

MUNICIPAL MARKET MYTHS AND REALITIES



Popular Perceptions Are Often Misconceptions

Headlines can be captivating, but rarely tell the whole story. Such has been the case recently as it relates to the municipal bond market, particularly in the immediate wake of Detroit's history-making bankruptcy filing. BlackRock's Peter Hayes and James Schwartz fact check some of the more pervasive perceptions, and offer insight and advice for wary investors.



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MYTH 1

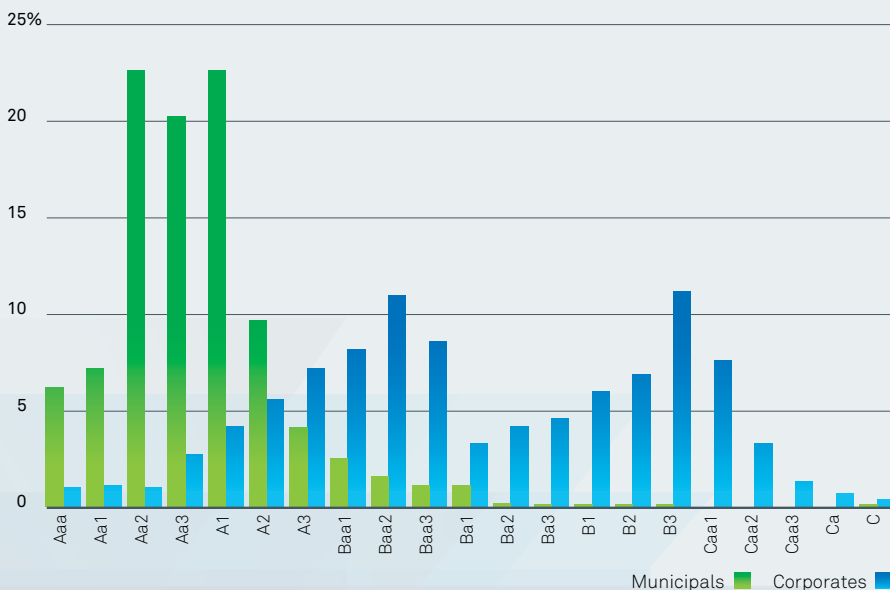
All municipal issuers and credits are created equal.

The reality is that the municipal bond market is a vast and diverse universe comprised of approximately 95,000 different issuers with roughly \$3.7 trillion in debt outstanding.¹ Issuers and credits run the gamut, covering a range of credit qualities, maturities, sectors and territories. Generalizations are difficult, and most often misplaced, in the municipal marketplace. No two states, for example, have the same socioeconomic profile or regulatory environment. State constitutions and priority-of-payment models also vary. It is an oversimplification to paint the municipal bond market with a single stroke. Ultimately, credit research is critical to separating the wheat from the chaff. As with any other financial asset, it is important to know what you own.

Notably, with an average rating of AA, the municipal market as a whole remains of high quality, particularly relative to the corporate bond market.

MUNICIPALS EXHIBIT HIGH QUALITY VS. CORPORATES

Ratings Distributions: Municipal Bonds vs. Corporate Bonds



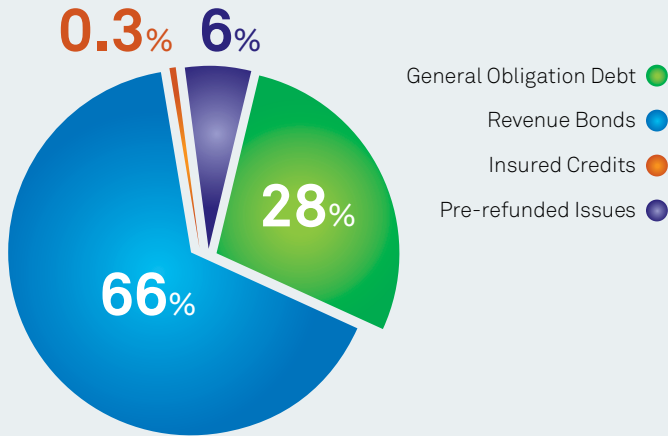
Source: Moody's, as of year-end 2012.

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Furthermore, a large portion—roughly two-thirds—of the municipal marketplace has assigned revenues that are an identifiable source of debt repayment.

LARGEST PORTION OF MUNI MARKET HAS ASSIGNED REVENUES



Source: Barclays Municipal Index as of June 28, 2013.

MYTH 2

Distressed cities are a major part of the municipal market.

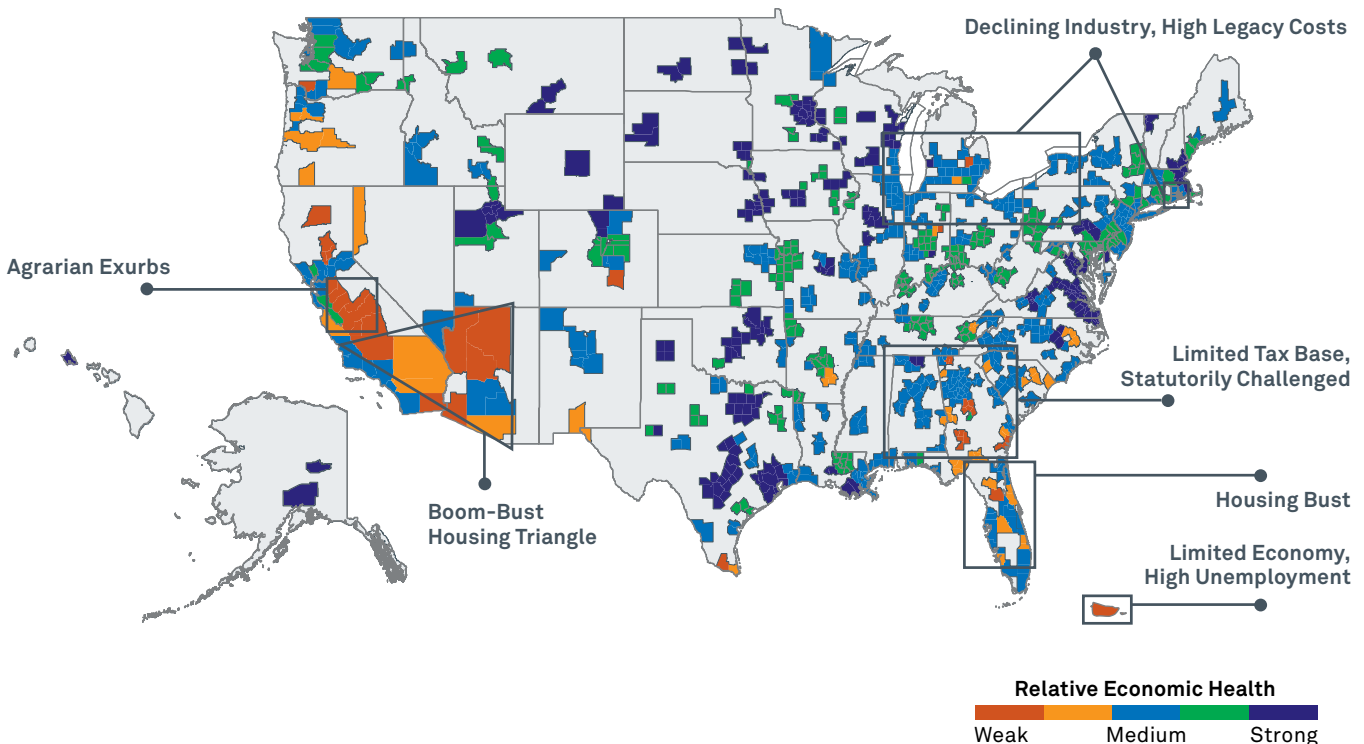
Truth be told, distressed cities are far and away the minority. According to Moody's, of the more than 7,500 municipal entities it rates, only 34 are assigned a rating of below

investment-grade. Quantified another way, over 99% of Moody's rated local government universe is rated investment grade. This tells us that the great majority of the country has been able to manage its debt.

We would also suggest that the trouble spots, albeit not extensive, are identifiable. Moody's had identified Detroit's plight and assigned a non-investment-grade rating more than four years ago. Among the signposts we look for in assessing hardship at the local level are high levels of foreclosure, unemployment and poverty, as well as out-migration population trends and, most importantly, fiscal mismanagement. The map below illustrates areas we believe are vulnerable to fiscal distress (and potential bankruptcy/default), as well as those areas representing greatest opportunity. In modern-day ghost towns (former booming areas struck by high foreclosures), there are undoubtedly municipal credits to be avoided. But there are many more strong credits that appear poised to perform relatively well.

Overall, municipal defaults have been and, we believe, will continue to be rare. Including all of Detroit's debt in default, \$6.7 billion in municipal defaults occurred through the first six months of 2013—just 0.18% of the \$3.7 trillion market. This compares to \$4.8 billion in all of 2012, or 0.13% of the market.² In addition, Municipal Market Advisors reports that the number of municipal defaults in 2013 is running at one-third the pace of 2011.

AREAS OF VULNERABILITY AND OPPORTUNITY, BY METROPOLITAN STATISTICAL AREA (MSA)



Sources: BlackRock, US Census, Federal Housing Finance Agency and Bureau of Labor Statistics. Areas of vulnerability as assessed by BlackRock and based on unemployment rates, change in home valuations, poverty levels and relative per-capita wealth, as of December 31, 2012. Uncolored areas not part of MSA.

MYTH 3

Detroit is a domino.

Since Detroit's history-making Chapter 9 filing on July 18, there has been a great deal of speculation about the precedent this could set for other distressed municipalities in Michigan and elsewhere in the US. Surely, some have argued, others will follow suit.

In reality, there's no place like Detroit. The city has suffered from severe out-migration, falling home values, cuts in services and the inability to attract businesses. The restructuring of the auto industry and exodus of big employers (e.g., Comerica Bank) have left the city with long-term structural problems. Detroit has experienced fraud and mismanagement, with a past mayor now serving a prison sentence. Other stressed cities, including the often cited Chicago, Philadelphia and Pittsburgh, have strong, stable regional economies and have been able to manage their deficiencies with greater success than Detroit.

Pittsburgh, once a steel powerhouse, has re-emerged as a presence in the healthcare and higher education sectors and was recently upgraded to A by S&P. Philadelphia has adjusted its tax base and saw a population increase of about 0.56% over the 2000-2010 period, while Detroit saw a greater than 25% decline. All told, we can cite no US city that is poised to follow precisely in Detroit's ill-fated footsteps. Detroit's financial collapse is unique given both its unwillingness to proactively tap all of its own available governmental powers and resources as well as its parent state's indifference to setting an alternative course to a bankruptcy filing.

History also is a worthwhile reference. The municipal market has seen bankruptcies and defaults before. There was New York City in the mid-1970s, Cleveland (OH) in the late 70s and early 80s, Orange County (CA) in 1994 and Jefferson County (AL) in 2011.³ None of these cases sparked a spate of Chapter 9 filings, and we have no reason to believe this time will be any different.

Notably, Chapter 9 is an option in only 26 of the 50 states. And in all cases of local distress, state back-up provisions are key. A wholesale withdrawal of state support would be required to initiate a domino effect in municipal defaults.

MYTH 4

Distress necessarily leads to Chapter 9.

Municipalities have faced stress in the past and they will face stress in the future. We know from historical experience, however, that Chapter 9 is the exception and not the norm.

The reality is that Chapter 9 brings with it a stigma that issuers generally will do anything to avoid. It is an extremely lengthy and expensive proposition. Just consider Orange County's protracted battle, which cost the municipality nearly \$90 million—monies it surely could have put to better use. Jefferson County has already spent some \$20 million in legal fees since its 2011 filing, and some estimate Detroit's filing could cost upwards of \$100 million. Chapter 9 also leads to credit downgrades and, even worse, cities' inability to access the market for future projects. This is critical for municipal governments, as the tax-exempt market is the only place to procure financing to fulfill their needs. Notably, the specter of rating downgrades is raised not only in the filing municipality, but in other cities and towns throughout the state. It is for these reasons that states are most often inclined to intercede to prevent a Chapter 9 filing—to protect the creditworthiness of its cities and to ensure the availability of future financing on the most favorable terms.

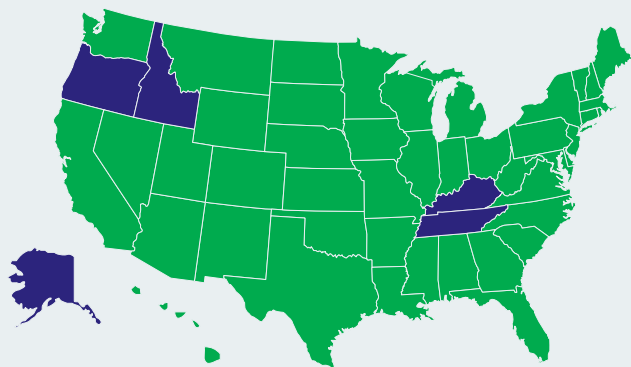
MYTH 5

Pension problems are set to sink the municipal market.

Pension-induced pressure is undeniable. The funding of public pensions and retiree health benefit plans (also known as other post-employment benefits, or OPEBs) are listed among long-term fiscal challenges for many state and local governments. Estimates on total retirement liabilities have ranged from \$1 trillion to \$3 trillion (depending on the discount rates applied). Rising pension costs have been cited among the culprits in many local government bankruptcies and state rating downgrades. State and local pension funded ratios were 75% in 2011, and are expected to decline to 73% in 2012 despite strong stock market performance.⁴

Clearly, the pension problem has a role to play in the fiscal well-being of many states and municipalities. That said, pension funds have been below full funding for most of the post-WWII era. This has never led to a sharp rise in municipal bond defaults or bankruptcies. Consider also these two very important points: 1) The pension problem is a long-term issue. In fact, payments on pension liabilities overall don't peak for many (perhaps 30) years, meaning municipalities have time to address this problem; and 2) the work of addressing the problem has already begun. In fact, 45 states have enacted meaningful pension reform since 2009. (See map on next page.) Cuts have focused on benefits for newly hired workers, but gates have been opened to extract savings from current employees. Notable city reformers have included San Jose (CA), San Diego (CA) and Providence (RI). Detroit, perhaps ironically given all the negative speculation, may be a catalyst for more meaningful local pension reforms.

PENSION REFORM SINCE 2009



Pension reform measures taken* ■ No changes made ■

* Measures taken include changes to either age, benefits or contribution requirements for new and/or existing employees.

Sources: PEW Center, National Conference of State Legislators (NCSL). Data as of December 2012.

MYTH 6 The municipal market is in trouble.

In the aftermath of the largest-ever municipal bankruptcy and a sharp correction just weeks before, many municipal market observers have been quick to jump to the conclusion that the market is in dire straits. This simply is not the case. The market's underlying fundamentals are very strong: state revenue collections have risen for 13 consecutive quarters while spending is declining; housing markets are improving

throughout the US; and state budgets are being passed on time after years marked by lengthy wrangling and can-kicking.

If anything, the May-June correction (which some might argue was overdue) restored value in municipal bonds, particularly relative to Treasuries. Municipal yields returned to levels not seen since 2011, offering a compelling buying opportunity for investors—all this at a time when broad market fundamentals are healthier than they have been in five years, prior to the financial crisis.

Final Thoughts

Many investors misstepped when they exited the muni market in late 2010 and 2011. Not unlike today, rates were rising then and headlines touted credit weakness. Spooked investors unwisely sold at exactly the wrong time, costing them a significant amount of money. We would urge investors to avoid making the same mistake today.

Cities that have pension problems and municipal debt outstanding represent a small fraction of the municipal market. The broad market is high quality, with an average rating of AA. Two-thirds represent revenue bonds that use specific project receipts to pay debt service.

Detroit-induced headlines will create noise, but we believe the underlying fundamentals rise above the din and speak much louder to the strength of the broader municipal market.

1 Sources: BlackRock and Federal Reserve Statistical Release, June 2013. 2 Source: Richard Lehmann, Distressed Debt Newsletter, as quoted in *Boston Journal*. 3 Both New York City and Cleveland defaulted on short-term notes: NYC deferred payment, and thus defaulted; Cleveland defaulted on bank notes. 4 Source: Center for Retirement Research's Public Plans Database (sample of 126 largest US plans).

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