January 2011

# Muni-Meltdown

Last January, I made a list of five possible "black swan" events for 2010. I didn't predict that they would happen, but wanted to warn readers of the possibility. Let's review them:

1. **A PIIG country leaves the Euro.** This hasn't happened yet, but 2010 left us with some major questions about the survival of the current European Union. In May, they bailed out Greece and in November, they bailed out Ireland.
2. **Global food crisis begins.** This black swan prediction came true in 2010. There were fires across Russia's wheat fields causing them to place a ban on exports. This in turn caused food riots to break out in Mozambique.[1] 2010 also brought floods that submerged much of Pakistan's Punjab region, destroying millions of tons of agricultural products.[2] If these two events were not horrible enough, we also saw a plague of locusts cover an area the size of Spain in Australia. They destroyed many crops and were so dense in areas that you could not fly a plane or play golf![3] The shortages compounded the problem of the evil money printers in 2010 and we saw the following annual increases in prices:

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   | Cotton | 92% gain |
   | Wheat | 90% gain |
   | Corn | 57% gain |
   | Soybeans | 31% gain |

   Unfortunately, the dollar's death/commodity surge isn't over and could turn into turmoil because as Bertold Brecht observed, "Food comes first, then morals."
3. **U.S. and Iran go to war.** Thank God this didn't happen.
4. **U.S and Pakistan go to war.** The real war turned out to be between Patraeus and Obama. Why are we still in Afghanistan, again?
5. **The Fed gets a real audit.** Chris Dodd and Barney Frank, puppets of the banking elite, helped to water-down the true audit the fed bill written by Ron Paul. The Federal Reserve however was recently forced to turn over the recipients of its $3.3 trillion lending spree during the crisis of 2008. Of course the "Too Big to Exist" banks were given loans but we also found out that many foreign banks and politically connected companies like Verizon, Harley Davidson, and Caterpillar were given money.[4] Unfortunately "Joe Six-Pack" was still too occupied with *Dancing with the Stars* and playing Angry Birds on his iPhone to be outraged by something that happened two years ago. Don't look now but Dr. Paul just got appointed to head the House Domestic Monetary Policy Subcommittee in charge of overseeing the Federal Reserve.

Last year, I threw out a list of extreme events to look out for. This year, I want to discuss only one concern—the amount of debt that has built up at the city and state level. Corporations have spent the last ten years restructuring, outsourcing, and upgrading their technology. Outside of

[1] http://www.guardian.co.uk/commentisfree/2010/sep/05/mozambique-food-riots-patel
[2] http://www.abc.net.au/rural/content/2010/s2995275.htm
[3] http://www.timesonline.co.uk/tol/news/world/article7098057.ece
[4] http://www.washingtonpost.com/wp-dyn/content/article/2010/12/01/AR2010120106870.html

home builders and the banking sector, many of the world's companies are in extremely good shape. Driven by pompous bureaucrats and the ghost of Keynes, cities and states have been spending like it is going out of style for the last ten years. That is not too surprising because most of them couldn't even stay within budget during the fat times of the 80s and 90s. Let's delve into a little background information on municipal debt.

Municipal bond income is generally federal income tax free and if you buy a bond in the state that you live in, you don't have to pay state income tax on the interest from the bond. If you are in a high tax bracket, these yields can be very compelling relative to other investment opportunities. In December of 2010, Bill Gross, CIO of PIMCO, personally invested $4.4 million into several of PIMCO's municipal bond funds.[5] One of the California bond funds that he purchased is currently yielding 8.8% tax free. If you are fortunate to make as much money as Mr. Gross and live in California, you pay 35% in federal income taxes and 10.3% on your highest income to the state of California. Because the municipal bond interest is state and federal tax free, Gross would have to find a taxable bond that yields 16.09% to compete with his 8.8% tax free yield (8.8%/(1-.453).

The other point muni-bond bulls frequently make is that municipalities rarely default and even when they do, they generally have a high recovery rate. They often site Orange County's 1994 bankruptcy. Orange County was forced into bankruptcy due to some bad advice that they took from a certain investment bank that ended up destroying itself by bad investments in 2008. Immediately, the bonds sold off as investors looked to cut their losses. The county knew that if they did not pay back their bond holders, it would be extremely difficult for them to ever issue bonds in the future and they would be forced to actually live within a dreaded thing called a budget. They decided to raise taxes and cut services and ended up paying back the interest and principal to the bond holders.

All too often, investors look to recent history to help them gage what the future may hold. From 1940 to 1991, the default rate on municipal bonds never exceeded 1.1%.[6] This is the same point many of the mutual fund families are making in recent phone calls to assure financial advisors to keep their clients invested in municipal bonds. Rest assured, I will not be on those calls getting immersed in propaganda to throw back up on retail investors. It is always the same shtick—they rarely default; they can always raise taxes and cut services. The focus on more recent history is the exact mistake that led the bond rating agencies into building models that assumed you couldn't have a nationwide downturn in real estate. I think you are going to have to look back to the depression for historical context of what is to come for municipalities.

Most people are not aware of the tax protestor movements of the great depression that is outlined in David Beito's book *Taxpayers Revolt: Tax Resistance during the Great Depression*. Authors, Neil Howe and William Strauss separate history into approximately 80 year cycles that are further broken into four turnings. The Great Depression was one such fourth turning and according to them we are currently in another fourth turning. Fourth Turnings are periods of turmoil and transformation where society removes the shackles of institutions that were created by previous generations that are no longer useful to the current society. The Great Depression was the last time the U.S. had a national housing slump and it was also when 4,770 municipalities filed for bankruptcy.[7]

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[5] http://www.bloomberg.com/news/2010-12-13/pimco-s-gross-buys-five-of-firm-s-muni-bond-funds-update1-.html?cmpid=yhoo
[6] http://www.citymayors.com/finance/bonds.html
[7] http://www.citymayors.com/finance/bonds.html

I think we have finally reached the point where the people can no longer afford the governments they have. The private sector used to be a desirable place to work because it paid more than the government. USA TODAY recently used Bureau of Labor Statistics data to compare pay between private and public jobs that exist in both categories. They found that private sector workers were paid less in eight out of ten occupations and that the median private sector job paid about 20% less than the equivalent government job. The study did not even count pensions and benefits, which averaged **$40,785** per federal government worker and $9,882 per private worker in 2008.[8] Corporations have already had to make the hard choices; it is time for the governments to do the same. Let's consider some of the facts:

- California may have a larger economy than Russia, but it also has $88.3 billion of outstanding bond debt, $500 billion of pension liabilities, and has had to pay some of its suppliers in IOUs for the last two years. The state will face a $28 billion budget gap this year and newly elected Governor, Jerry Brown, says the state has reached its "day of reckoning. It will be interesting to see how "painful" his new budget will be when it is announced on January 10th.[9]
- All 50 states have approximately $140 billion in deficits during the next fiscal year.[10]

  After trying to file bankruptcy twice, Prichard, Al (near Mobile) decided to stop sending monthly pension checks to its 150 retired workers. They did this despite the fact that they were breaking state law. "Prichard is the future," said Michael Aguirre, the former San Diego city attorney, who has called for San Diego to declare bankruptcy and restructure its own outsize pension obligations. "We're all on the same conveyor belt. Prichard is just a little further down the road."[11]

- New York law firm, Cravath, Swaine and Moore has recently agreed to advise Harrisburg, PA for free to get the experience and win out their competition.[12] This is a very high-end law firm that realizes that there will be millions in advisory fees over the next few years. They have smartly taken this case pro bono to position themselves as the go-to firm in this soon to be booming area for lawyers.

- Ten states are proposing legislation that would bar private sector unions from forcing workers they represent to pay dues or fees, reducing the flow of funds into union treasuries. Several other states are threatening to take away government workers' right to form unions and bargain contracts. Ohio Governor, Scott Walker, said "We can no longer live in a society where the public employees are the haves and taxpayers who foot the bills are the have-nots."[13]
- Government pensions are massively underfunded and will not be able to pay out the benefits that they promised retirees. Business Insider has a fascinating slide show that shows the biggest train wrecks coming. They state that the city of Chicago has an unfunded pension liability of $44.8 billion that works out to almost $42,000 per household![14] The

[8] http://www.usatoday.com/news/nation/2010-03-04-federal-pay_N.htm#chart
[9] http://www.bloomberg.com/news/2011-01-03/brown-says-calif-budget-he-proposes-next-week-will-be-painful-.html
[10] http://www.bloomberg.com/news/2011-01-03/brown-says-calif-budget-he-proposes-next-week-will-be-painful-.html
[11] http://www.nytimes.com/2010/12/23/business/23prichard.html
[12]http://www.zerohedge.com/article/cravath-swaine-advise-harrisburg-bankruptcy-pro-bono-will-charge-millions-muni-default-dam-f
[13] http://www.nytimes.com/2011/01/04/business/04labor.html?pagewanted=1&_r=2&partner=rss&emc=rss
[14] http://www.businessinsider.com/first-city-pensions-insolvent-2010-12#2-chicago-9

> Illinois' state pension fund is projected to be completely dry in seven years.[15] If you are counting on your municipal pension to be there in its current form for your entire retirement, I admire your faith.

Someone once said that the best way to look at the unemployment rate is to add the real unemployed to the government payroll. As contentious as that may sound, I think that is a more accurate picture of the economy than anything coming out of the BLS. As Howard Segermark observed, "The only numbers that I believe coming out of Washington are the mile markers on I-95." In *The Ethics of Liberty*, Murray Rothbard wrote:

> For there is one crucially important power inherent in the nature of the State apparatus. *All other* persons and groups in society (except for acknowledged and sporadic criminals such as thieves and bank robbers) obtain their income voluntarily: *either* by selling goods and services to the consuming public, or by voluntary gift (e.g., membership in a club or association, bequest, or inheritance). *Only* the State obtains its revenue by coercion, by threatening dire penalties should the income not be forthcoming. That coercion is known as "taxation," although in less regularized epochs it was often known as "tribute." Taxation is theft, purely and simply, even though it is theft on a grand and colossal scale which no acknowledged criminals could hope to match. It is a compulsory seizure of the property of the State's inhabitants, or subjects.[16]

All states steal from the productive and give to unproductive causes to help pacify the electorate or generate votes in a democracy. Every dime they spend is taken directly from citizens or borrowed and will be taken from the hides of future productive citizens. In a free market, many of the government "services" would no longer exist because people would not be willing to voluntarily pay for these things. To see how far the pendulum has flung, click here to see a list of almost 500 California state agencies, departments, and commissions.

How can the municipalities expect a hallowed out country to continue to pay for these government services? A whopping 43 million Americans or 14% of the U.S. population is currently living on food stamps.[17] As we discussed in "Cooked Books," the real unemployment rate in the United States is much higher than the doctored statics coming out of the BLS. As you can see from the chart below the actual unemployment rate is closer to 23% than the often stated 10%. The ugly truth is that many of these jobs are not ever coming back because the dollar is still too high relative to many foreign currencies and the excessive taxes and regulations we are burdened with. Additionally, a large segment of the population is unemployable. Many are illiterate, innumerate, and don't have the discipline or self control to hold down a job. The hard work and ingenuity that made the United States the world's super-power after World War II has morphed into complacency and entitlement. How many jobs did you promise the stimulus would create, Obama?

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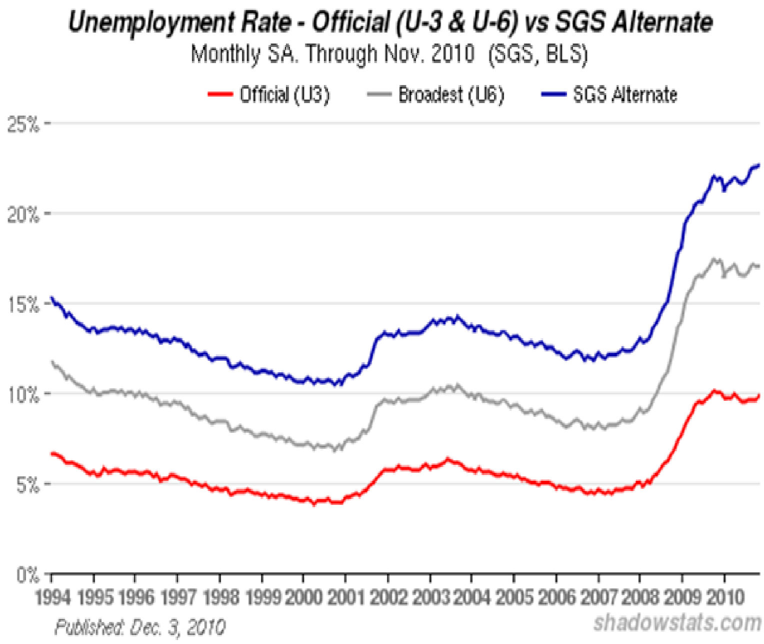
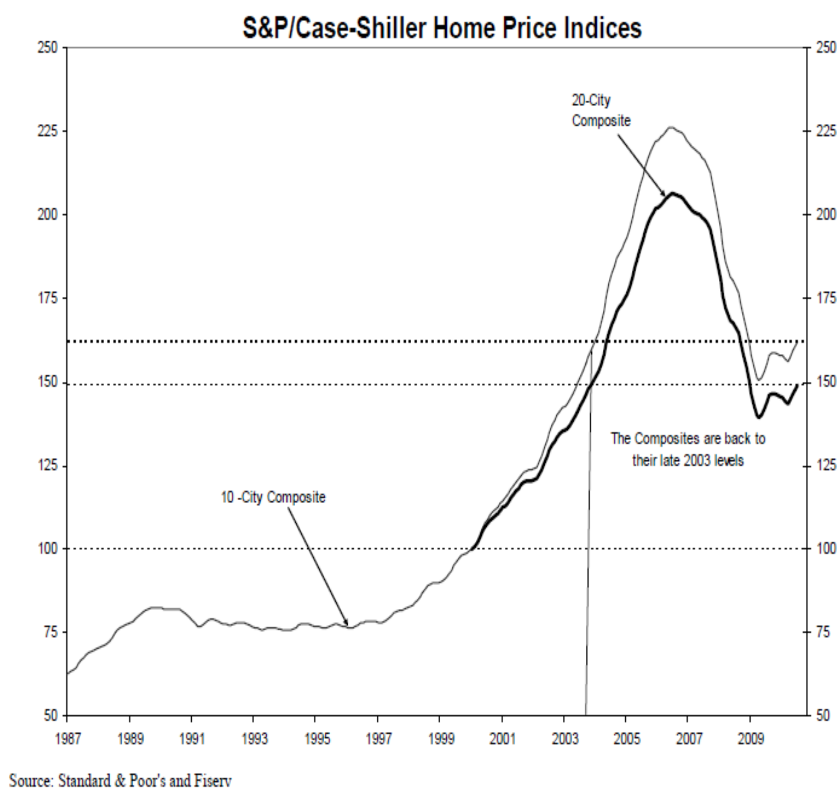
[15] http://www.businessinsider.com/the-state-pension-funds-in-the-most-trouble-2010-10#1-illinois-11
[16] http://www.lewrockwell.com/rothbard/rothbard160.html
[17] http://finance.yahoo.com/news/Food-stamp-use-spikes-One-in-cnnm-2280036884.html?x=0&sec=topStories&pos=2&asset=&ccode=




**Source: Shadowstats.com**

In addition to being forced to pay huge sums for unemployment insurance and getting less sales tax revenue from the underemployed, municipalities have been dealt a blow by the ever-sinking real estate market. Instead of using the housing boom to shore up pensions and pay down debt, public officials assumed that house prices would keep rising to the moon. The Keynsian sugar-high from the stimulus checks in the summer of 2008 did not prevent the recession; the housing tax credit gimmick will not be able to prevent the market from clearing the bubble prices of the 2000s.

As you can see on the chart below, the easy money the Fed created from 2001 to 2004 created a parabola up in rising home prices. Home prices peaked in 2006 and they had a waterfall decline until the homebuyer's gimmick. The last four months (latest data is approximately 3 months delayed) of data have seen a decline in the index and prices are now lower on the 20 city index year over year. The latest report shows that six cities just hit new lows since 2006. This does not bode well for deeply indebted cities and school districts. There are also untold numbers of homes that will be going through the foreclosure pipeline in the next few years as more people lose unemployment payments and option ARM loans come for renewal.




Source: Standard & Poor's and Fiserv

**http://www.standardandpoors.com**

The "stimulus" package of 2009 was loaded with band-aids for the states. As more and more Americans become terrified of the national debt and as the bond vigilantes tell Obama and CONgress to stop the profligacy, the politicians' ability to pass further bailouts wanes. As the chart below shows, since Helicopter Ben's November 3 announcement of a jaw-dropping $600 billion more in money printing, ten year treasury notes have had a substantial drop in price as


Courtesy of StockCharts.com

yields have sky rocketed. Mortgage rates have a high correlation to the ten-year note. If rates stay where they are or continue to rise, the refinance boon is over and there will be less of an incentive to purchase new homes.

The rise of the Tea Party and the hatred of bailouts will make it very difficult for politicians to vote to bailout bloated municipalities. Texans will be furious to be forced to bailout Californian's excesses. Nebraskans will not tolerate a subsidy to New York. I don't even see how there will be the political will for Texan's to bail out the Texas prepaid tuition 529 plan. Why should I be forced via higher taxes to guaranty the investment returns in the Texas prepaid tuition plan? For that matter, why should my taxes be raised so that a city or state worker can get a guaranteed pension payment for life? Many people in the private sector will rightfully ask what a pension even is.

The answer to the muni-meltdown is politicians that are not afraid of unions and being unpopular. We will see more public servants like Ronald Reagan who was willing to back up his threat of firing 11,345 air traffic controllers in 1981 when they went on strike to demand higher pay and a 32-hour workweek.[18] New Jersey Governor, Chris Christie, is a trailblazer when it comes to trying to balance state budgets. He is not afraid of telling teachers that if they don't like their pay, they can quit and find a new job. He has cut state aid to municipalities and is doing a great job of trying to right the state's books.[19] New Jersey is already one of the highest taxed states in the Union and Christie realizes that the answer lies in cutting expenses and not raising taxes.

In 2011, don't listen to the rhetoric that bankruptcies are the end of the world as we know it. The ancient Israelites knew how crushing excessive debt could be and instituted Jubilee. The founding fathers even had the foresight to give congress the power to "establish uniform laws on the subject of bankruptcies throughout the United States." Just as GM still makes cars and still owns factories, there will still be government in Illinois when they file bankruptcy. Bankruptcies or restructurings will allow municipalities to get out of the crippling debt, pensions, and union contracts that they can no longer afford. There will be disruptions in the short term, but it is the only path forward. As

[18] http://en.wikipedia.org/wiki/Professional_Air_Traffic_Controllers_Organization_%281968%29
[19] http://www.bloomberg.com/news/2010-12-20/christie-cuts-to-local-aid-make-new-jersey-towns-lead-u-s-bond-downgrades.html

long as your income does not depend on the cities, counties, or states, and you weren't foolish enough to have lent money to a bankrupt municipality, you have nothing to fear. Risk takers who own muni bonds will likely lose money and the salaries, benefits, and pensions of government workers will be cut, but the world will keep spinning and we will finally get back on a sustainable path. Municipal union members wake up—there are literally thousands of unemployed workers that will be happy to do your job for less pay and no guaranteed pension for life. Demand more goodies at your own peril and don't forget the lessons of Vallejo, California.

## Markets

Below is a chart of the iShares S&P National Municipal Bond ETF for 2010. This is a good proxy for the national muni-bond market. California and Illinois bonds have fared much worse than this. Returns usually come off faster than they are put on. Investors in this instrument lost an entire year's worth of return in just seven trading days. If I have labeled my Elliott Waves correctly, we should see one more fifth wave down taking the ETF below $97. There is also no assurance that the next move down is the end of the destruction that I expect for the municipal bond market. Buyers beware.

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