



Government Securities Insights: Muni Sectors Priced for Opportunity

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For many years, the municipal bond market flew under the radar of most taxable fixed income investors. That has changed. Over the past several years, a series of changes and challenges has raised the visibility of the muni market. The dire condition of state and local government finances promises to be a high profile issue in 2011 and beyond. A blanket dismissal of the muni sector, however, would be a big mistake, including for investors in taxable bonds. The municipal bond market bears watching not only for its growing importance to the overall economic and investment environment, but also because munis appear to offer several attractive opportunities. To summarize:

- Most state and local governments are experiencing financial stress. Much of their current budgetary imbalance stems from the economic downturn. Revenues dropped sharply and have only recently begun to recover. State government revenues generally dropped more sharply than did revenues at the city and county level.
- The (slowly) growing economy and adjustments in state and local tax rates will ease, but not cure, the fiscal challenges of states and municipalities. State and local governments are similar to both the federal government and General Motors in that they have, (in some cases, for decades), been making promises that they could not hope to fulfill. This widespread conflict between taxpayers and beneficiaries and its resolution will play out over years to come. Embedded in the vast gap between promises to pay and wherewithal to pay will lead to contentious divides along economic, political and social lines.
- The cyclical and secular fiscal stresses now experienced by municipal governments do *not* imply a rash of municipal bankruptcies in 2011 or the foreseeable future. Fears of municipal Armageddon are unfounded.
- Opportunities for taxable investors exist in both taxable and tax-exempt municipal securities. In particular, in our view, the end of the Build America Bonds program creates a very favorable supply/demand dynamic in a sector replete with liquid, high quality and high-yielding bonds.

Recent Municipal Finance Developments

The recent rapid transformation of the municipal market got under way even before the great financial market meltdown of late 2008. An oft-used financing technique for municipalities had been to tap investor demand for short assets by issuing floating- or adjustable-rate debt and using the swaps market to convert the debt to a long-term fixed liability better suited to the issuers' needs. This arrangement suffered a setback when the auction rate securities market came under pressure in 2007. The market collapsed in February 2008 amid widespread auction failures. Auction rate issuance has been partly replaced by alternative floating-rate products, but fixed-rate issuance is now a larger component of the market. This same timeframe saw the disappearance of the major monoline insurance companies that insured the debt of many smaller municipal entities. MBIA, AMBAC and FGIC have all left the market. Assured Guaranty (formerly FSA) now provides nearly all the bond insurance in the municipal market, but Assured Guaranty recently lost its last AAA credit rating and insured bond issuance is waning.

The market received a boost in 2009 with the American Recovery and Reinvestment Act. The act authorized Build America Bonds (BABs), a program whereby municipalities could issue taxable debt with an interest subsidy of 35% from the federal government. BABs lowered the cost of debt to municipalities in that the higher interest rate on the debt (arising from the lack of tax exemption) was more than offset by the federal subsidy. More importantly, BABs dramatically expanded the municipal investor base by creating a product of interest to taxable investors. The program was an immediate success, appealing to both issuers and investors. Over \$180 billion in BABs were issued between April 2009 and December 2010, displacing a similar volume of tax-exempt issuance. BABs accounted for nearly a third of all municipal issuance over that period and almost two thirds of long-term issuance. The program expired at the end of 2010 and was not extended by Congress in its late 2010 tax legislation. Incoming House Transportation and Infrastructure Committee Chairman John Mica has vowed a "reincarnation" of the program, but that appears doubtful. Incoming Ways and Means Committee Chairman Dave Camp better represented the attitude of the new Republican majority in Congress when he called the program a "relic" of the "failed stimulus bill".

Municipal Default Risk

The issue of municipal default risk has gained currency of late. For years, the team now at DoubleLine warned of the problem of the enormous unfunded liabilities of government at all levels. The issue was carried to a wider audience by a *60 Minutes* segment broadcast on December 20, 2010. We hesitate to give undue publicity to a report that we think contained some inconsistencies, but the issues addressed were genuine even if, in our view, many of the suggestions and conclusions were unfounded.

The *60 Minutes* segment featured a forecast by independent equity analyst Meredith Whitney of 50 to 100 municipal defaults worth hundreds of billions of dollars occurring in the next two years. The first problem with the forecast is that the 100 largest county and city issuers do not in aggregate have \$100 billion in debt outstanding. (The *60 Minutes* report concluded that no state government would default.) More importantly, the forecast seems to fail to recognize the difficulties facing a municipal government

wishing to repudiate its debts. Municipal bankruptcy is qualitatively different than corporate bankruptcy. Vital public services provided by a city or county government cannot be easily replaced by a more efficient or better managed competitor. Nor can a city or county function effectively without access to debt markets. County and city defaults were common in the nineteenth century but are exceedingly rare now. Moody's recently examined the defaults from 1970 to 2009. Of over 18,000 rated municipal issuers, defaults totaled 54, of which four were counties and two were cities. Twenty-six states prohibit their municipalities from filing bankruptcy and others discourage it.

The Orange County, California bankruptcy in 1994 resulted in bondholders being repaid 100% of their money. The Vallejo, California bankruptcy, filed in 2008, has yet to be resolved. The city faced a substantial budget deficit driven by labor costs and an unfunded pension liability of over \$195 million. The city was in a unique situation in that it could not cut any expenses without violating contractual agreements. It now has a tentative work plan that delays payments to bondholders but preserves principal. After two years and \$10 million in legal fees, the city still has not disposed of either its labor contracts or pension liabilities. The public employee unions, which refused to make contract concessions in the months leading up to the bankruptcy filing, are likely to lose some of the benefits they were trying to preserve. The lesson other cities and counties are drawing from the Vallejo debacle is that bankruptcy, even if permitted, should be avoided.

Current Investment Opportunities

Combined with the end of the BAB program, the financial stress of state and local governments has given rise to an unusual investment opportunity. Chart I below shows the historical yield ratio of 10-year A-rated state general obligation bonds versus the 10-year Treasury. The ratio is typically below 1.00, reflecting the tax exempt status of the GO, and averaged 0.90 from 2000 through 2007. The ratio spiked during the financial crisis of late 2008 and early 2009 and then gradually recovered through 2009 in tandem with most credit sectors. Through the last three quarters of 2010, though, the ratio again moved sharply higher. By contrast, 10-year A-rated corporate spreads remained steady through 2010.

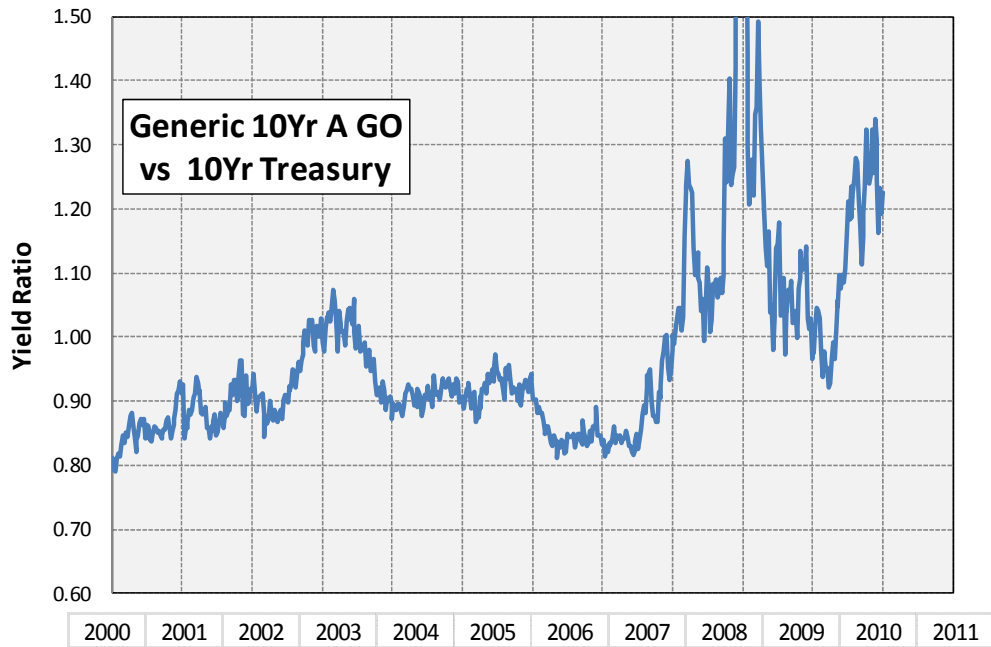


Chart I by DoubleLine Capital from Bloomberg data

Chart II shows the yield spread between a generic 10-year A-rated state GO and a 10-year California GO. California debt has moved wider than other municipal debt of similar rating. The market has begun to move to a two-tiered structure, with the “riskier” names trading wider than the “less risky” names with a rating category.

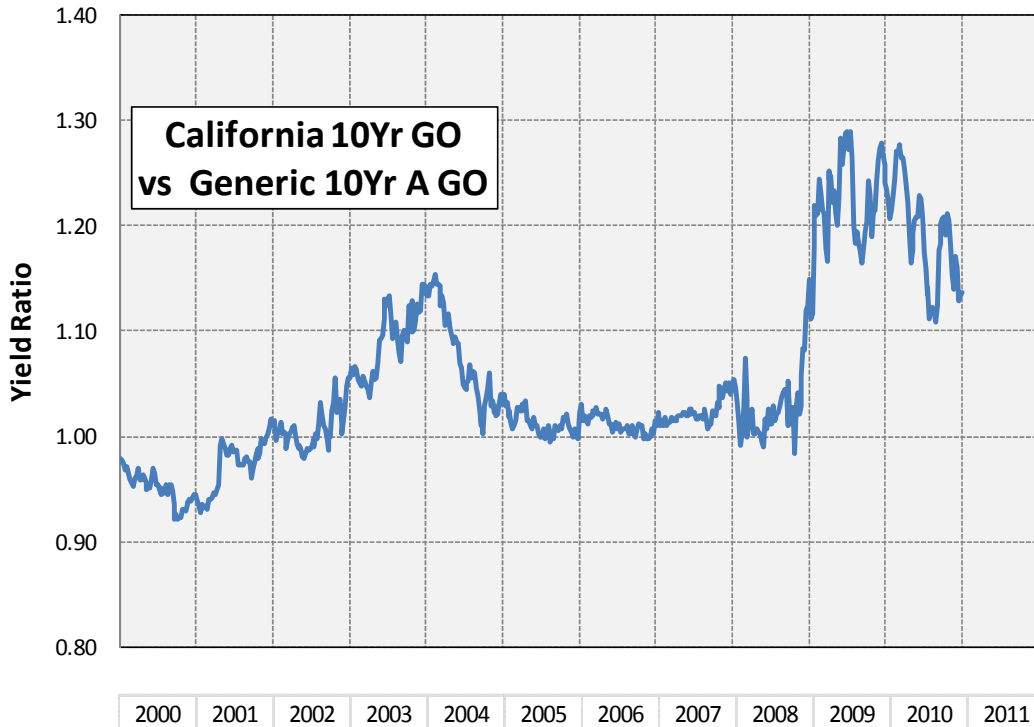


Chart II by DoubleLine Capital from Bloomberg data

California Build America Bonds are at still wider spreads to Treasuries due to their taxation provisions. Ten-year California BABs are currently +215 basis points (bps) versus the 10-year Treasury, and 25- to 30-year BABs bps are +280 to the 30-year Treasury. California was largest issuer in the BAB program with over \$14 billion issued. Most California BABs enjoy active, liquid secondary markets. The California BABs appear to us to offer a compelling combination of yield and liquidity, and the end of the BAB program creates a favorable technical environment as well.

Please see the following page for important information regarding this report, risk factors and DoubleLine Capital LP.

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