

## MUNICIPAL BONDS: ARE THE CONCERNS FAIR OR FOUL?

Expect higher-than-historical volatility



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*For a segment of the domestic fixed income market long renowned for its relative tranquility, municipal bonds have received plenty of attention lately. Muni bond price volatility spiked in 2010's fourth quarter as investors focused on the credit ramifications of state and local government fiscal stresses stemming from the Great Recession and residential real estate debacle. In the first quarter of 2011, new issuance of tax-exempt bonds fell by more than half compared to last year and to the lowest level in more than a decade.<sup>1</sup>*

*But is it accurate to generalize about a \$2.9-trillion market comprising tens of thousands of individual municipal issuers? Does security selection matter? And should the unique nature of the tax-exempt sector, in which mostly buy-and-hold investment strategies account for almost three-quarters of the market,<sup>2</sup> be taken into account when forecasting how investors will react if and when a highly publicized municipal default occurs?*

*Recently, we asked Bob Browne, Northern Trust's Chief Investment Officer, and Tim McGregor, Northern Trust's Director of Municipal Fixed Income, to address these and other issues that could affect tax-free bonds.*

### **How does Northern Trust's approach to risk management align with investor expectations?**

**Bob Browne:** For most of our clients, investment-grade bond investments are intended to generate income and preserve capital. Those dual objectives dovetail perfectly with our cautious approach to managing high-quality bond portfolios. Maintaining the credit quality of the roughly \$300<sup>3</sup> billion that we manage in fixed income assets is deeply ingrained in the corporate culture of Northern Trust. It is one of the attributes that defines who we are as a money management firm.

The municipal market, in particular, is a core area of expertise. We're conservative in our security selection, focusing on proprietary research and due diligence. Though we respect the work of the ratings agencies, we do not rely upon them and don't take the ratings to be infallible. Nor do we depend upon bond insurance to bail us out of imprudent decisions. We do our own homework. So we think our cautious style of risk management aligns with what our clients want us to do, which is to generate an attractive tax-free income stream without unnecessarily jeopardizing their principal.

### **What happened to munis during the fourth quarter 2010?**

**Tim McGregor:** Credit concerns accounted for some of the selling, but there were other factors as well. Overall fixed income rates backed up, and though munis are far from perfectly correlated to Treasuries, they do tend to move in the same direction. Meanwhile, muni issuance doubled to about \$10 billion a week for a time. The fact that the Build America Bond program was not extended also hurt market sentiment. Finally, redemptions from mutual funds caused some forced selling of bonds, which created a snowball effect for a time.

<sup>1</sup> "US muni bond demand slides into deep freeze." Financial Times. March 29, 2011. Page 23.

<sup>2</sup> Ibid.

<sup>3</sup> As of 12/31/10



### ***Should we expect ongoing risks in municipal bonds in 2011?***

**Bob Browne:** It's likely that we're headed for a period of elevated volatility, not just in municipal bonds but in the broader fixed income market as well. But some perspective is in order here. We're coming off a secular period of low or falling interest rates that began in the early 1980s. Recently, cyclical factors and the global financial crisis have exacerbated that trend. But with regard to the municipal bond market, it is important that investors make the distinction between higher-than-normal risk and unacceptably high risk.

**Tim McGregor:** Historically, the default rate in tax-free bonds has been exceptionally low, so it could rise without actually reaching worrisome proportions. The municipal bond universe is made up of more than 50,000 issuers, and while there almost certainly will be more defaults over the next year or two, we believe that the overwhelming majority of general obligation and essential service revenue-based credits are on firm ground.

### ***What should muni bond investors focus on, given the heightened volatility?***

**Bob Browne:** Fixed income investors should focus on credit quality. That's what we do every day as part of our overall effort in fixed income.

Diversification also is a cornerstone of any sound investment strategy, and even more so in a portfolio of investment-grade bonds. Unlike equities, fixed income investors are not rewarded for taking concentration risk. At maturity, the bond will pay off at par value, so there is not unlimited upside. It is worrisome that individual investors who piece together their own tax-free bond portfolios often have quite elevated levels of concentration risk. In combination with insufficient credit research, that could be a combustible combination.

**Tim McGregor:** Liquidity management is especially important during periods of elevated volatility, and I expect it (elevated volatility) will continue in coming months. Selling bonds at depressed prices to meet liquidity needs is expensive. Also, we saw in the fourth quarter of 2010 and during the global financial crisis that even temporary volatility can distort the real value of financial assets. Investors should work with their advisors to make sure they have enough in cash equivalents and short-duration fixed income investments to meet liquidity needs in any crisis.

### ***What is your outlook for inflation in 2011?***

**Bob Browne:** We do not think domestic inflation will become a problem this year. Even with the economic recovery gaining traction, the core inflation rate in the United States is near the lowest levels since the early 1960s. The labor market is still too soft for wage pressures to take hold, even if workers expect a prolonged period of elevated food and energy prices. Remember, labor and housing costs are two main drivers of inflation in the United States, and both remain quite subdued. There is also excess productive capacity remaining from the Great Recession, as well as global competitive pressures that minimize pricing power. Our forecast for U.S. core inflation is from 1.5% to 2%, which is close to what the Federal Reserve also expects.

### ***Aren't fuel and food prices going up?***

**Bob Browne:** We understand that many Americans are feeling the pinch of higher food and energy costs – items that don't show up in the core inflation numbers. There are other pockets of cost pressures as well, such as medical and tuition bills, that could create the impression with some consumers that broad-based inflation might be getting out of hand. But we do not foresee a sustained rise in broad-based consumer prices in the United States over the next year or two.

***What if your fairly benign assessment of near-term U.S. inflation is wrong? What would happen to bonds in that case?***

**Bob Browne:** High inflation is bad for investment-grade bonds. Period. And it's important to note that we think the secular downtrend in rates is over, even if inflation remains well contained. Anyone who expects headline inflation to break out to the upside should be extremely cautious about over-allocating to fixed income, because most bond prices would be adversely affected in that scenario. But for now, at least, we see credit issues as the more pressing concern for the tax-free market.

Recall that investors can also consider other investment vehicles to try to guard against inflation, such as real estate, commodities, gold and TIPS (Treasury Inflation-Protected Securities).

***Speaking of credit issues, if there were some high-profile muni bond defaults, would the entire market lock up, similar to what happened to commercial paper during the global financial crisis?***

**Tim McGregor:** That would depend upon how widespread the problems became. If they were limited to just a handful of entities, I think the market would digest the issues relatively easily. But certainly, if investors came to view rising defaults as systemic, there would be the potential for at least a temporary freeze in liquidity as market-makers stepped away. Of course, that's true of virtually any market if and when sentiment morphs from appropriate concern to outright panic.

***Given the challenging credit environment, are there types of muni bonds that investors should focus on owning — or avoiding?***

**Tim McGregor:** Absolutely. You can't lump all tax-free bonds into a single basket and say that they all are creditworthy or that none are creditworthy. The current environment is a perfect example of why individual bond selection based on diligent proprietary credit research is so important.

The details of a bond covenant matter; the fine print matters. Who gets paid first? We want to get paid from the top of budgets, not from the bottom. That means investing in unlimited general obligation bonds and essential service dedicated revenue bonds where the income stream comes directly to the bondholder first. It means avoiding small, project-specific revenue bonds and appropriation-type debt and leases. It means understanding whether the issuer is managing its overall obligations effectively — pension and healthcare obligations, derivatives exposure, co-signer or other guarantees to projects that are not viable.

The bottom line is that the tax-free market has become quite inefficient lately, which gives active managers who ask the right questions a chance to add potentially significant value. And we think that's a good thing for our investors.

**FOR MORE INFORMATION**

Look for a more detailed discussion of Northern Trust's credit review process in a follow-up white paper. To learn more about municipal bonds, please contact your relationship manager or visit [northerntrust.com](http://northerntrust.com).

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