

Say It Ain't So, Municipal Bonds Are the New Junk: Joe Mysak

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Commentary by Joe Mysak

Feb. 1 (Bloomberg) -- You can well imagine my surprise when looking for the next thing to blow up in the credit markets, I was informed it would be municipal bonds.

There it is: Municipal bonds -- the New Junk.

You should be skeptical when an entire asset class is trashed, especially one where most of the securities involved finance essential purpose stuff like roads, bridges and airports. But hear the skeptics out. Their prognostications, shrieks and dire warnings will soon be broadcast far and wide for the delectation of thrill-seekers everywhere.

Keep in mind that, except for the people actually in the market, like issuers and underwriters, and the 4.5 million taxpayers who claim tax-exempt interest (and maybe not even them) there is a national, cultural bias against municipal bonds.

That's because bonds are boring, and bonds sold by states and localities are boring and also complicated in terms of how they are put together and what secures their repayment. Plus, compared with the stock market, there's limited upside.

There's unlimited downside risk, though, as the critics will tell you. Run! Here come the bears!

``Today's bond market might prove even more vulnerable to a severe economic contraction, should one occur," is how a writer for Barron's put it. ``A crisis is clearly brewing in the general-obligation market that appears particularly ominous in its intractability."

This article appeared not last week, but in the issue of Oct. 29, 1990.

`Problem Child'

The headline on the cover read ``The New Junk? Risks Are Rising in the Vast Municipal Bond Market."

Now comes Bennet Sedacca, president of Winter Park, Florida-based Atlantic Advisors LLC, to tell us, ``The problem child ahead may be the municipal bond market." He makes his case in a Jan. 28 newsletter titled ``The Next Shoe to Drop?"

Sedacca, 48, is the first municipal market skeptic, that is, broad-based skeptic, who is bearish on all municipals, to appear in recent times. He won't be the last. Sedacca's firm manages \$3 billion in assets for its clients, and he proudly says he hasn't been in municipal bonds for at least two years. He also says he doesn't care what happened in the past, and is instead relentlessly focused on what's ahead.

No Bailout

Sedacca doesn't buy the prospect of a bailout of the municipal bond insurers. He doesn't even like the one so-far untainted bond insurer, Financial Security Assurance International Ltd., which now dominates the new-issue municipal market. "If FSA is stripped of their AAA rating, which I find highly likely, you had better be ready to trade the bond on its own merits," he writes.

I asked Sedacca about this. I told him that FSA seemed to have been given a perfectly clean bill of health by the rating companies, as well as the market.

"So was Countrywide," he replied, referring to the troubled mortgage lender that is being acquired by Bank of America Corp.

The real problem, though, as Sedacca sees it, is the leveraged closed-end municipal bond funds. Closed-end funds have a limited number of shares, and enhance their returns by borrowing money through the sale of floating-rate securities to buy more bonds. The funds are being forced to pay more in the short-term market, Sedacca points out.

Flexible Market

"The problem I see going forward is that if the values of municipal bonds drop, as I fear they will, the asset values of many of these funds could drop, perhaps dramatically," writes Sedacca. "This could lead to a general lack of confidence in the issuance of the floating-rate money market notes and lead to a forced liquidation of the funds."

There are 266 closed-end muni funds, with assets of almost \$100 billion. "They are nothing more than a `margin account in drag,'" concludes Sedacca, who has a certain provocative way with words.

I am by nature skeptical of the skeptics, and what's more, like to see what happened in the past. I agree with Sedacca that if you're in the municipal market, you had better know exactly what you own, if only for your peace of mind. But the market itself is a lot more flexible than critics calculate. Property taxes decline: municipalities reduce spending. Auction rates rise: issuers sell fixed-rate debt.

If you own municipal bonds, time is on your side.

(Joe Mysak is a Bloomberg News columnist. The opinions expressed are his own.)

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