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Fixed Income Commentary

Defeat of Unemployment Bill Could Hurt Municipal Issuers

With the effective defeat of the unemployment benefits bill last week in the U.S. Senate, many state budgets that were depending on extended federal aid now have even bigger shortfalls.

Of note, in the American Recovery and Reinvestment Act (ARRA), the Federal government increased matching Medicaid funds provided by states by 6.2%. The program is called the Federal Medical Assistance Program (FMAP). In an attempt to get the latest bill passed, Democrats pared down the increase to 3.2% in the second fiscal quarter and 1.2% in the third fiscal quarter. These reductions, however, did not persuade those opposed to the bill. The FMAP program is set to expire on December 31, 2010 along with the rest of the ARRA, which means most fiscal budgets would still get two quarters' worth of the ARRA increase if not extended. But states are attempting to get the federal government to extend the program by another two fiscal quarters through June 2011, which marks the end of the fiscal year (FY) for most states.

Thirty states have balanced their FY 2011 budgets by assuming a total of $24 billion in extended medicaid reimbursements. A sample of states that assumed an extension through FY 2011:

California	$1.5 billion
New York	$1.1 billion
Pennsylvania	$849 million
Illinois	$737 million
Washington	$480 million
Arizona	$394 million
New Mexico	$160 million

Backup Plan

Twenty states developed budgets that did not assume an extension. Of the states that DID assume an extension, only nine states included contingency plans in their budgets specifically in anticipation of this event. These plans include eliminating some eligible categories and benefits, depleting reserves, and intrafund borrowing. Now that U.S. Senate Majority Leader Harry Reid has indefinitely shelved the bill, the rest of the states will have to plug their budget holes in similar fashion.

The following states have backup plans: California, Florida, Idaho, Louisiana, Maine, Maryland, Mississippi, Oklahoma and Oregon.

Housing, BABs Also Affected

Two other points to note on the defeated bill:

1. The bill included an extension on the home buyer tax credit so builders would be given time beyond June 30 to complete a contracted home. Without the extension, they'll have to complete the homes before Wednesday in order for their buyers to receive the credit. To the extent buyers were motivated by the credit, there could be more cancellations after 6/30 (earnest money deposits are generally far less than $8,000, and in this market are probably refundable anyway). Management teams of several builders have said they will have "no problem" closing houses by 6/30 and that an extension isn't needed. With orders in June reportedly down 20-25% year-over-year and ongoing elevated cancellation rates, this likely says as much about the number of homes currently under construction as it does about companies' efficiency. That said, after the low May new home sales report, there is already talk of designing a new homebuyer tax credit to stimulate housing.
2. The bill included a 2-year extension of the Build America Bonds (BABs) program through 2012 with a declining federal subsidy in each year. If the BABs program is not extended it will likely have two, contradictory effects:
    - States and municipalities will attempt to issue as many BABs as possible in calendar 2H10, in an effort to get cheaper funding while possible.
    - Investor interest may decline because of a deadlined, finite market size. Some believe the BABs extension was collateral damage and may get passed in another form.

Implications for Municipal Issuers

Month-to-date (MTD) through June 26, taxable municipal spreads are +34 basis points vs. +5 bps for overall corporates, although year-to-date (YTD) they are still outperforming at +12 bps vs. +24 bps for corporates. The MCDX index of credit default swaps (CDS) on municipal issues, while thinly traded compared to its corporate counterpart CDX, has also been widening substantially and is wider by +83 bps MTD vs. -3 bps for CDX.

The recent widening has been largely led by Illinois which makes up almost 13% of the municipal index and is +92 bps MTD and +117 YTD , as the state is expected to bring $900 million in Build America Bonds to market next week and likely another $3.5 billion in front end pension obligations by the fall.

Outside of Illinois, spreads on average are more in the 15-30 bps range MTD. Bay Area Toll Authority bonds are +36 bps wider after their sub deal came substantially wider than initially thought. The original price talk for the deal was in the low 200s, initial guidance was +275 bps and in ended up coming at +300 bps, and they also downsized the deal to match demand.