RIVERBEND
Capital Advisors

Market Comment 7/22/13

Detroit is Bankrupt…and We Landed on the Moon!

How did this happen? And can it happen here?

The City of Detroit filed for Chapter 9 bankruptcy last Thursday. Surprise? Not really. This is probably the slowest moving train wreck in municipal bond market history. Detroit's unfortunate declaration is the culmination of decades of dramatic population decline, shrinkage of its industrial and residential tax bases, and egregious fiscal mismanagement. Detroit's level of economic despair has been well-telegraphed for many years and should come as a shock to no one.

Is Detroit a typical American city? A harbinger of what's to come for municipalities across this country? Highly unlikely. It is an outlier and its problems are not contagious. Detroit's unique and idiosyncratic struggles are specific to its troubling situation and not representative of the current state of municipal finances. The overall outlook for municipal credit continues to improve. US states are experiencing strong tax receipts. In FY2012, tax revenue increased in all but five states. In 2010, states faced a collective budget gap of $191 billion (which they closed via cutbacks and tax increases). In 2013, the deficit was approximately $50 billion. The National League of Cities report similarly positive trends.

First time muni defaults through 2Q2013 amounted to $2.1 billion and Detroit pension certificates of participation comprised 68% of that total. Most of the rest was a single issue of Bronx Parking Development bonds for Yankee Stadium. The balance of the defaults were concentrated among small, unrated issues in speculative sectors such as land development, gaming, nursing homes, multifamily housing, small convention centers, etc. (We avoid these sectors in client portfolios managed by Riverbend Capital). In general, declarations of Chapter 9 municipal bankruptcy are very rare. They have averaged seven per year since 2007 and most were not governments.

Why Have Munis Been Selling Off For Weeks?

For the last two months, the municipal bond market has been under pressure for reasons completely unrelated to Detroit or general concerns about credit quality. Anticipation of the Fed's tapering of US Treasury bond purchases initiated the sell-off and munis tracked UST's lower in price (higher in yield). However, the municipal bond market is more susceptible to mutual fund flows than other fixed income sectors, and outflows over the last few weeks have been exceedingly heavy, pressuring the market and driving prices even lower. During the last week of June, muni funds saw the heaviest outflows since tracking of this information began in 1992.

Approximately two thirds of the municipal bond market investor base consists of retail investors, either via direct ownership of individual securities or through municipal bond mutual funds. Unfortunately the fund investor base in particular tends to be tenuous, often selling at the slightest sign of distress. We have just experienced eight consecutive weeks of fairly consistent fund outflows. While most market participants would agree that Detroit's bankruptcy is not a surprise and should not be interpreted as an indicator of heightened systemic credit risk in the muni market, the impact of the timing of the bankruptcy filing in the midst of heavy fund outflows may exacerbate the problem. Additionally, many dealers are operating with a diminished level of capital, which has hampered liquidity and amplified the effects of changes in market sentiment.

Sudden Impact

Of Detroit's $19 billion in liabilities, approximately $600 million is in the form of general obligation bonds and most of the rest is pension and benefits to retired city employees. Kevyn Orr, Detroit's emergency manager, offered creditors around ten cents on the dollar before filing for Chapter Nine. These terms were not accepted (some analysts have estimated that an actual recovery rate may be in the 35-55 cent range – below the typical 70% rate for municipal defaults). More troubling was that the emergency manager has proposed treating the general obligation bonds as unsecured creditors, of the same priority as pensions and other debt.

The full faith and credit backing of general obligation bonds has always been interpreted as senior. For example, in 2008 Vallejo California declared bankruptcy but all debt service payments were made on time and the city exited Chapter 9 in 2011. Orr's efforts are unprecedented. Should they be successful, it could alter the perception of the full faith and credit guarantee of general obligation bonds. This potential development may have particular relevance for those who invest in municipal general obligation bonds of marginal or speculative quality, and perhaps less so for investors in high-grade municipal issues where bankruptcy recovery rates are less likely to come into play. Specialization, expertise and research are increasingly important for investing in this asset class.

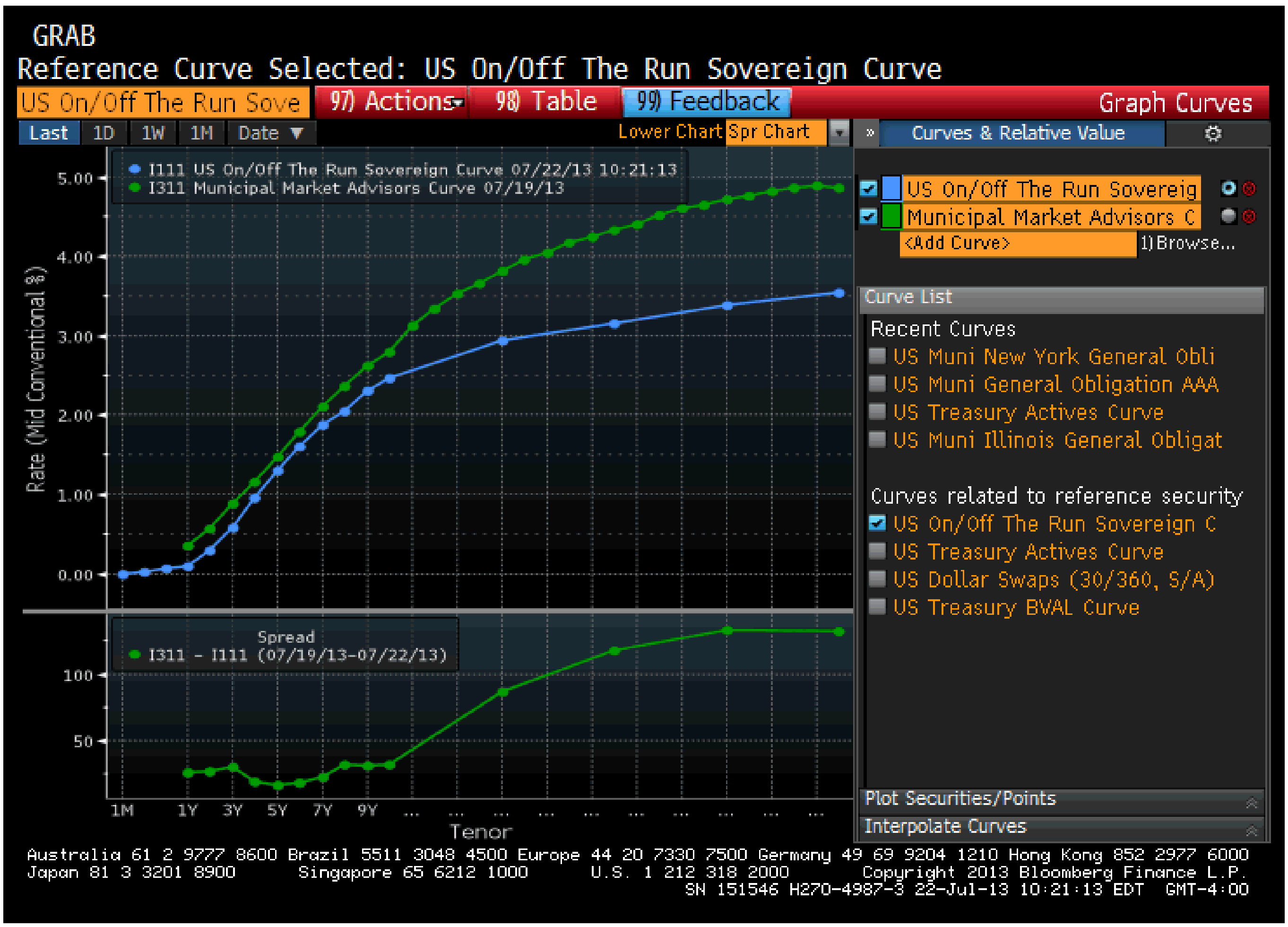
Riverbend, Bond Structure, and Detroit

Recent trading activity indicates a notably diminished degree of liquidity in the market for intermediate and longer bonds with coupons lower than 4%. Higher coupon bonds are more defensive and tend to hold their value better in a rising rate environment. If you have a "market duration" portfolio structured by Riverbend Capital and have ever been unsure of why all or most of the individual holdings are high coupon premium bonds, it has been in anticipation of the type of market behavior that we've been experiencing over the last few weeks.

How many municipal bond portfolios structured by Riverbend Capital include Detroit GO's? Zero. And none ever have. Which municipal bond funds include Detroit? Check this link for a breakdown. You may find it interesting:

http://www.freep.com/interactive/article/20130613/NEWS03/130612016/Database-Which-muni-bond-funds-hold-Detroit-bonds-

Detroit's situation is not indicative of broader municipal credit stress. Few local governments face circumstances similar to Detroit. In light of generally improving municipal credit conditions, there is no fundamental basis for the selling of high-grade municipal bonds in the current environment. Recent market weakness is due to tapering concerns, subsequent higher rates and liquidity issues - not deterioration of overall municipal credit quality. The true systemic risk is the potential impact on demand for the asset class. However, market dislocation may create mispricing of securities and can affect relative value. Over the last 25 years, the average ratio of ten year munis to UST's is 85%. It is currently well over 100%. See the Bloomberg graph below which shows muni yields in excess of UST's across the curve. A large, high profile situation like Detroit's bankruptcy overlaid on broader market weakness is likely to manifest itself in the form of continued volatility.



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