California will prove more challenging. Of course, issuers face longer-term challenges as well, so it's possible the federal government may step in with more support down the road.

The healthcare sector is facing its own set of challenges: because fewer people are insured, they defer healthcare appointments, so overall usage is going down. At the same time, hospitals' investments have been hit hard by the declining market, and healthcare interest rates, or borrowing rates, have gone up. Healthcare issuance tends to be capital project-oriented, and looking ahead we expect the healthcare sector will see more government support and less reliance on additional bond issues.

Q: Given the funding challenges facing municipalities, are you concerned about rising municipal bond defaults?

Blair: Municipal bonds have historically low default rates, even in the worst economic times, and they also have comparatively high recovery rates. Default rates have been very low in non-depression periods, even as you go down the credit spectrum. According to Moody's, from 1970 to 2006 the default rate for munis has averaged 0.01% annually, and the average recovery rate for defaulted muni bonds was

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approximately 60% compared to approximately 40% for corporate bonds. And even during the Great Depression, the average annual default rate was 1.8%, with 97% of the defaulted principal eventually recovered.

Our team recently completed a robust study entitled *Historical Perspective on Municipal Credit Risk*, analyzing muni defaults from the present all the way back past the Great Depression to the panics of the 1800s. Overall, default rates during most depression periods were low considering the high level of economic stress experienced.

While muni issuers face new challenges today, such as unfunded pension liabilities and infrastructure costs in addition to the stresses posed by the economic environment, we still expect overall default rates to remain low, especially for general obligation (GO) and most types of tax-backed bonds. As for recovery rates, in a recessionary environment, healthcare issues, industrial development bonds and special tax land-secured bonds used to finance real estate projects all tend to have lower recovery rates due to their particular sensitivities to lower levels of economic activity; this brings down the otherwise relatively high average recovery rate for municipal bonds.

Q: What is the outlook for new municipal issuance in the coming year?

Blair: There is a certain amount of concern about new municipal bond supply coming to the market in 2009, and whether the market will be able to absorb it. However, it's important to remember that in a broader perspective, new issue supply is currently dramatically lower than a year ago: down 34% for the quarter ending December 2008 (year-over-year) and down almost 9% for the full year from 2007. Looking ahead, it's likely that the federal aid to states may have some dampening effect on issuance. All that said, the calendar of municipal issues in early 2009 indicates increased supply forthcoming due in large part to a backlog of issuance that couldn't come to market in late 2008 (in fact, for a few weeks in late November and early December, new issue supply was at a standstill). When dealers price new issues we are seeing strong demand from high net worth individuals and even some insurance companies looking to put their money in a high-yielding, comparatively prudent investment.

Q: Given the municipal market outlook, what is PIMCO's strategy going forward?

Fields: We believe our portfolios are positioned to benefit from additional price appreciation in the asset class. And we are positioning our muni portfolios to take advantage of several opportunities available to investors, even as we streamline them and make them more plain vanilla, utilizing fewer non-muni exposures in order to lower volatility. Overall, PIMCO is comfortable with municipal credit risk, but given the ongoing headline risks, we believe the best approach for investors today is caution and the best opportunities remain in the higher quality GO bonds and essential service bonds such as water, sewer and power. Compared to Treasuries, mortgages and interest rate swaps, the yields on munis are extremely attractive right now, and given the low default rates they are very attractive compared to many fixed income asset classes with similar yields.

Our goal is to deliver consistent after tax returns while prudently managing risk. At present levels, municipal bonds should provide attractive risk-adjusted returns for 2009.

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In these stressful periods, however, we believe it's important to stick to the higher credit quality securities to best weather this economic storm.

Gentlemen, thank you for your time.

Past performance is not a guarantee or a reliable indicator of future results. Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk; investments may be worth more or less than the original cost when redeemed. Income from municipal bonds may be subject to state and local taxes and at times the alternative minimum tax. The credit quality of a particular security or group of securities does not ensure the stability or safety of the overall portfolio.

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