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The 2014 Takeaways from State and Local Finance.

A look back at four of this year's trends in public finance.

Some threats really are empty.

Remember the threat of the taper? When former Federal Reserve Chair Ben Bernanke hinted at slowing down the Fed's practice of quantitative easing (buying municipal bonds with newly printed money), it prompted a major sell-off in the market and spiked interest rates in the summer of 2013. Then, newly minted Chair Janet Yellen, actually did it after she took over in February of this year. So what happened? The municipal market prepared itself for higher rates, witnessed the successive tapering process, and then was taken by surprise as global weakness and declining inflation drove interest rates lower, noted Loop Capital Markets Strategist Chris Mier in his look back at 2014. Calling the falling interest rates "one of the most durable trends of the year," he said rates fell steadily from 4.75 percent to 3.83 percent, "with barely a glance in the rear-view mirror."

The fear of rising interest rates did have one notable result, however. That prospect, combined with government's reticence to increase debt loads, resulted in a slower municipal market in 2014. Total bond issuance declined nearly 10 percent from 2013.

Pensions aren't sacred. But retirees still have sway.

First Detroit's bankruptcy judge ruled that pensions could take a haircut alongside bondholders in municipal bankruptcies. Then Stockton, Calif.'s judge ruled similarly this year. Both rulings sent shockwaves through the municipal community but the end result was far less dramatic. Stockton, citing cuts already made to retiree healthcare, didn't cut pensions and exited bankruptcy in late October. Detroit did cut pensions — but far less than the cuts to what it owed bondholders. The Motor City exited bankruptcy in November.

Both cities' final plans caused concern among the credit community — up until this year, the General Obligation bond was pretty much sacrosanct. And it was just a few years ago that the Rhode Island town of Central Falls exited bankruptcy keeping bondholders whole while dealing major cuts to pensions. So what's the trend now? Investors are a little unsure and, not surprisingly, the credit ratings agencies have slightly different views. Moody's Investors Service said last month in a credit analysis, "pensions are likely to enjoy better treatment than general government debt in Michigan and California Chapter 9 cases, and potentially in bankruptcies filed in other states. [This has] negative credit implications for local government bond investors in Michigan and California, and the U.S. as a whole."

Meanwhile, Standard & Poor's said in a presentation this week to investors that city bankruptcies were still too unique to start drawing conclusions that a new trend is emerging. "Despite months of headlines and court battles, ultimately the outcomes of these bankruptcies will not impact our view on GO bond ratings," said Horacio Aldrete, managing director for S&P's U.S. Public Finance-State & Local Government Group.

Management matters. A lot.

Aldrete also noted that investors say a government's financial management is of the biggest difference-makers in S&P's rating assessments. Of the governments that S&P rates AAA (the top rating), 90 percent have either a strong or very strong management score. Conversely, the majority of credits rated BBB or lower got a weak or very weak management score. An analysis this week by the Municipal Market Advisors takes and puts some faces, er, stats, to that story.

At the end of the financial crisis that began in 2008, New Jersey and California were both grabbing headlines for monstrous budget woes. Today, one state is reforming its ways while the other keeps trying to fix problems with the same old tools. California ended a decade of budget deficits in 2013 and took that momentum into this year with a budget surplus. Gov. Jerry Brown throughout his tenure has been keenly focused on reducing the state's debt load and "exuberance over CA's fiscal and rating improvements led the state's securities to outperform the market for a second year," notes MMA's Matt Fabian. (In other words, California got good deals on its bond sales.)

Of particular note, the state's voters this fall approved new legislation that will double the size of the state's General Fund reserve, require deposits from capital gains windfalls to address revenue volatility issues and protect the funds from withdrawal. "These are authentic, structural improvements in the state's budget that should not be underappreciated," Fabian wrote. S&P agreed. The agency upgraded California's credit rating one notch to A one day after the voter approval.

Meanwhile, New Jersey has faced multiple bond rating downgrades under Gov. Chris Christie and this year it continued to use one-time fixes to plug its massive budget deficits. Fabian notes the state's lagging economic performance, overly optimistic budget projections and failure to consistently fund pensions, retiree healthcare and transportation has led to a persistent structural imbalance and a deteriorating fiscal position. "The lack of a Rainy Day Fund and thin General Fund balance — less than 1% of the budget — limits flexibility and cushion to address any unforeseen circumstances," he added.

This might be as good as it gets.

Two state and local governmental organizations recently released annual reports on government financial health. They both essentially came to the same conclusion: Many governments are past the immediate pains of the recession but are now feeling the duller aches of the slow-growth economy. [The National League of Cities' City Fiscal Conditions Survey](#) found that cities made some key gains in fiscal year 2014 although many still can't claim a full recovery from the recession. Mainly, they have started to make up for areas where there were spending cutbacks during the downturn and they are increasing their reserve funds. And the overall positive figures are widespread — 80 percent of city finance officers reported improved fiscal conditions this year, the highest such number in the 29-year history of the survey.

The National Association of State Budget Officers also released its [year-end report](#) on the health of state finances. That analysis found state spending is increasing for the fifth straight year but growth continues to be minimal and the competition for limited dollars remains fierce. That's because much of the projected 3.1 percent spending increase will be gobbled up by rising costs in education and Medicaid, leaving little money available for spending in other areas. Additionally, in no year since the recession has spending growth matched the nearly four-decade average of 5.5 percent. Even more alarming: This year's total general fund spending of \$748 billion is still 2 percent below the pre-recession peak, after accounting for inflation. "If we continue to see this for another two to three fiscal years," said Scott Pattison at the report's release, "we have to assume we are in a new

economic era...this 'new normal' that economists talk about.”

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