After an extraordinary year in the municipal bond market, finance officers have a number of questions about what is to come. What will happen in regard to the monetary policy measures the Federal Reserve undertook in 2009? Will the yield curve flatten? Will improved bank profitability mean lower costs? Will liquidity improve, and will municipal bond volume increase? Are there any surprises in store regarding the credit quality of state and local governments? This article will cover some of the basic events of 2009 as a starting point for tackling these tough questions.

WHAT HAPPENED IN 2009

The U.S. financial markets were volatile and uncertain in 2009. The year began with a piece of record-breaking news: In January 2009, the Bank of England lowered its target interest rate to 1.5 percent, the lowest rate in its 315-year history. Meanwhile, data released the same month showed the U.S. economy slowing at the fastest pace in 26 years. Unemployment rose to its highest level since World War II, to almost 3.1 million jobs lost in 2008, with 22 percent of that loss in one month: December. The weak labor market was a problem throughout 2009.

While the pace of bad news continued throughout the first quarter of the year, a couple of themes began to emerge. The severe liquidity problem that occurred after the Lehman Brothers bankruptcy in September 2008 began to slow, steady improvement in early 2009. Also, the federal government was making an historic level of fiscal commitment to help support the economy, featuring the American Recovery and Reinvestment Act of 2009 (ARRA), which Congress passed in the first quarter of the year. The ARRA created Build America Bonds (BABs), a taxable municipal bond allowing the issuer to get a 35 percent federal subsidy or to give the 35 percent to the investor as a tax credit. BABs were designed to ensure market access for municipal units of government engaged in financing “shovel-ready” projects — projects that have been fully vetted and approved and are ready to proceed immediately. The municipal market embraced BABs enthusiastically, with $70 billion coming into market between the bond’s late April inception and the end of the year.

The Federal Reserve’s monetary policies, including the quantitative easing that flooded the banking system with excess reserves, began to bear fruit in the summer of 2009. Gradually, the tenor of the economic data became less severe, with declining weekly initial jobless claims and improved industrial production. After a summer of stronger-than-expected data, the consensus among economists tentatively fixed the low point of the business cycle at August or September.

As 2009 progressed, many financial and economic factors continued to affect the municipal bond. State and local governments expressed their growing concerns about the problems confronting the municipal market — including access to funds at reasonable interest rates — to the Obama Administration, and to the Treasury Department. The State of California issued warrants to vendors as its cash reserves ran dangerously low. In September 2009, the state of California was willing to borrow at rates about four times what the highest-rated governmental borrowers had to pay, so great was its need to be certain it could meet essential obligations such as payroll.

The stock market was the first sign that the strong medicine of fiscal and monetary policy was having a favorable effect on the economy. The S&P 500 bottomed on March 9, 2009, and began a rally that would last the rest of the calendar year. By the end of 2009, the index had rallied almost 70 percent from its low point. The solid improvement of the stock market did little to boost the spirits of financial market participants until late fall, however, when a preponderance of favorable data — consumer confidence, manufacturing, the housing sector, and more — established that a recovery was indeed underway.

The price of gold was another indicator that drew the market’s attention over the course of the year. In 2009, gold continued the rally it had started in 2007. But the psychology behind rising gold prices was quite different from what had motivated the improvement in stock prices. Rather than discounting improved prospects for business, as stocks had, gold investors were looking beyond the growth path of the economy to incipient inflation, thought to be the likely product of overly expansive monetary and fiscal policy.

Overall, higher interest rates and the increased probability of higher marginal tax rates should increase interest in municipal bonds. Traditional tax-exempt bonds will be somewhat scarce, with the continued growth of Build America Bondss siphoning off tax-exempt bond issuance.
THE MARKETS AT YEAR’S END

Lest the financial markets get too complacent, another wave of credit anxiety tempered the year-end enthusiasm. Credit concerns reemerged in December 2009, when Greece was downgraded to BBB. The action reignited concerns that even powerhouse economies such as Great Britain and the United States might be vulnerable to a downgrade by the credit rating agencies, given the huge budget deficits the countries had committed themselves to in order to boost economic activity.

Another interesting development in 2009 was that banks that had accepted money from the Treasury’s Troubled Asset Relief Program earlier in the year paid off their federal bailout monies when restrictions on bonus payments began to interfere with their ability to keep and attract new talent. Critics wondered if this was the same talent that got them into trouble in the first place and why was it necessary to pay people so much money just to lose shareholder value. And the improvement in profitability in the banking and brokerage industries was not universal.

But at the end of the year, combined issuance for both tax-exempt bonds and BABs was amazingly close to a normal year, at about $409 billion. Municipalities have used BABs to gather funds readily at lower net rates than were available in the tax-exempt market. From April through December 2009, issuance migrated from the tax-exempt market to the BABs, with the market expanding as BABs became more familiar to both issuers and investors. (See Exhibit 1 for bond volume in 2009.) By year’s end, BABs comprised about 30 percent of total municipal bond volume. The success of BABs resulted in a reduction in the available volume of traditional tax-exempt bonds, which helped lower the yield ratio of tax-exempt yields to Treasury yields. At certain points in the summer, when retail demand was strong, traditional tax-exempt bonds got a boost because of their scarcity.

Another benefit of the ARRA legislation was to broaden the ability of smaller municipal bond issuers to use bank-qualified issues. Bank-qualified issues are generally sold by smaller school districts, townships, counties, etc., that had traditionally used their local commercial bank as a source of financing.

Exhibit 1: Municipal Bond Volume in 2009

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The 1986 tax act had limited the ability of commercial banks to borrow funds to facilitate the purchase of municipal bonds. The ARRA expanded the definition of bank-qualified bonds and liberalized bank holding requirements so smaller municipal bond issuers could continue to finance their local projects at reasonable interest rates.

As 2009 wound down, the Treasury yield curve was at its steepest in 30 years, and the municipal yield curve remained very steep. Steep yield curves tend to suggest an expectation of stronger growth, and with it, stronger inflation. While the recovery was strong enough to motivate a narrowing of corporate credit spreads, municipal credit spreads remained wide, with lower-rated hospitals, universities, and other issuers finding liquidity scarce as well as expensive. (See Exhibit 2 for bond yields in 2009.)

**MOVING INTO THE FUTURE**

While 2010 started out substantially better than 2009 did, nagging questions remain. Will the federal government extend BABs, or expand their usage to other programs, in 2010? Will the economy lapse or will it continue to generate positive, but below-trend, growth? Can credit spreads in the municipal and corporate bond markets narrow further? Is there another shoe to drop with respect to the credit quality of state and local governments?

A likely scenario is for the Federal Reserve to start removing some of the more extreme monetary policy measures undertaken in 2009. This includes the quantitative easing done specifically to unfreeze markets and get capital flowing again, such as the Term Asset-Backed Securities Loan Facility. This program was designed to stimulate financial flows in the asset-backed securities market. The gradual movement of the target federal funds rate from virtually zero to perhaps as high as 1.5 percent at the end of 2010 should result in flattening of both the Treasury yield curve and the municipal yield curve. A flatter yield curve would create better opportunities for municipal borrowers to

![Exhibit 2: Municipal Bond Yields in 2009](image)

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advancing refund their debt, and take advantage of the favorable interest rate environment.

Improving bank profitability should lead to a reduction in both the cost of and the availability of letters of credit and back up liquidity facilities, which provide a buyer for variable-rate securities that fail to be remarketed to other investors. Municipal credit spreads should begin to narrow, as corporate spreads had substantially narrowed in 2009. The principal building blocks of supply — the level of interest rates, the ratio of municipal bonds to Treasuries, the slope of the curve, and the growth in tax receipts at state governments — suggest a substantial year of total volume (BABs and tax exempts) somewhere around $435 billion. Some areas of increased financing might include short-term fixed-rate notes for cash flow, budget balancing bond issues, pension obligation bonds, more basic infrastructure financing, and a pick-up in airport financing. About 30 percent of the total volume in 2010, or $130 billion, is expected to be BABs. The higher interest rates and flatter yield curves that are expected in 2010 should result in governments refunding more of their debt than the (estimated) $97 billion that was done in 2009. (Just like homeowners, municipalities refinance their debt to secure lower interest costs.) This combination, if it occurs, should create a better atmosphere for issuers to execute advance refundings in 2010.

State and local government budgets are estimated to be out of balance by a combined $56 billion as they prepare for the 2011 fiscal year. While the economic recovery is a little stronger than anticipated, any recovery in tax revenues will be too little and too late to ameliorate this situation. California continues to be at the forefront of states with economic and financial difficulties. The state is currently suffering from high home foreclosure rates, an economic contraction that is deeper than what most other states have experienced, and a severe budget problem. On December 24, 2009, the state asked Washington for special funding consideration to help repair a budget that is about $21 billion out of balance. Moving into 2010, credit issues will likely remain a significant factor for the investors that finance the activities of state and local governments via the municipal bond market. While no state is expected to miss a debt service payment, there may be some near misses that accrue primarily from political intransigence.

CONCLUSIONS

We are likely to see fewer liquidity problems in 2010 than 2009, but more credit problems. BABs will help municipal issuers tap broader markets and enjoy a lower cost of capital as a result. New job stimulus measures could broaden the BABs mandate, if Congress succeeds in converting qualified zone academy bonds (QZABs, a tax-credit bond created as part of a ARRA for carrying out school renovations and repairs, and making other improvements) and qualified school construction bonds (similar to QZABs, but for construction) to a BABs structure. Since the market has embraced BABs, changes that shift tax-credit bonds to a BABs structure will improve liquidity for issuers and improve the functioning of the capital markets for municipal debt. Keeping the bank-qualified threshold

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at $30 million is another change that would improve the municipal market by maintaining smaller issuers’ access to low-cost capital.

Overall, higher interest rates and the increased probability of higher marginal tax rates should increase interest in municipal bonds. Traditional tax-exempt bonds will be somewhat scarce, with the continued growth of BABs siphoning off tax-exempt bond issuance. At the same time, improving profitability in the banking sector should allow for more letter of credit availability to municipal issuers at a lower price.

The rate of new issues using municipal bond insurance will likely increase from a modest 9 percent in 2009 to about 15 to 20 percent in 2010, although a return to levels seen prior to the credit crisis is unlikely to occur, or will be very slow to take hold. The process of regaining the market’s trust will be slow and arduous. The two remaining insurers cannot charge the rates they formerly commanded, which has reduced the opportunity to improve the net cost of issuance for municipalities. The market can survive without bond insurance, as it did before the first insured municipal bond issue in the early 1970s. It is unclear, however, if the decrease in using bond insurance is driving some investors, especially individual investors, away from the municipal market.

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