

SPECIAL REPORT: THE MUNICIPAL MARKET, A New Paradigm?

Lazard U.S. Fixed Income

3Q 2008 Outlook



Three prominent negative events have affected the municipal bond market in recent months: the credit erosion of the monoline insurance industry; a series of failed auctions; and episodes of municipal bankruptcies. Although each of these events has happened separately in the past, this time around they have occurred in tandem. The magnitude—and interconnectivity—of these events has had an impact on all municipal bonds, regardless of sector, maturity, or credit support.

The culprit behind the current crisis can be readily identified—the significant deterioration of mortgage underwriting, combined with leverage and a misunderstanding of certain structured investments (which had in the recent past been popular with investors around the globe, including some municipalities). The (mis)perception that these losses would be confined and limited to few investors led both municipalities and the rating agencies to dismiss the possibility of any serious fallout of such defaults hitting the municipal sector. Once it became clear, however, that these losses were not contained but widespread, it also became apparent that the monoline insurance industry would be negatively impacted, directly affecting in turn the tax-exempt sector. Sector participants had been anticipating softening revenues due to property tax declines, collection delays, and

tax certiorari claims, but it was the aggregated effect of these events that ended up hurting public finance and credit to a staggering degree, impairing investor confidence and frustrating public officials.

This unexpected unfolding of events has highlighted what is perhaps one of the most important lessons of the past six months: that the perceived stability of the supporting structures and liquidity options in our market are no longer valid, because the investor base and product universe have changed radically.

The Monoline Insurance Industry

Bond insurers' troubles, which began at the end of last year, continued to weigh on the market. Investors wrestled with a new pricing criterion centered upon underlying credit fundamentals and liquidity, culminating with the two largest bond insurers, Ambac and MBIA, losing their triple-A status from both Moody's and Standard & Poor's in June 2008. As shown in Exhibit 1, the financial condition of the monoline insurance industry has eroded significantly over the past six months.

A Series of Failed Auctions

These dramatic rating downgrades have in turn significantly affected tax-exempt short-term financing. Municipal auctions began to fail back in late 2007, but at the time these failures were attributed to weak underlying credits. In February 2008, however, all kinds of auctions, regardless of the quality of the underlying issuer, began to fail, as perceived liquidity from remarket-

Exhibit 1: Rating Actions on the Bond Insurers

	Current as of January 1, 2008			Current as of July 22, 2008		
	Moody's	S&P	Fitch	Moody's	S&P	Fitch
Ambac	Aaa Negative	AAA Negative	AAA Negative	Aa3 Negative	AA Negative	AA* Negative
Assured Guaranty	Aaa Stable	AAA Stable	AAA Stable	Aaa Negative	AAA Stable	AAA Stable
CIFG	Aaa Negative	AAA Negative	AAA Stable	Ba2 Uncertain	A- Negative	CCC Evolving
FGIC	Aaa Negative	AAA Negative	AAA Negative	B1 Negative	BB Negative	BBB Negative
FSA	Aaa Stable	AAA Stable	AAA Stable	Aaa Negative	AAA Stable	AAA Stable
MBIA	Aaa Negative	AAA Negative	AAA Negative	A2 Negative	AA Negative	AA* Negative
Radian	Aa3 Negative	AA Negative	A+ Stable	A3 Negative	A Negative	A+* Stable
XLCA	Aaa Negative	AAA Negative	AAA Stable	B2 Negative	BBB-Negative	BB Negative
ACA	NR	CCC Developing	NR	NR	CCC Developing	NR

* Rating withdrawn by request of the issuer.

Downgrades shown in red. Source: Lazard Asset Management, Moody's, Standard & Poor's, Fitch Ratings

ing agents—broker-dealers who historically stepped in to provide bids—evaporated due to significant capital constraints on their balance sheets and were compounded by the monoline rating downgrades (most auction rate securities, or ARS, issued by municipalities carry insurance).

Suddenly, indentures were re-read, and many issuers learned the hard way that the punishment for a failed auction is an excruciatingly high penalty rate (as high as 20%, in some instances) on the illiquid paper. Although such high rates might appear attractive to some, most ARS investors owned these instruments for liquidity, not yield. This development has served as a harsh reminder that most ARS are long bonds (30- to 40-year) with a variable coupon, and not cash-like investments.

Historically, municipal issuers have been active participants in the auction rate market: about 50%, or \$165 billion, of all outstanding ARS at the end of the 2007 fiscal year were issued by municipalities. But after living through months of high interest payments, coupled with uncertainty and expensive refinancing, most issuers have exited the ARS market completely, and vowed never to participate in such structures again.

Episodes of Municipal Bankruptcies

Up until recently, cumulative default rates on Moody's and S&P single-A-rated municipal bonds over various 10-year periods have been several times lower than identically rated corporate issues (see Exhibit 2). Considering both this low default rate, and an expected recovery rate of approximately 90% (compared with 50% for corporate bonds), it is clear, based solely upon these risk metrics, that the rating agencies have been systemically underrating municipals. After the precipitous failures in the auction

rate market, where issuers were punished by the rating downgrades of the bond insurance companies, several state and local officials began investigating how rating agencies graded the risk of municipal bonds. Most call the agencies' established practices unfair, some even say illegal; presently, the U.S. Congress is examining these practices in order to force rating agencies to adopt a more uniform approach. Moody's has already published a report announcing a transition of its public finance ratings to a different, uniform global scale. We have not yet heard of a similar announcement from Fitch Ratings or Standard & Poor's.

Tax-exempt financing is vital to all current and future municipal issuers; projects and properties securing these bonds are essential to the well being of communities and voters. The historical track record of the municipal bond sector is stellar when it comes to actual defaults and recoveries. In addition, the world of public finance is rather highly regulated and monitored (especially for states and large issuers). Nonetheless, we are concerned that the sector's history of infrequent and highly dispersed bankruptcies might not necessarily carry into the future.

One possibly ominous sign of change occurred recently in Vallejo, a small city northeast of San Francisco. The city filed a petition for bankruptcy protection under Chapter 9 of the United States Bankruptcy Code. Since 1934, Chapter 9 has been evoked only about 600 times by municipalities. (By comparison, corporations filed that many petitions in a single two-week period in 2006).¹ But this track record might change drastically if more cities decide to proceed in a similar direction as Vallejo. Earlier this year, Jefferson County in Alabama discussed bankruptcy as an option to exit its swap agreements. In this case, the AA-rated county's discussion reminded market

Exhibit 2: 10-Year Cumulative Default Rates

	Moody's (1970 - 2000)			S&P (1986 - 2005)	
	Municipalities	Corporates		Municipalities	Corporates
Aaa/AAA	0.00%	0.68%	Aaa/AAA	0.00%	0.44%
Aa/AA	0.03%	0.80%	Aa/AA	0.00%	0.81%
A/A	0.01%	1.47%	A/A	0.04%	1.83%
Baa/BBB	0.06%	4.86%	Baa/BBB	0.31%	5.82%
Ba/BB	1.34%	21.29%	Ba/BB	1.35%	18.29%
B/B	3.98%	47.38%	B/B	9.04%	32.38%
Caa/CCC	10.55%	76.79%	Caa/CCC	34.31%	53.05%

As of December 31, 2000

Source: Citigroup, Moody's, S&P.

As of December 31, 2005

participants that credit risk is not only defined by the ability of an issuer to pay, but by its willingness as well. There is a risk that bankruptcies will become a political tool, with fewer stigmas attached to them, and investors need to be ready for the “unthinkable”—bankruptcies of cities, towns, and local school districts across the country, if the macroeconomic environment deteriorates significantly. We believe that understanding the legal provisions, as part of the fundamental credit analysis, will be even more crucial going forward.

Final Thoughts

While the market continues to wrestle with deteriorating credit metrics, failed auctions and poor liquidity, we are cautiously optimistic on the municipal sector. We acknowledge that the deteriorating credit environment will be the largest obstacle for the sector. We expect sales and tax revenues to continue to drop for most states, as further problems in housing are likely to translate into even lower property values and tax collections, fewer refinancing surcharges and mortgage taxes, and less robust overall consumer spending. We believe that the 2008 fiscal year marked a turning point for state finances, with a significant increase in states experiencing financial difficulties. While the budget stress was not universal—some states benefited from high energy prices and others remained insulated from housing-market declines—it is reasonable to assume that the 2009 fiscal year will be seriously financially challenging for all municipalities, small and large. Expenditure pressures for states stem from rising health care costs, pension liabilities, demographic shifts, and infrastructure needs.

States are entering this challenging fiscal year (for most states, FY2009 started on July 1, 2008) with declining reserves: in 2006 average general fund balance was around 11%; by 2009 this cushion may likely decline to about 7%. While these reserves continue to be higher than the historical average of 5.8%, they are likely to evaporate quickly. All 2009 state budgets share concerns around a weak economy, lower expectations for revenues, and growing fixed costs, and all are addressing these problems by calling for higher “sin” taxes and lower spending (on all but education programs)—and by issuing additional debt.²

Whether we have already navigated past this difficult investment environment, or we are in the eye of the storm, it is clear that the historical data needs to be reviewed and reconsidered. With so many unknowns—rating agencies’ scales, outside participants impacting demand, new monoline insurance companies entering the market as others are pushed out—we continue to stay committed to fundamental analysis, focusing on the underlying factors driving credit quality, as well as a thorough understanding of all legal provisions.

John R. Senesac Jr., CFA, Senior Vice President and Senior Portfolio Manager/Analyst, U.S. Fixed Income

Evgenia (Eve) Lando, Vice President and Municipal Credit Analyst, U.S. Fixed Income

About Lazard's U.S. Fixed Income Strategies

In developing an optimal allocation to the universe of fixed-income assets, Lazard incorporates a dual methodology that is both bottom-up (security selection) and top-down (portfolio construction). From a bottom-up perspective, we focus on identifying investment opportunities that we believe are financially sound. Financial soundness is analytically determined by the combination of a comprehensive parametric review of an investment's structure (financial engineering) and a disciplined credit review of an investment's recovery potential (intrinsic value). The parametric analysis focuses on the underlying drivers of return and the reliability of the investment's expected total return behavior to changes in those underlying drivers. The credit analysis focuses on an understanding of the steps required to secure a recovery as well as the probability and value of the expected recovery. Investments with acceptable risks are then considered subject to a multi-disciplinary valuation process designed to identify the relative attractiveness of competing alternatives. From a top-down perspective, we pay close attention to shifts in public policy, business cycles, consumer habits, and key economic variables, such as inflation, interest rates, and

unemployment. These shifts tend to be gradual and can guide our assumptions about the volatility and nature of the probable scenarios that will affect fixed income market returns. We then use these scenarios in our portfolio construction process to gain a comprehensive understanding of the macro bets that may be inadvertently embedded within our security selection process. This discipline of supplementing traditional quantitative portfolio risk analysis with fundamentally derived scenarios enables us to combine investment opportunities within a dynamic framework that protects the final invested portfolio from unintended consequences that may otherwise not be apparent. Many times what appears to be an attractive investment on a stand-alone basis gets trimmed or eliminated as a result of this dynamic construction framework.

Ultimately, by focusing on individual investments that are financially sound within a dynamic top-down framework, we strive to consistently outperform both markets and the competition through the uncertainty of investment cycles at relatively low levels of risk.

NOTES:

1 Source: Mintz Levin presentation to MAGNY (Municipal Analysts Group of New York), http://www.magny.org/event-presentations/20080613_a-guide-to-municipal-bankruptcy.ppt, June 13, 2008

2 Source: Fiscal Survey of States, National Governors Association and National Association of State Budget Officers, <http://www.nga.org/Files/pdf/FSS0806.PDF>, June 2008

The securities identified above are not necessarily held by Lazard Asset Management and should not be considered a recommendation or solicitation to purchase or sell any particular security. It should not be assumed that any of the referenced securities were or will prove to be profitable, or that the investment decisions we make in the future will be profitable.

Published on July 28, 2008.

Information and opinions presented have been obtained or derived from sources believed by Lazard to be reliable. Lazard makes no representation as to their accuracy or completeness. All opinions expressed herein are as of the published date, and are subject to change.

© 2008 Lazard Asset Management LLC

