

David,

As discussed, below is the full text version of our January 4, 2011 market commentary “From the Desk of the CIO: Numbers Matter,” which you have requested to publish/reproduce with attribution to WSC. Below is the link to our web site page from which this content may also be accessed.

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I look forward to reading your future commentary, and applaud and encourage your continued efforts to provide accurate, timely and useful information about the public finance industry and municipal bond market to the investing public, analyst community, media and our respective clients and constituent contemporaries.

Best wishes,

Michael

p.s. After writing this piece, and upon further reflection, it occurred to me that I should have just named it: Numbers Matter, because small numbers matter as much, if not more, than big scary numbers. In fact, as you and other well-informed municipal analysts are aware, debt service – both principal and interest payments combined, represents a relatively small and very manageable 3-8% of the average state & local government budget, and that this percentage has remained small for decades. Furthermore, in 2010 the total tax-supported net debt-to-personal income ratio of the average municipal issuer was unchanged at just 2.5%, which was very close to the 15-year average of about 2.3%. Numbers matter, even the smallest of the small. (Sources: Moody’s, Federal Reserve, Barclays Capital).

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*Michael J. Schroeder
President & Chief Investment Officer
Wasmer, Schroeder & Company, Inc.
600 Fifth Avenue South, Suite 210
Naples, FL 34102*



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Numbers Matter: Especially Big, Scary Numbers

Hundreds of billions. That, in the context of the relatively small \$2.8 trillion municipal bond market, is a huge number, I think we'd all agree. Even a former bank equity analyst would agree - or at least I hope so, since it was a former bank equity analyst in a recent TV interview with CNBC's Maria Bartiromo who said it. Meredith Whitney claimed this was the dollar amount of municipal debt that would default in the next 12 months.

How many "hundreds" she did not say, but most college math professors would take it to mean at least two, perhaps even three, hundred billion. So, that's \$300,000,000,000 in municipal bond defaults before January 1, 2012, according to Meredith Whitney, she of Citigroup dividend-cut fame --- sub-prime mortgage crisis-era, former bank stock analyst for Oppenheimer & Co., now the de-facto head of Meredith Whitney Advisory Group, a firm that has supposedly put a hat in the ring to become a NRSRO, or Nationally-Recognized Statistical Rating Organization. Her firm, if granted such status, would presumably offer up competitive municipal and corporate bond credit quality ratings to the ratings provided by Moody's, Standard & Poor's and Fitch, for a fee of course.

But if one is to become a NRSRO, and as such be recognized as an authority on the topic of the assessment and surveillance of municipal issuers of debt, one might expect such an authority to capitalize on the 15 minutes of fame celebrated upon her by no-less than "60 Minutes," or CNBC's Bartiromo, by showcasing, or at the very least, offering at least one credible sample of her "statistical" acumen for her chosen new field of endeavor.

Back to the math.

Whitney acknowledges that the states will likely make good on their bond debt, so let's start with that. \$2.8 trillion in outstanding municipal debt, minus \$200 billion in bonds escrowed or pre-refunded in U.S. government obligations (defeased, in effect, and accordingly, not really even true debt of the municipality any longer), leaving \$2.6 trillion owed by some form of municipal government, of which there exist about 91,000 such entities in the form of cities, towns, townships, counties, school districts, housing and other state or local agencies, water and sewer and redevelopment authorities, fire districts, special taxing districts, etc. The states and their agencies owe about 40% of the total, or \$1 trillion, leaving \$1.6 trillion owed by the various counties and parishes, cities and towns, taxing districts, local authorities, colleges and universities, tribal governments and electric coops.

That's about \$53 million for each of them, if you assume one-third have outstanding bond debt, which, according to Moody's and S&P, is pretty close. Whitney says, "50 to 100, maybe more, will default in the next 12 months," without indicating which issuers, exactly, her prediction might involve. And therein is the problem with her math. 50 to 100, maybe more --- how about 200, for argument's sake?

200 issuers times \$53 million each equals a grand total of just over \$10 billion in defaulted municipal bonds, or 0.6% of the \$1.6 trillion non-escrowed, non-state issued debt. But hold that thought, because the math really, really does matter here. BTW, that percentage is consistent with the Moody's and S&P, 1970-2009 default rate for rated municipals of 0.3%, but my number includes unrated debt as well, so it should be a tad higher, but you get the idea.

General obligation debt issuance for the five years 2005 through 2009 averaged one-third of the total long-term issuance and revenue bond issuance was the other two-thirds of the total. That means \$1 trillion, roughly, of the \$1.6 trillion are revenue bonds backed by a dedicated, pledged revenue source like airports, water and sewer systems, electric power systems and toll roads. \$600 billion of that debt is general obligation, IOU-type debt backed up by the municipality's general credit.

I just illustrated why even 200 issuers defaulting would total only \$10 billion, not \$300 billion as Whitney claims. But let's see if she did her math some other, perhaps unique and ingenious way that we may have missed. She said in her interview with CNBC that the smaller, local issuers would be most likely to default, yet we've pretty much shown that the math doesn't work, so maybe she just misspoke and meant to say the big urban cities and counties, or a few major airports, perhaps?

Los Angeles, Chicago, Detroit, Boston, New York, Atlanta, Philadelphia, Denver,

San Antonio, Dallas, San Jose, Houston, St. Louis, Seattle, Minneapolis-St. Paul, Miami, San Francisco, Phoenix, Cleveland and Birmingham have combined outstanding direct and overlapping net municipal debt of \$115 billion.

Well, that can't be it. Even if all 20 went bust, that's barely over \$100 billion.

Am I sure? Collectively, in fiscal year 2009, these 20 large cities had roughly \$3.4 billion general fund balances, and, for their relative 2009 fiscal years, ran a net general fund surplus of approximately \$880 million, with a market valuation of just under \$3.0 trillion. For you muni analysts out there, that's a total debt/valuation of less than 4%, and that includes all overlapping debt. To amortize that debt over 10 years equally would require around \$12 billion annually, or less than 1% of assessed value. Yep, pretty darn sure these 20 cities are okay for the next 12 months, though a couple of them will definitely have a much tougher time than the other 18.

So, if it isn't 200 "average" sized issuers, and it isn't the largest cities (adding cities doesn't get you there either because the next 20 cities have even less debt, and the next 20 even less, and so on), then what is she referring to? To arrive at a figure of "hundreds of billions" of par amount defaulting in the next 12 months, by my estimate, over 5,000 issuers would have to default on their municipal debt, or about 1 in 7 that have debt outstanding.

We welcome and encourage any statistical or other empirical evidence from any source that might lend credibility to such dire forecasts as Ms. Whitney's, but forgive us for not holding our breath.

NOTE: Bond Buyer Yearbook, EMMA, Moody's, Congressional Budget Office and market research were the primary sources for the numbers shown above.

Michael J. Schroeder
Chief Investment Officer
Wasmer, Schroeder & Company
600 Fifth Avenue South, Suite 210
Naples, FL 34102
(239) 436-1077