Municipal Market Comments

Ascent Investment Partners

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Detroit Default Rattles the Muni Market; Highlights the Importance of Credit Selection

The financial disaster in Detroit is raising concerns for many municipal bond investors. In mid-June, Detroit's emergency manager released a proposal for restructuring the city's debt that seeks to categorize the city's unlimited tax general obligation bonds as unsecured obligations. The plan proposes to refinance all $11.4 billion of the city's unsecured obligations (including those G.O. bonds) with new debt that would only repay current bondholders 10 cents or less per dollar of principal. Following the release of the proposal, Detroit defaulted on $1.4 billion of payments on unsecured pension obligation certificates and the city's emergency manager has declared a moratorium on payment of interest and principal on all other "unsecured" city debt.

Detroit's workout proposal is just the first step in the long process of restructuring the city's finances. The city has stated that if it is unable to negotiate a workout with creditors, it would seek Chapter 9 bankruptcy protection to force a resolution. The city emergency manager's approach starts with a very low initial offer to creditors and seeks to use the threat of bankruptcy as leverage in negotiations. His position is that investors in Detroit bonds should have recognized that "this has been building for decades and decades" and that investors "understood the risk."

In Michigan, bankruptcy by a local municipality would have to be approved by the Governor. In the past, the Governor has said that he would not approve any municipality to seek protection under Chapter 9, though it is certainly possible that events could force a change in that policy down the road. There is no clear precedent in Chapter 9 for this situation – we are not aware of cases in which an issuer has challenged the security position of its tax-secured general obligation bonds. The fact that the emergency manager is asserting that the bonds are unsecured is a shocking development for many analysts and traders, as the market has historically viewed such security pledges as the "gold standard" of municipal bondholder security.

Detroit may or may not ultimately recalibrate how municipal investors view the strength of property tax pledges relative to pledges of defined revenue streams (like state aid, utility revenues or sales taxes). Our point here is not to debate whether G.O. pledges are relatively less secure today than they were two weeks ago. Rather, we view Detroit as another important reminder of one of the cornerstones of responsible fixed-income investing: it is critical that investors use careful credit selection when purchasing and holding fixed-income securities.

As the city's emergency manager noted, Detroit has been under financial pressure for many years. Investors buying or holding Detroit bonds have been making a decision, consciously or not, to trade increasing default risk for incrementally higher investment yields. Currently, credit spreads (the yield differential between highly rated and lower rated bonds) are compressed to historical lows, making the potential yield pick-up for investing in riskier bonds small. We do not believe that the current incremental yield gains from buying or holding troubled credits come close to adequately compensating investors for the credit risk incurred. Today it is more important than ever that investors carefully select and monitor their investments to ensure their conservative fixed income portfolio allocation remains secure.

As Detroit's restructuring unfolds, it may shed new light on the relative security of different municipal bond security structures in bankruptcy situations. Regardless of the ultimate outcome for Detroit bondholders, this default should provide a valuable lesson for fixed-income investors. Conservative investors are well served by avoiding potential credit problems, especially in rate environments that do not provide significant yield reward for increasing credit risk. Careful credit selection, and close ongoing surveillance of holdings, can avoid the vast majority of credit problems before they become potential defaults.

Brian Tournier
Director of Research
Ascent Investment Partners

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