

EXECUTIVE SUMMARY

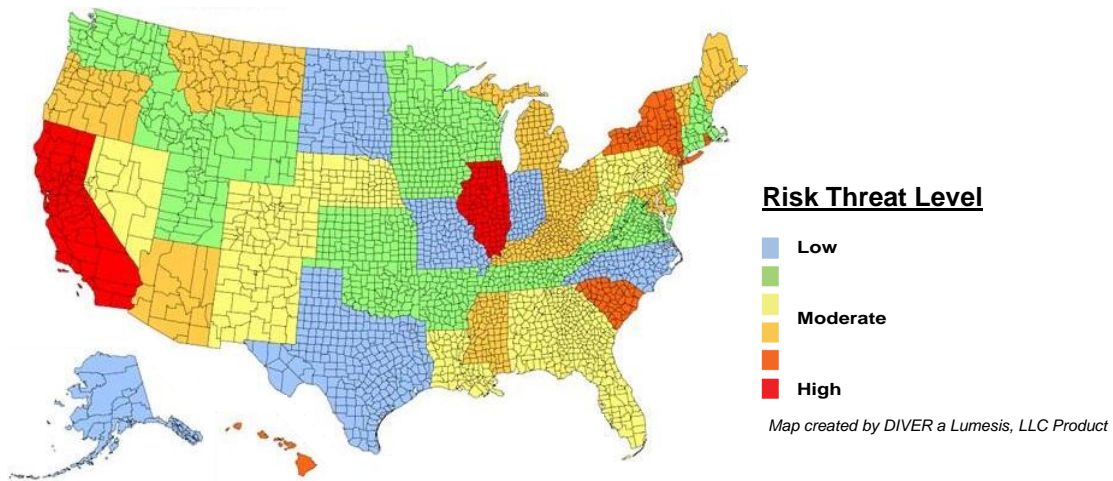
LOCATION, LOCATION, LOCATION – THE CHANGING MUNICIPAL BOND MARKET

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This note is a summary of a more in-depth Laffer Associates analysis that examined the current trends in the municipal bond market. For more information or to subscribe to Laffer Associates Municipal Research Service please contact Ron Felmus at 615-320-3989 or at rfelmus@laffer.com.

The destabilizing impacts from poor fiscal and monetary policy at the national level, fiscal policy mistakes at the state and local level, and longer-term structural trends at the state and local level that are now coming due threaten the stability of the municipal bond market. Municipal bond investors who ignore these destabilizing impacts and the diverse consequences that these impacts portend for different states and municipalities are increasing the risk profile of their portfolios without increasing their current rates of return to compensate for the higher risks.

Figure 1
Laffer Associates State Risk Assessment



Fiscal Problems: Due to the unprecedented growth in the burden from government expenditures, federal fiscal policies have created a slower growth economy. The regulatory uncertainty from the implementation of ObamaCare, new financial regulations (Dodd-Frank), and EPA rulings creates additional business uncertainty that weakens the overall U.S. economic landscape.

- This slower economic growth path, which should not be confused with the cyclical economic upswing currently underway,ⁱ implies that states and municipalities will face weaker revenue growth and higher expenditure growth.
- The impacts from the slower growing economy will not be felt equally across the states and municipalities.

Inflation Problems: As we have been arguing for some time, the actions of the Federal Reserve are creating significant inflationary pressures in the economy.ⁱⁱ

- In an earlier Laffer Associates paper we estimated the long-term relationship between growth in the money supply and growth in inflation.ⁱⁱⁱ Based on current monetary trajectory policy and the historical empirical relationships, double digit rates of inflation are a significant risk between 2011 and 2015.
- For municipal bond investors, the risk of significant inflationary pressures creates two separate issues. Current municipal bond yields have a benign inflationary environment priced into them. However, a significant inflation will reduce the real burden of the state and municipal debt outstanding as well as any non-indexed expenditure obligations.

State & Local Issues: States and localities entered the economic recession with different competitive positions, different structural problems, and have responded to the revenue and expenditure trends differently. As a consequence, the impacts from the national economic policies will not be felt equally.

- *Falling off the ARRA Cliff:*
 - The stimulus programs (especially the American Recovery and Reinvestment Act (ARRA)) failed to stimulate the economy and have now left the states in a worse financial position.
 - The amount of federal aid to the states will decline \$37.9 billion in FY2012 – what is being called the ARRA cliff.
 - In total, states are facing possibly \$82.1 billion in shortfalls that they must address in the upcoming budget years.
 - The states with the largest estimated FY2012 budget gaps or face the largest ARRA face significantly higher risks.
- *Anti-growth Tax Increases*
 - States that address the ARRA cliff through anti-growth tax increases will be at risk of facing continued budget problems as the economic environments in these states underperform the national average.
 - States that already impose large progressive tax burdens and burdensome regulations will experience, on average, slower economic growth than states that implement more cost effective regulations more affordable, flatter tax burdens.^{iv}
 - States with the least competitive economic environments or worsening economic competitive environments, when coupled with the slower growth national landscape, will continue to face larger budget problems and therefore represent greater investment risks for municipal investors.
- *The Housing Crisis and Municipal Revenues*
 - As we have discussed in other Laffer Associates papers, the housing market is still not on solid foundations.^v Continued housing weakness coupled with the 1 to 2 year lag between recovery in the property market and recovery in local property tax revenues implies that municipal revenue growth will remain anemic for several years to come.
- *Structural Trends*
 - The number one structural problem facing states and localities are the large unfunded pension liabilities. And, the problems created by an unfunded pension system are no longer an issue for tomorrow.
 - Various estimates show that in aggregate pension funds are currently around 79% funded with at least \$1 trillion in unfunded liabilities.^{vi} Equally important, the value of the unfunded liabilities of the states depends on return assumptions that could be overly-optimistic.^{vii}
 - These trends point to significant budgetary stress that will vary depending upon how well particular state and municipal pension obligations are funded.
 - Beyond pension issues, inefficient spending allocation has created infrastructure investment needs that according to the American Society of Civil Engineers equal \$2.2 trillion over the next 5 years. States that do not address these issues effectively can compromise the future spending flexibility and competitiveness.

The Implications for Municipal Bond Investors: States and municipalities face a tough economic environment over the next couple of years. A slower growing economy will weaken tax revenue growth – weaker income and sales tax growth at the state level and significantly slower property tax revenue growth for municipalities. As states and municipalities manage this difficult environment, there will be a wide variation in the economic and fiscal outcomes.

Municipal bond investors need to consistently monitor the economic and fiscal policies in order to properly manage the changing risk profile of municipal bonds.

ⁱ Arthur B. Laffer, "Money, Growth and Politics, Laffer Associates Economic Outlook", *Laffer Associates*, August 03, 2010.

ⁱⁱ Arthur B. Laffer, Ford M. Scudder and Mark A. Wise, "Following the Fed II", *Laffer Associates*, September 03, 2009. Arthur B Laffer, Ph.D, Kenneth B. Petersen, Ph.D, and Scott Vaughn, "Ben Bernanke's 100% Confidence", *Laffer Associates*, December 20, 2010.

ⁱⁱⁱ Kenneth B. Petersen and Nicholas C. Drinkwater, "Economy Downing An Ocean of Liquidity, Going for the Inflation High", *Laffer Associates*, December 16, 2010.

^{iv} For more details on the latest state competitive environments see the forthcoming Laffer-ALEC publication *Rich States, Poor States*.

^v Arthur B. Laffer and Scott Vaughn, "Housing's Long and Winding Road to Recovery", *Laffer Associates*, December 09, 2010.

^{vi} Bonafede, Julia K., Foresti, Steven J., Walker, Russell J. (2010) "2010 Wilshire Report on State Retirement Systems: Funding Levels and Asset Allocation" *Wilshire Consulting*, March 3(2009) State and Local Government Retiree Health Benefits: Liabilities Are Largely Unfunded, but Some Governments Are Taking Action" *Government Accountability Office*, GAO-10-61 November; <http://www.gao.gov/new.items/d1061.pdf>. (2010) "The Trillion Dollar Gap" *Pew Center on the States*, February 18; http://www.pewcenteronthestates.org/report_detail.aspx?id=56695. The GAO has also examined the total funding issue, see: (2008) "State and Local Government Retiree Benefits: Current Funded Status of Pension and Health Benefits" *Government Accountability Office*, GAO-08-223 January 29; <http://www.gao.gov/new.items/d08223.pdf>.

^{vii} Bonafede, Julia K., Foresti, Steven J., Walker, Russell J. (2010) "2010 Wilshire Report on State Retirement Systems: Funding Levels and Asset Allocation" *Wilshire Consulting*, March 3.