GRANT'S

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Concerning the American repudiation gene

Three weeks ago, a San Diego County civil grand jury handed up an indictment against the quality of the financial management of the San Diego city fathers. What to do with a municipality overburdened with $2.2 billion in unfunded pension liabilities and $1.3 billion in unfunded healthcare liabilities? The panel proposed, among other courses of action, a filing for protection under Chapter 9 of the federal Bankruptcy Code. Was this not a shocking trial balloon? Not at all, according to Bloomberg's Joseph Mysak Jr.: Four other major American cities—Harrisburg, Detroit, Los Angeles and Miami—have dropped the same broad hint this year.

The risks and rewards of the $2.8 trillion tax-exempt bond market are the subjects at hand—a controversial declaration all by itself. "The municipal market" is, in fact, a misnomer, reputable authorities assert. It does not exist. What does exist are discrete markets in the obligations of states, cities, counties, special assessment districts and tax-advantaged industrial borrowers, among other species of debtor. A single, homogeneous municipal market is a concept as far removed from reality as a single American weather forecast, they say. Point taken. However, so low are yields, so complacent are investors, so persistent are fiscal deficits, so heavy is the weight of post-retirement employee benefits and so ill-equipped are mutual funds to deal with anything resembling a shareholders' run that we are prepared to take the analytical leap. On the length and breadth of the muni market, we declare ourselves bearish.

Curiously, investors in tax-exempt securities seem resistant to the syndrome identified in these pages as "2008-on-the-brain." If taxable investors continue to jump at the ghosts of triple-A-rated CDO tranches, municipal bond buyers have retained their storied imperturbability. "By 2018," as *The Economist* reports, "Illinois will be paying $14 billion a year in [post-retirement pension and health] benefits, equal to more than a third of the state's revenue, compared with $6.5 billion now." Bondholders should worry, the magazine quotes a pair of researchers as sensibly advising, "because several state constitutions, including those of Illinois and New York, make state pensions senior to bond debt."

Yet bondholders seem not to worry. Possibly, they reason, federal tax rates are probably going up, and Chapter 9 is a costly and time-consuming procedure. (A California Senate committee recently approved a measure to discourage the Golden State's public borrowers from going that route to renegotiate public-employee union contracts.) The Obama administration still has the checkbook and printing press with which to fend off a crisis, and the financial press is on high alert—witness the more than 15 minutes of attention accorded the decision of broke little Central Falls, R.I., to place its affairs in the hands of a receiver. If a well-advertised disaster is no disaster, state and local finance ought to be home free.

Besides, the bullish argument continues, not even the Great Depression stopped the overwhelming majority of cities and states from discharging their obligations. In modern times, the defaults of New York City in 1975, Cleveland in 1978, Saco, Maine, in 1979, the Washington Public Power Supply System, Project Nos. 4 and 5, in 1983 and Orange County, Calif., in 1994 were notable mainly for their novelty. Of Chapter 9 bankruptcies, there have been 554 since the 1930s, the 1984 filing of Sanitary and Improvement District No. 3 of Sarpy County, Neb., being a deservedly obscure example (Orange County is the notorious one, Vallejo, Calif., a recent one). These blemishes are, or have been, the exception. A February report by Moody's Investors Service entitled, "U.S. Municipal Bond Defaults and Recoveries, 1970-2009," shows that while defaults in the market as a whole are rare, those in the general-obligation department of the market, in which securities are supported by the full taxing power of the issuing government, are virtually nonexistent.

If past performance guaranteed fu-

(Continued on page 2)

"Not sure about the bond market, but North Korea and the Ivory Coast are knotted at zero."

(Continued from page 1)

Moody's rated municipals
average cumulative default rates, 1970-2009

	year									
	1	2	3	4	5	6	7	8	9	10
Aaa	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Aa	0.00	0.00	0.01	0.01	0.01	0.02	0.02	0.02	0.03	0.03
A	0.00	0.00	0.01	0.01	0.01	0.01	0.02	0.02	0.02	0.03
Baa	0.01	0.02	0.04	0.06	0.08	0.10	0.11	0.13	0.14	0.16
Ba	0.22	0.71	1.06	1.33	1.57	1.91	2.27	2.52	2.71	2.80
B	3.65	6.00	7.88	9.91	11.73	12.40	12.40	12.40	12.40	12.40
Caa-C	7.07	8.97	11.03	11.60	11.60	11.60	11.60	11.60	11.60	11.60
Investment grade	0.00	0.01	0.01	0.02	0.03	0.03	0.04	0.05	0.05	0.06
Speculative grade	1.05	1.86	2.49	3.00	3.43	3.79	4.10	4.32	4.47	4.55
Total	0.01	0.02	0.03	0.04	0.05	0.06	0.07	0.07	0.08	0.09

source: Moody's

ture results, the muni market would surely be golden. There were just 54 defaults in those 39 years, Moody's finds (a default being defined as a missed or delayed interest payment, a bankruptcy filing or a distressed exchange). As there were 60,000 rated issues, the average cumulative default rate after 10 years of issuance amounted to 0.09%. While 11.6% of Caa-C rated munis did default (they were perilously close to the edge from the start), not one Aaa-rated bond bit the dust. Default rates for Aa-rated and A-rated bonds were an identically trivial 0.03%. Compare and contrast corporate bonds, of which, 10 years after the date of issuance, 11.06% had defaulted, including 2.5% that were investment grade.

"The credit profile of the U.S. state and local government sectors is very strong," Moody's asserted in another February analysis (its title and thesis were one and the same: "U.S. State and Local Governments Remain Inherently Resilient, Despite Growing Pressures"). "[A]nd we fully expect that, under our baseline scenario for the macroeconomy, the vast majority of municipal governments will make timely debt service payments, consistent with the remarkably low default experience seen in this sector over the last 60 years." Yes, the Moody's authors concede, most of these governments are—and will remain—"pressured," but "severe credit stress" will be "selective and idiosyncratic." Might defaults increase? Yes, Moody's allows, but "[i]n our opinion, it is extremely unlikely that there will be a cultural shift in the market towards increased use of Chapter 9 bankruptcies or a wholesale erosion of investor appetite sufficient to threaten liquidity to this market." Moody's continued, "The states are inherently resilient from a credit perspective, and for a variety of reasons we do not expect that states will default on general obligation debt, even under the most stressed economic conditions."

Even under the most stressed economic conditions. In point of fact, the fiscal condition of the states is shaky enough under economic conditions that are not so very "stressed." The recession is over, the silence of the keepers at the National Bureau of Economic Research notwithstanding, but the states are still gasping for revenue. "The worst recession since the 1930s," the Washington-based Center on Budget and Policy Priorities reports, "has caused the steepest decline in state tax receipts on record. As a result, even after making very deep spending cuts over the last two years, states continue to face large budget gaps. At least 46 states face or have faced shortfalls for the upcoming fiscal year (FY 2011, which will begin on July 1 in most states). These come on top of the large shortfalls that 48 states faced in their current budgets (FY 2010). States will continue to struggle to find the revenue needed to support critical public services for a number of years, threatening hundreds of thousands of jobs."

And were it not for massive subsidies from Washington, the states' P&Ls would be printed in an even deeper shade of red. The legislative Christmas tree called the American Recovery and Reinvestment Act of 2009 earmarked $135 billion to $140 billion for the states over 2 1/2 years, "or between 30% and 40% of projected state shortfalls," the Budget and Policy Priorities' analysts note. "But it now appears likely," they add, "the federal assistance will end before state budget gaps have abated." Medicaid funding, which constitutes a major part of federal life support, could stop as soon as December. "So even though the 2011 budget gaps may well be larger than those for 2010, there will be less federal money available to close them."

In the hot seat at the Financial Crisis Inquiry Commission on June 2, Warren Buffett ruminated on the creditworthiness of American states and localities. "I mean," he testified, "if the federal government will step into help them, they're triple-A. If the federal government won't step in to help them, who knows what they are? If you are looking now at something where you could look back later

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on and say, 'these ratings were crazy,' that would be the area. Because it's bimodal basically. I don't know how I would rate those myself now. Because it's a bet on how the federal government will act over time."

Just so, Keith Bronstein, Chicago commodity trader and paid-up subscriber par excellence, agrees. Only last week, Bronstein points out, Illinois sold $300 million of long-dated, taxable "Build America" bonds at a yield of 7.1%, or 297 basis points over the 30-year Treasury rate. Two months earlier, on a similar issue, the state had paid a premium to Treasurys of only 205 basis points. Illinois does have its problems, a $13 billion budget deficit and an intractable post-retirement benefits' funding shortfall among them. Either it will, or will not, solve its problems, Bronstein posits. If not, the Treasury will intervene, and the two yields—the Illinois rate and the Treasury's—will converge. But if Illinois refuses to mend its ways, and if the federal government goes the way of Illinois, the two rates will chase each other higher. It would be a case, says Bronstein, "of bad money (or bad debt instruments) driving out the good."

Not so long ago, observes Radford Klotz, a partner at Brown Brothers Harriman, it was the monoline bond insurers that underwrote the credit quality of the new-issue wing of the tax-exempt market. Fully 57% of new issuance came wrapped in an insurance policy as recently as 2005. With the downfall of MBIA and the collapse of Ambac, less than 10% of new issuance is so guaranteed today. And observe, adds Klotz, that Buffett himself, no mean appraiser of long-tail actuarial risk, has kept his distance from the muni-bond insurance business.

Absent the ubiquitous monoline triple-A guarantee, you'd expect the credit quality of individual tax-exempt issuers to come to the fore. And it has, to a degree. Helping to push it forward is the new market in municipal credit-default swaps. Bloomberg quotes CDS on a dozen states and the city of New York, including such hard cases as Illinois, at 313.6 basis points, California (296.0), New York (244.8) and New Jersey (243.0). Before this innovation in financial technology, it was next to impossible to lay down a bearish bet on a state and local borrower. It's still next to impossible (CDS volumes are tiny), but, at a minimum, someone's best guess about the creditworthiness of at-risk states is out in the public domain.

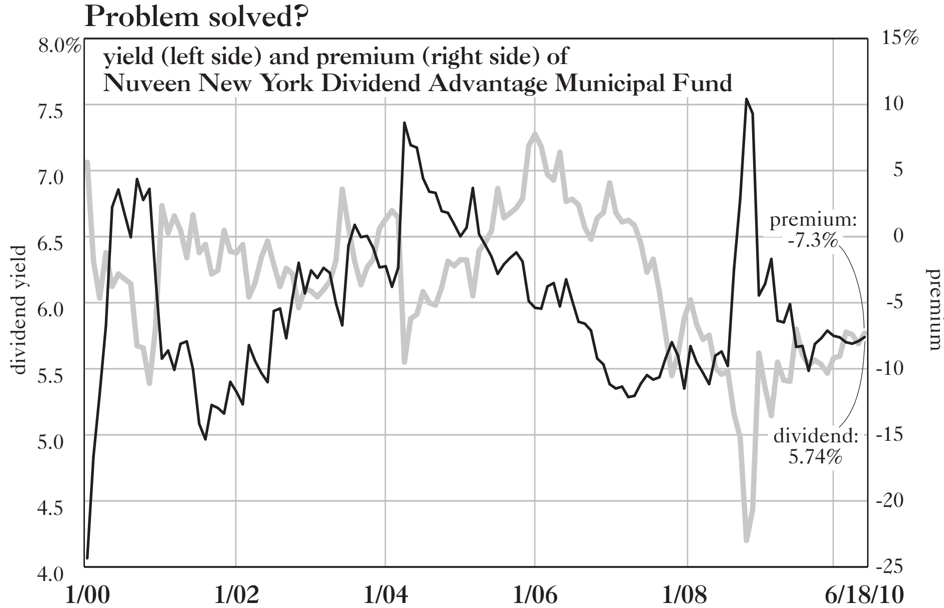
New York, with its dysfunctional legislature, $9.2 billion budget deficit, business-unfriendly tax regime and inventive public policy ideas (e.g., a new proposal to allow the state and municipalities to borrow nearly $6 billion from the state pension fund to facilitate their payments to the same pension fund) makes a useful lab specimen. With respect to the Empire State's creditworthiness, one may compare a CDS contract to a closed-end fund. The Nuveen New York Dividend Advantage Municipal Fund (NAN on the New York Stock Exchange) is that fund. It has a market capitalization of $125 million and a yield of 5.8%, the yield enhanced by the leverage afforded by a $37 million issue of preferred stock.

"Prior to July 2007," colleague Dan Gertner relates, "NAN traded at an average discount of 1% to its net asset value. In 2008, as the auction-rate preferred market stopped cold, panicked investors drove the discount to as much as 34.9%. As the auction-rate crisis passed, so did the discount narrow until, today, it stands at 7.3%, an expression of something very like confidence in Albany's debt-servicing capacity. Compare, however, the implied message of the market in New York state credit default swaps. Between June 2008 and October 2008, the cost of insuring $1 million a year for five years was 50 basis points. It spiked to 300 basis points at year-end 2008, from which height it spent most of 2009 descending. However, in November 2009, it resumed its climb and is quoted today at 250 basis points—an expression of doubtful confidence." We are going to say that the CDS market, though it trades only a couple of million dollars of New York state contracts a day, has the clearer line of sight.

Klotz and his Brown Brothers' partners smile at the quirks of the tax-exempt market. They wryly call it a "patient" market. Stocks and commodities and Treasurys may lunge and spike, but munis mosey. That is—an important distinction—tax-exempt securities prices have tended to mosey. In any market, past is prologue until, suddenly, it isn't. "I think that there is a very real danger of a shift in thinking about the municipal market if we have a sizable bankruptcy," Klotz says. "We've had so few defaults since the Great Depression that most buyers, even with the negative press of late, view munis as having virtually a zero chance of default. That is the mind-set of most owners, particularly older, wealthier people who tend to be disproportionate owners of munis. That is the way they think of them—virtually no risk."

Listening to Klotz, we think of the late, great bull market in American residential real estate and the triple-A-rated mortgage tranches it collateral-

Problem solved?



source: The Bloomberg

ized. In living memory, there had been no coast-to-coast bear market in houses. Ergo, the 2005-era argument went, there couldn't be one. It made no difference to the true believers that collateralized debt obligations, priced at par, offered negligible upside but 100 points of downside. Their historical record spoke for itself. The analogy with municipal debt today only goes so far. For one thing, according to data compiled by Moody's, the ultimate recovery on bonds that defaulted between 1970 and 2009 averaged 67 cents on the dollar. Be that as it may, we are reasonably confident that, for today's munis, as for yesteryear's mortgage-backed securities tranches, the downside looms larger than the upside.

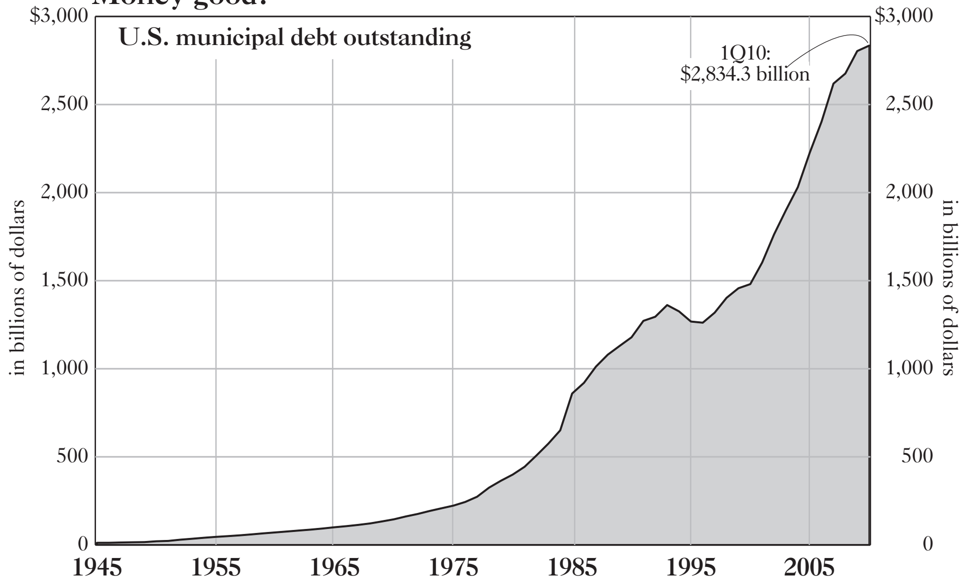
Not the least of the troubles with tax-exempt securities is that there are so many of them. Except for a brief decline in the mid-1990s, the volume of outstanding state and local government debt has grown at an average rate of 8.9% a year since 1945. For perspective, the federal government's debt, over the same span, has risen by an average rate of only 5.6% a year. As a percentage of GDP, today's $2.8 trillion of tax-exempt debt amounts to 19.4%, a new high and up from 14.6% in 2000, as Steven Malanga notes on the op-ed page of the June 14 *Wall Street Journal*. As troubling as the dollars raised is the uses to which they are increasingly put, Malanga goes on: "[M]uch state and local debt now exists in independent authorities whose borrowings are not subject to voter approvals. Some of these agencies have operated recklessly," the Massachusetts Bay Transportation Authority being a case in point.

The exemplary post-World War II credit record of the tax-exempt market obscures a checkered history. While the past is over and done with, and the institutions of 21st-century American finance bear scant resemblance to those of the second half of the 19th century, the human heart remains the same. The repudiation gene is ever present. The question is whether circumstances in the tax-exempt market may coax it out of latency and back into action.

We are going to speculate that the debtors and creditors of the 1870s had a moral compass not much different from that of their 21st-century descendants. They defaulted on municipal debt; we walk away from mortgages. If we seem less willing to renounce a public debt, it might just be that the Federal Reserve, by its massive dollar printing, has pushed the temptation to do so into the future. The Panic of 1873 had brought on a depression. Prices, tax receipts and the value of assessed real estate declined (there being no Fed). Yet the contracted value of debts remained the same. Encumbered cities, states and counties struggled to meet fixed charges. Some decided not to pay, or to pay on their own terms—among them, the states of Alabama, Arkansas, Florida, Georgia, Louisiana, Michigan, Minnesota, Mississippi, Tennessee and Virginia.

How might a politician unburdened by a conscience no greater than average size rationalize a decision to repudiate a public debt? The Civil War had ravaged the debt-servicing capacity of southern economies and governments, of course. One might therefore invoke force majeure. Besides that pretext, relate Carl H. Chatters and Albert M. Hillhouse in their 1933 study, "Municipal Debt Defaults, Their Prevention and Adjustment," governments had lent their credit to railroads, just as in the 1920s they would lend it to real estate promoters, and, in the 2000s, they would lend it to the builders of Major League Baseball stadiums and the Nascar Hall of Fame. "The bonds

Money good?



source: Federal Reserve

More risk, less reward

source: The Bloomberg

voted in the late [1860s] and [1870s] for railroad aid were often authorized without the vote of the people. . . ," the authors write. "It also was not unknown for a railroad promoter to import into a town enough of his laborers in order to secure a sufficient favorable vote where the law required a referendum on bond issues."

On reflection, many a politician decided, such debts were as indefensible as they were unpayable. What business had a state or municipal government in guaranteeing the debts of a private enterprise, anyway? So people very much like us sought recourse to default and unilateral renegotiation. In the worst of the depression of the 1870s, 20% of the market was in default, compared to 11.1% at the bottom of the Great Depression of the 1930s. Once in default, a certain number of bonds so remained for years on end. In one Missouri county, Chatters and Hillhouse report, "one of the qualifications for office [was] . . . that the candidate be willing to go to jail, rather than be a party to any levy in satisfaction of these bonds."

It was to cut short these Hatfield-and-McCoy disputes and to facilitate equitable adjustments between lenders and borrowers that Congress, in 1934, weighed enactment of legislation to facilitate the renegotiation of unpayable public debts. As the Senate Judiciary Committee took up the measure in January 1934, more than 2,000 American municipal borrowing units were in default. Under the bill before the committee, a government struggling under unmanageable debts could, with the consent of 30% of its creditors, file a petition with the court to prepare a workout. If two-thirds of the creditors approved, and if the court did not disapprove, the plan could be put into effect with the authority of the federal government. The Depression was, in fact, over, as posterity would see (the date of the trough was March 1933), but that did not mean happy days had begun. Florence, S.C., was in default on its debts, and so was Palm Beach, Fla. Of $18 billion of municipal, county and district bonds issued and outstanding in 1934, no less than $2 billion was in arrears, and the number of defaulting borrowers was growing by 100 a month.

To review the macroeconomic backdrop of that time of trouble, you wonder how any debtor remained solvent. That the vast majority did so is one of the best arguments against extreme bearishness in 2010; somehow, the world turns. "The fluctuation in commodity prices certainly is one of the fundamental underlying reasons for municipal defaults," Chatters and Hillhouse point out. "The wholesale commodity price index number of the Bureau of Labor Statistics was 154.4 for 1920, 100 for 1926 [a short, brutal deflation followed World War I], 68.6 for December, 1931, and 61.5 for April 29, 1933. Stated in different terms, this means that more than twice the quantity of commodities must be sold in 1933 as in 1920 to pay the same debt."

Nor was 25% unemployment exactly a constructive force for municipal creditworthiness. "Many municipalities," the authors continue, "find their ability to pay seriously affected by industrial unemployment and decreased assessable property value. Some industrial centers, relying primarily on one industry, find the value of industrial payrolls in 1933 only one-quarter of the 1929 level. In Fall River, Massachusetts, the textile properties paid 55% of the taxes in 1920 and 15% in 1932. The decrease of employment made taxpaying extremely difficult, where not impossible, for both home owner and manufacturer. Re-

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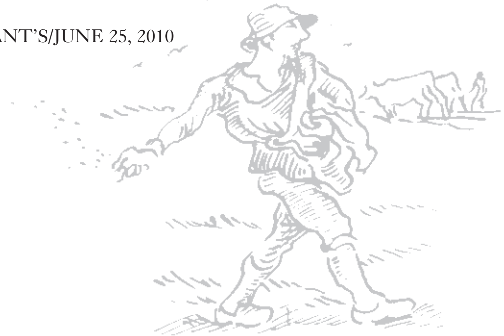


CREDIT CREATION

FEDERAL RESERVE BALANCE SHEET
(in millions of dollars)

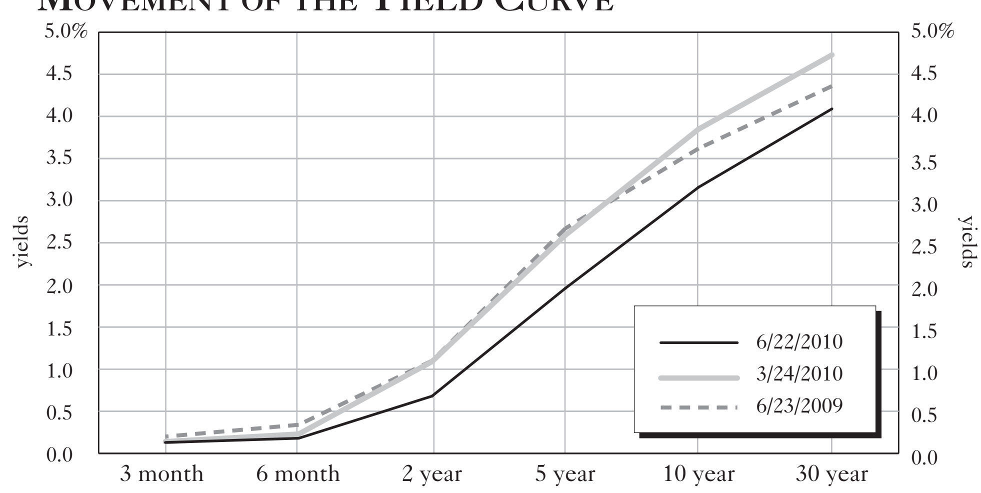
	June 16, 2010	June 9, 2010	June 17, 2009
The Fed buys and sells securities…			
Securities held outright	$2,064,505	$2,057,291	$1,176,290
Held under repurchase agreements	0	0	0
and lends…			
Borrowings—net	70,369	70,966	460,304
and expands or contracts its other assets…			
Maiden Lane, float and other assets	186,966	185,331	418,528
The grand total of all its assets is:			
FEDERAL RESERVE BANK CREDIT	$2,321,840	$2,313,588	$2,055,122
Foreign central banks also buy, or monetize, governments:			
Foreign central bank holdings of Treasurys and agencies	$3,079,842	$3,075,891	$2,751,710

EUROPEAN CENTRAL BANK BALANCE SHEET*
(in millions of euros)

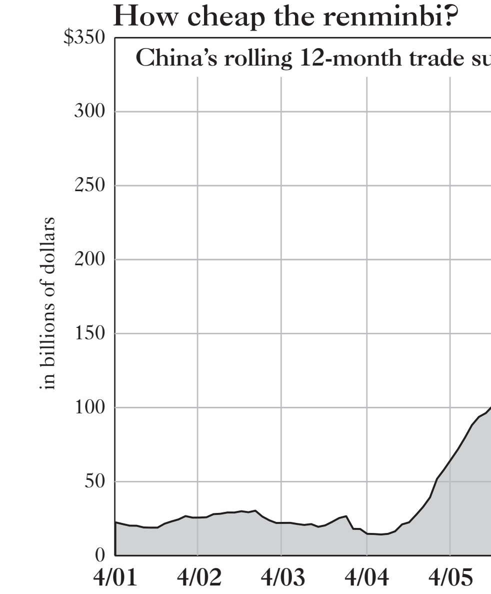
	June 2010	May 2010	June 2009
Gold	€286,691	€286,692	€240,629
Cash and securities	743,362	738,277	615,479
Loans	844,913	815,138	896,839
Other assets	249,774	248,343	244,372
Total	€2,124,740	€2,088,450	€1,997,319

*totals may not add due to rounding

MOVEMENT OF THE YIELD CURVE



source: The Bloomberg



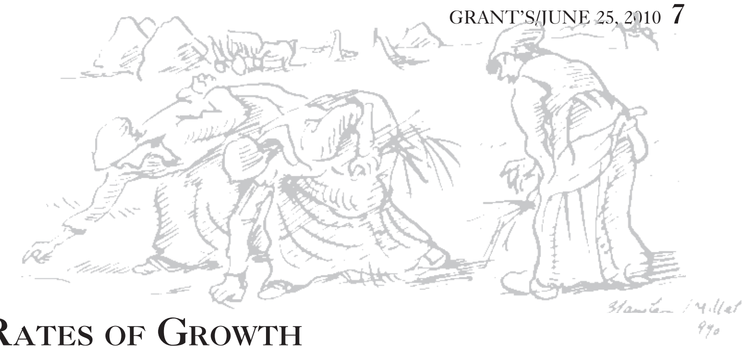
source: The Bloomberg

Not so sc

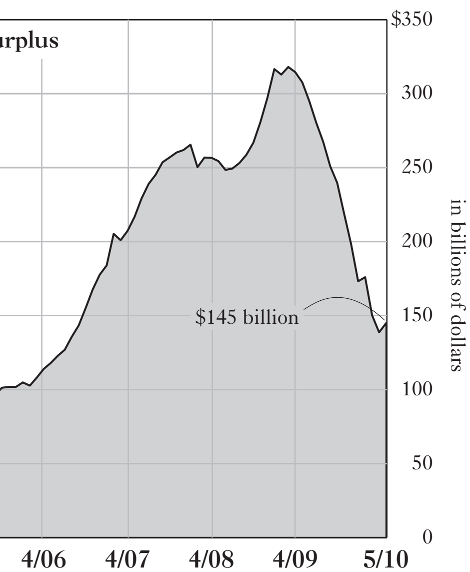
Renminbi bulls cheered the weekend's news of the unplugging of China's dollar peg, but the forex market is more complex than a single exchange rate. In particular (Congress, please copy), for the economy of the People's Republic, there are other exchange rates besides renminbi-dollar. Did you know, Sen. Chuck Schumer, that a trade-weighted index of China's exchange rate has actually increased by 5% in the past two years?

China's real exchange rate is appreciating because, on the mainland as in few other places in the world, the measured rate of inflation is rising. And a good thing, too, America's central bankers might judge in a moment of candor; it was only a year ago that the People's Republic was in deflation. But while the CPI is higher by just 3.1% from the year-earlier reading, food prices are up by 6.1%, and various intermediate goods indices are rising even faster. Year-over-year, China's purchasing price index is up by 12.1%, its producer price index by 7.1%. The recent bout of labor activism at Chinese factories could be a catalyst for faster wage inflation. The World Bank estimates that rural incomes (a proxy for migrant wages) increased by 16.4% year-over-year in the first quarter.

"Given real exchange-rate appreciation," colleague Ian McCulley writes,



• Cause & Effect



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"it's worth asking if the RMB/USD exchange rate is, in fact, so undervalued? The People's Bank suggests in certain and idiomatic English that it is not. 'The basis for a large-scale RMB appreciation does not exist as the RMB exchange rate is moving closer to its equilibrium level,' it says on its Web site, and China's external accounts imply as much. So far in 2010, imports have risen by 57.5%, exports by only 33.2%. The Peterson Institute for International Economics estimates that the fair value of the renminbi is 5.5 to the dollar, stronger but not dramatically so if one allows a decent interval—say, five years—for adjustment.

"Perhaps, though," McCulley winds up, "the renminbi bulls have looked at the actions of the Swiss National Bank and thrown up their hands. Maybe they've decided that what a central bank thinks is ultimately irrelevant. Thus, after spending nearly CHF150 billion so far this year to weaken the franc against the euro, the SNB last week admitted defeat. Despite the massive intervention, the Swissie has still appreciated by 9% against the euro in 2010. *The Wall Street Journal* attributed the failure to 'currency markets . . . grown so large that it is hard for any single player to have a decisive impact.' So the arms of the gnomes are too short to box with God."

•

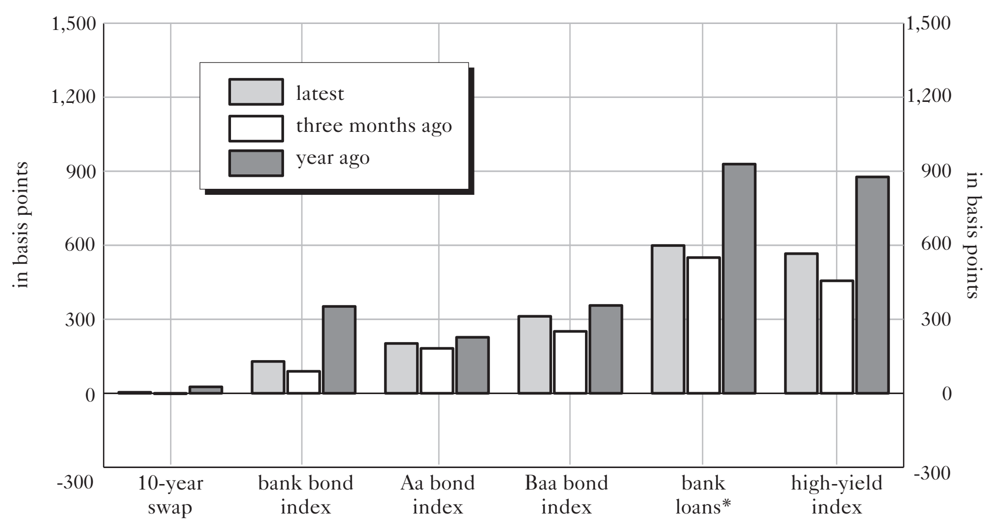
Annualized Rates of Growth
(latest data, weekly or monthly, in percent)

	3 months	6 months	12 months
Federal Reserve Bank credit	12.1%	14.6%	11.2%
Foreign central bank holdings of gov'ts.	14.9	9.9	12.9
European Central Bank assets	52.9	39.7	16.9
Commercial and industrial loans (May)	-7.6	-13.7	-18.5
Commercial bank credit (May)	-1.3	3.5	14.3
Primary dealer repurchase agreements	6.5	8.8	4.0
Asset-backed commercial paper	17.7	-22.0	-19.3
Currency	4.0	4.3	3.7
M-1	2.4	3.6	7.5
M-2	0.0	0.5	1.6
Money zero maturity	-4.1	-4.4	-1.9

Reflation/Deflation Watch

	Latest Week	Prior Week	Year Ago
FTSE Xinhua 600 Banks Index	8,994.65	8,945.46	11,359.80
Moody's Industrial Metals Index	1,663.44	1,652.82	1,358.54
Silver	$19.83	$18.23	$13.71
Oil	$77.18	$73.78	$71.37
Soybeans	$9.61	$9.46	$12.14
Rogers Int'l Commodity Index	3,021	2,923	3,003
Gold (London p.m. fix)	$1,256.00	$1,220.00	$940.50
CRB raw industrial spot index	476.44	475.78	400.28
ECRI Future Inflation Gauge	(May) 98.9	(Apr) 101.8	(May) 79.8
Factory capacity utilization rate	(May) 74.7%	(Apr) 73.7%	(May) 68.5%
CUSIP requests	(May) 1,636	(Apr) 1,658	(May) 1,232

Credit Spreads



*spread over three-month Libor
sources: The Bloomberg, Standard & Poor's LCD

(Continued from page 5)

ports from Schenectady, New York, show that the community income for the services and labor of its citizens, which for the years 1925, 1926, and 1927 averaged $55,700,000, was only $22,000,000 in 1932. In spite of this, however, the city has maintained its credit on a high plane."

Opponents of the proposed bankruptcy legislation called it licensed repudiation and predicted a wave of bankruptcies once the door to nonpayment was opened by federal statute—something of the kind had happened in the 1870s. *The Bond Buyer*, then as now the trade's daily newspaper, insisted that municipal credit was sounder than the alarmists admitted. Just $200 million of tax-exempt debt was in default with respect both to principal *and* interest, it reported. The American Bankers Association and the American Bar Association lined up against the governmental bankruptcy legislation, the latter on the ground that it was unconstitutional. The titans of the bond-buying life insurance industry—John Hancock, New York Life, New England Mutual, Phoenix Mutual—threw their weight against it.

"If a federal act is passed allowing a loophole in the legal background of municipal securities," Harry B. Wade, representing the specially organized League for the Preservation of Municipal Credit, testified before the Judiciary Committee, "the security behind all issues, new or old, would go down and the interest on all new obligations would undoubtedly have to rise. We could not, as trustee of the funds of widows and orphans, afford to invest their money in securities that allow loopholes for the borrower to squirm through. A high rate of interest must be paid on the general class of securities so that when one borrower does squirm through, we can make it up by taking it out of the pocketbook of the borrower who does not."

Opponents of the 1934 legislation turned out to be wrong on every substantive financial point but correct (or, at least, in accord with the views of the Supreme Court) on the constitutional question. Struck down in 1936 for impinging on the powers of the states, the 1934 act was rewritten in 1937, and this time it held. Amended in 1946 to constitute Chapter 9 of the Bankruptcy Act, it did not, after all, unleash a wave of repudiation. Neither did the institutional buyers of tax-exempt securities absent themselves from the market in protest against the new loophole. As late as 1950, commercial banks were the largest class of owner of tax-exempt debt in the United States, holding 40%, or $8.2 billion, on which they earned the princely average triple-A-rated yield of 1.94%.

Today's triple-A yield, ranging from 2.7% to 3.8% according to maturity, is not so much higher than the one in place 60 years ago, but the market would otherwise be unrecognizable to a time-traveling bond buyer from the Truman administration. Way back then, households owned just 26.6% of outstandings, while state and local governments themselves held 9.7%. Nowadays, commercial banks hold just 7.7% and state and local governments hardly any (maybe they see the handwriting on the wall). Households have filled the breach, holding two-thirds, roughly evenly divided between direct investments and mutual funds. The tax-exempt market is the people's market, if one can still think of the rich and well-to-do in 2010 as "people."

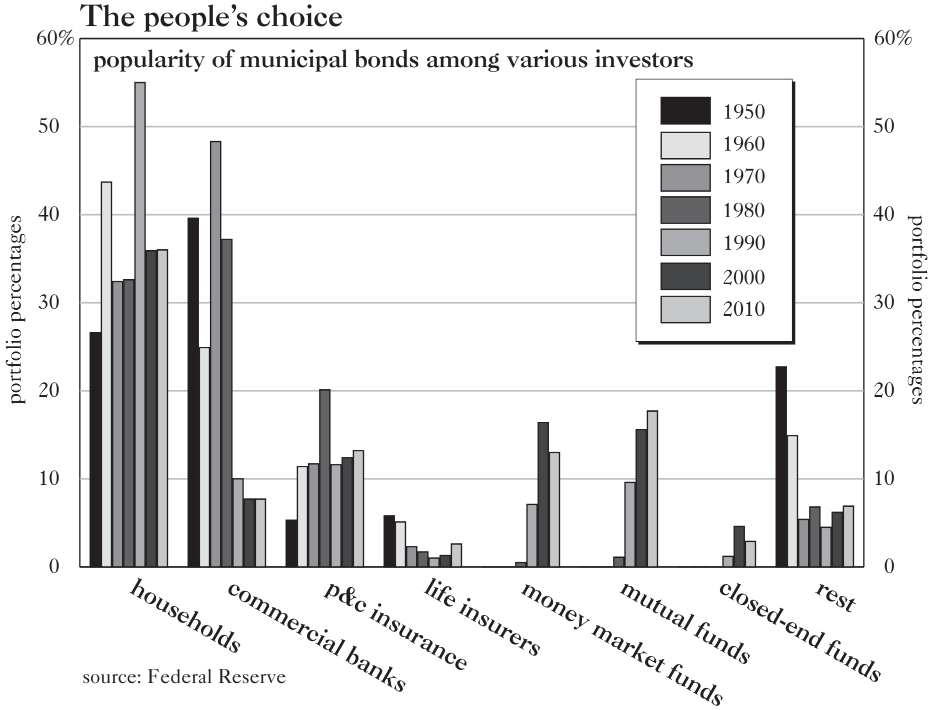
As the subject of this essay is what could go wrong, let us speculate. The fact of credit deterioration we take as a given. The unknown factor is how, when and by whom that fact is recognized. Members of the Brown Brothers' bond department worry that an unexpected default by a household name could set off a run, or at least a brisk walk, for liquidity.

Tax-exempt mutual funds promise daily liquidity, in which feature they resemble equity funds. The characteristic in which they do not resemble equity funds is that the municipal market is comparatively illiquid. It would be hard to turn great blocks of infrequently traded tax-exempts into cash if enough shareholders urgently came calling.

The Vanguard Intermediate-Term Tax-Exempt Fund (VWITX), with $29 billion in assets, an expense ratio of just 20 basis points and four stars from Morningstar, is among the best of its type. As of May 31, it owned 2,804 individual bonds with an average maturity of six years and an average duration of 5.6 years. Triple-A was the rating assigned to 27.7% of these names, double-A to 44.6%, single-A to 23.9%, triple-B to 3.5% and not rated to 0.3%. As of Jan. 31, the latest disclosure of individual portfolio holdings, 98.6%, or $26.9 billion, of the fund was invested in bonds, 1.14%, or $312 million, was in money-market funds and 0.2% in other assets. It appears that 4% of these bonds, worth $1.1 billion, are putable, therefore sources of liquidity should the shareholders suddenly demand it.

As it is, however, shareholders have been clamoring to get in. From January to May, Vanguard's net assets climbed

The people's choice



source: Federal Reserve

by $1.7 billion, or 6.2%. Industrywide, inflows rose by 5.3% through the first four months of 2010, following a 23% surge in 2009, one of the biggest such gains on record. Plainly, where we see risk, the majority of investors see safety and soundness. If they are right, they stand to earn, let us say, $3\frac{1}{2}$% free of federal and (where applicable) state income tax. If they are wrong, they stand to lose more than money. Nothing less than the peace of mind of the average well-to-do American is at risk in an unscripted crisis of state and local finance. Maybe the play is Ambien.

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Bernanke's curious silence

Prices are falling, your editor's arguments, remonstrances and forecasts notwithstanding. Whatever the index—the Consumer Price Index, the core CPI, the Personal Consumption Expenditures Index, the core PCE, the Cleveland Fed's median CPI, even the Dallas Fed's trimmed mean PCE—the message is broadly the same: Consumer prices are as weak as they've been in a generation.

Is this a bad thing? For now, we put aside that question as well as our oft-sounded objections to the word "deflation" to describe everyday low, and lower, prices. Besides, real deflation—falling prices in conjunction with failing banks—might just be what's on tap.

Nothing in today's price readings is unprecedented. Consumer prices registered 13 successive months of year-over-year decline in 1954-55. What is unprecedented is the massive silence from Ben S. Bernanke in the face of weakening prices. Not since Jan. 3 has the chairman of the Federal Open Market Committee uttered the word "deflation" in a public speech. Either he has undergone a late-onset intellectual conversion, or he's about to dust off his old sermons. The second possibility is the one we're betting on. "Quantitative easing," Part 2, might be in the works already.

Rereading FOMC statements from 2002-03, when then-Governor Bernanke was whispering (and shouting, too) into the ear of then-Chairman Greenspan about the risks of an unacceptably slow rate of dollar debasement, you wonder why QE 2 hasn't set sail by now. Thus, on June 25, 2003, the day the FOMC lowered the funds rate to a then-unheard-of 1%, the members worried that "the probability, though minor, of an unwelcome substantial fall in inflation exceeds that of a pickup in inflation from its already low level. On balance, the committee believes that the latter concern is likely to predominate for the foreseeable future."

In his aforementioned remarks of Jan. 3, Bernanke set out to explain why the Fed eased as much as it did in 2003-04, when the CPI was rising and economic growth was quickening. Inflation measures were giving off conflicting signals, he explained. "Notably," said Bernanke, "core PCE inflation for 2003 was initially reported, in the first quarter of 2004, as having slowed to about 1%, and it appeared to be on a steep downward trajectory. These data heightened concerns about deflation on the FOMC. In contrast, the CPI data released at the same time showed core inflation for 2003 of about 2%. In this case, data revisions ultimately raised estimates of PCE inflation for that period, implying that deflation was less of a risk than was thought at the time. But that such revisions would occur could not be known in advance, and policy decisions, of course, must be made based on the information available at the time."

Today, there is no such ambiguity. "Perhaps the most striking feature of the distribution this month," said the Cleveland Fed's blog in the wake of the release two Mondays ago of the CPI for May, "was that just 18% of the overall index (by expenditure weight) rose at rates exceeding 3%, its lowest share on record (back to 1967). As has been the case over the previous six months, a majority of the distribution (63% in May) either rose less than 1% or exhibited outright price decreases."

In 2003, when he was still just another Federal Reserve governor, Bernanke flew to Japan to dispense a little free advice on how to whip deflation. Must reading, if we do say so, is the *Grant's* account of that important speech (it's posted on our Web site). In it, Bernanke urges his Japanese monetary hosts not only to resist falling prices but also to commit to print enough yen to push the price level back to where it would have been had they not permitted prices to drop in the first place.

It's in the context of these truly radical ideas (and the implications they hold for genuinely heavy-handed central bank intervention) that the gold price goes up and up.

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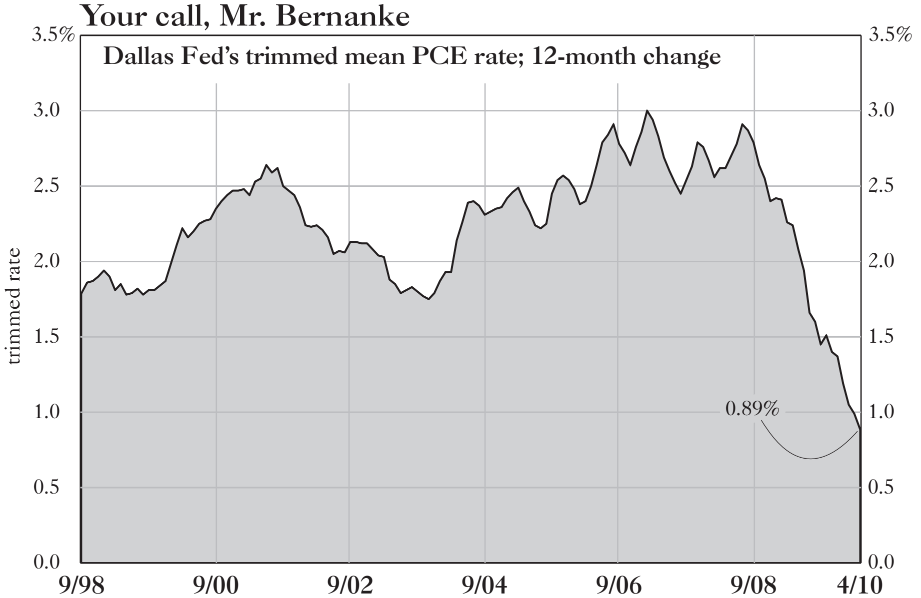
Your call, Mr. Bernanke



source: Dallas Federal Reserve

Mobile payout

To the list of big-cap stocks that may produce a better return than the obligations of America's mega-cap government, we hereby add Vodafone Group Plc, the London-based mobile telecom giant. Vodafone is a globe-girdling blue chip that happens to gird a little too much of the euro zone for the stock market's liking. For that reason and others, the shares (listed in London, VOD LN, and in New York via an ADR, VOD US) are quoted at nine times earnings and at a ratio of enterprise value to earnings before interest, taxes, depreciation and amortization of 7.3; they yield 5.8%.

We say "they yield" without meaning to imply that there is anything firm, settled or contractual about the dividend rate. It's contingent on forces too numerous to imagine, let alone mention, even if the chairman of the Vodafone board, Sir John Bond, writing in the new annual report, did go on record saying, "The Board is . . . targeting to maintain growth in dividends per share at no less than 7% per annum for the next three years." You don't hear Timothy Geithner making that kind of pledge. The Treasury's principal aspiration, as a matter of fact, appears to be that the U.S. dollar should command fewer and fewer units of the Chinese renminbi.

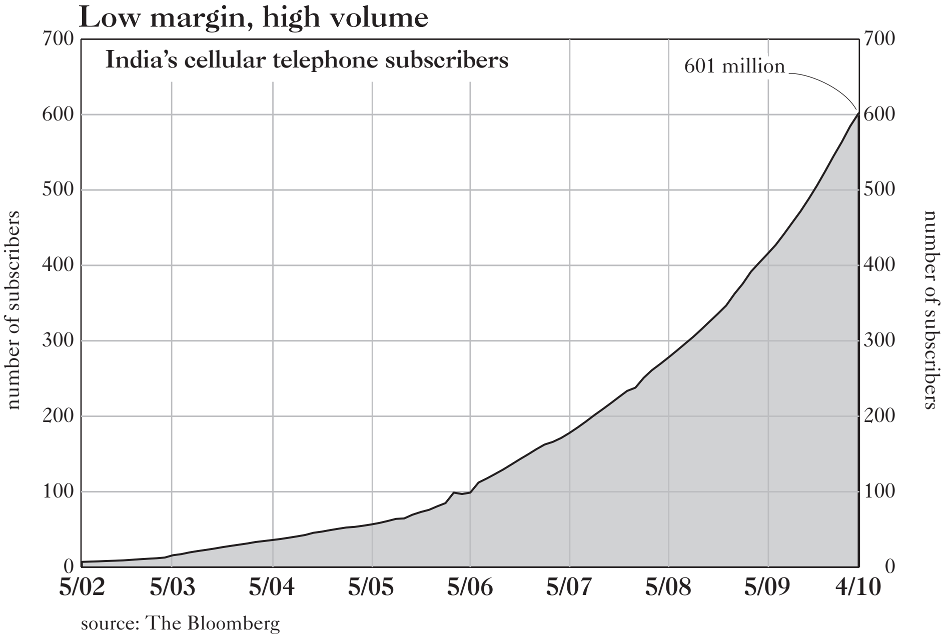
Though Vodafone operates in Western Europe, Eastern Europe, Africa, the Middle East, Asia and North America (by dint of its 45% ownership of Verizon Wireless), it's old Europe that furnishes 67% of its £44 billion top line and 74% of its £15 billion EBITDA. Germany, contributing 18% of companywide revenue and 21% of EBITDA, is the No. 1 market. Italy is No. 2, followed by Spain and the United Kingdom. As investors do not need to be reminded, these are not the world's growth meccas (nor are the Netherlands, Greece, Portugal, Albania and Malta, in which Vodafone also operates). European-generated revenue did grow by 0.8% in the fiscal year ended March 31. However, before the flattering effects of currency movements and other nonoperating factors, it fell by 4.1%, with Spain and the U.K. leading the downside charge. But—a mitigating fact—the rate of decline in the European business moderated as the year wore on, to 2% in the fourth quarter from 5.4% in the second.

"Unquestionably," continues Sir John, "this has been the most difficult economic environment in which your company has ever operated. Against this background, I am very pleased to report that the group delivered an adjusted operating profit of £11.5 billion (down 2.5%) and generated £7.2 billion of free cash flow (up 26.5%). . . . The telecommunications sector as a whole has seen declining revenue through this period, but we have not seen the extremely steep declines in revenue experienced by some other sectors of the economy—mobile communications remain an essential element in most people's lives."

Not so long ago, even a Great Recession might not have slowed the cell phone business' meteoric growth. But now that most people in most countries have a phone seemingly growing out of their ears, the macro economy comes more into play, as does regulatory policy, especially in India. Vodafone bought its way into India with its $10.7 billion purchase of Hutchison Telecom International's Indian subsidiary in 2007. It was a hearty price, as we said at the time (*Grant's*, Oct. 19, 2007), though—as Vodafone must have reasoned—the growth opportunity was hearty, too. And so it turned out to be. Post-acquisition, Vodafone's Indian subscriber population has increased to more than 100 million from 28 million. The trouble is that, under the Indian government's licensing policies, as many as 15 cell phone providers compete in the same Indian market. Thus, in the past year, while Vodafone's subscribers jumped by 60%, its Indian revenues were up by only 18%. Referring to the ferocious competition implied by those numbers, as well as to looming outlays for cap-ex, an analyst quoted by Bloomberg last month characterized Vodafone's Indian adventure as a "fiasco." Fiasco or not, Vodafone remains the No. 2 entrant in a country that is adding 20 million new

Vodafone Group Plc
(in millions of British pounds, except per-share data)

	Year ended 3/31/10	3/31/09	3/31/08	3/31/07
Revenue	£44,472	£41,017	£35,478	£31,104
Cost of sales	(29,439)	(25,842)	(21,890)	(18,725)
Gross profit	15,033	15,175	13,588	12,379
Selling and distribution expenses	(2,981)	(2,738)	(2,511)	(2,136)
Administrative expenses	(5,328)	(4,771)	(3,878)	(3,437)
Share of result in associates	4,742	4,091	2,876	2,728
Impairment losses, net	(2,100)	(5,900)	-	(11,600)
Other income and expense	114	–	(28)	502
Operating profit	9,480	5,857	10,047	(1,564)
Nonoperating income and expense	(10)	(44)	254	4
Investment income	716	795	714	789
Financing costs	(1,512)	(2,419)	(2,014)	(1,612)
Profit before taxation	8,674	4,189	9,001	(2,383)
Income-tax expense	(56)	(1,109)	(2,245)	(2,423)
Profit for financial year	8,618	3,080	6,756	(5,297)
Minority interest	(27)	2	96	129
Profit to shareholders	8,645	3,078	6,660	(5,426)
Diluted earnings per share	16.36p	5.81p	12.50p	(9.84)p
Goodwill	£51,838	£53,958	£51,336	£40,567
Property, plant and equipment	20,642	19,250	16,735	13,444
Investments in associates	36,377	34,715	22,545	20,227
Non-current assets	142,766	139,670	118,546	96,804
Trade and other receivables	8,784	7,662	6,551	5,023
Cash and cash equivalents	4,423	4,878	1,699	7,481
Current assets	14,219	13,029	8,724	12,813
Total assets	156,985	152,699	127,270	109,617
Long-term borrowings	28,632	31,749	22,662	17,798
Non-current liabilities	37,559	39,975	28,826	23,378
Short-term borrowings	11,163	9,624	4,532	4,817
Trade and other payables	14,082	13,398	11,962	8,774
Current liabilities	28,616	27,947	21,973	18,946
Total liabilities	66,175	67,922	50,799	42,324
Shareholders' equity	90,381	86,162	78,043	67,067
Shares outstanding (millions)	52,663			
Price per share	£1.43			
Market cap	75,308.09			
Price/earnings	8.71x			
Price/book	0.83			



subscribers a month and has only just crossed the 50% overall penetration mark, compared with 100% and more penetration in developed markets and 70% or less in most emerging markets. "Looking out over a longer time horizon," colleague Ian McCulley observes, "the current price war should eventually lead to weaker players exiting the field, leaving Vodafone's business in good shape. There are worse things in the world than being the No. 2 mobile provider in a 1.2 billion-person country growing GDP at 7% a year."

If India is not Vodafone's crown jewel, Verizon Wireless just might be. As noted, Vodafone owns 45% of the Verizon mobile provider (Verizon Communications, the parent, has the rest). For good reason, Verizon Wireless is an investor fan favorite. Its subscriber base is growing, its financial health is glowing and its average monthly revenue per user—no less than $50—is amazing. For perspective, Vodafone's German operations pull in $20 per user per month. So far iPhone-less, Verizon Wireless would shine even brighter were it to obtain that shiny new Apple toy.

"While Vodafone booked over £4 billion of operating income as a result of its 45% share in Verizon Wireless," McCulley notes, "it received dividends worth only £1 billion, roughly enough to cover its tax liabilities. It's Verizon's corporate policy to pay down debt with free cash flow, not return it to the shareholders. But there's only so much debt to repay. In the first quarter, the Verizon sub generated $4.8 billion in free cash flow, with which it paid down $3.2 billion of debt. As its outstanding obligation totals $23 billion, it would take only six or seven more quarters to extinguish it—if that were the goal. But it makes no sense to de-lever the company completely given its growing cash flow and healthy margins. From this line of thinking, it would follow that there could be action on the Verizon Wireless dividend within the next nine to 12 months. The market would likely begin to mark up the value of Vodafone's stake in the Verizon sub if Vodafone began to receive a regular cash distribution. Any M&A—Verizon Communications buying out Vodafone, a spin-out, a merger—would also likely lead to value realization for the Vodafone shareholders.

"Note, please," McCulley goes on, "that the 45% Verizon Wireless interest goes unreflected in Vodafone's EBITDA line and thus in that measure of valuation. As it is, Vodafone changes hands at 7.3 times enterprise value to EBITDA. Say that the Verizon sub could generate $25 billion of EBITDA this year. At a multiple of six, that would be worth $150 billion. Subtract $22 billion in net debt, and you're left with an equity value of $128 billion. Vodafone's share would be £39 billion. The implication of that number is that the rest of Vodafone's businesses trade at a 4.6 times multiple (and not the 7.3 multiple at which it does trade). If Verizon Wireless were valued higher, say, at an eight multiple, the rest of Vodafone's businesses would have to be valued at a 3.6 multiple. On a global basis, multiples have compressed in the past three years. Big mobile phone operators trade at between four and five times EBITDA in developed markets and at six or seven multiples in emerging ones. Still, an implied—and very hypothetical—multiple of three or so does seem cheap."

It will be said that big, dividend-paying brutes like Vodafone have cheapened in the stock market because, when the Bush tax cuts die their expected death in 2011, dividend income will be taxed as ordinary income, not at the current favored 15% rate. Those in today's top 39.6% federal bracket are, therefore, staring at a meaningful cut in dividend income. In the case of Vodafone, one's after-tax dividend return would drop to 3.6% from 4.9% (without regard to state income tax). Then, again, corporate managements are nothing if not adaptive. If dividend income holds less after-tax allure than capital gains, share buybacks might return front and center. Besides, Treasury coupon payments are already taxed as ordinary income and that hasn't slowed down the bond bulls. Tuesday's two-year note auction was hammered down at a yield of 0.74% (the coupon was five-eighths of 1%, the lowest on record). Whatever that yield amounts to after tax, it's lower than the payout that the board of Vodafone is striving so mightily to deliver.

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Not so scrutable

Renminbi bulls cheered the weekend's news of the unplugging of China's dollar peg, but the forex market is more complex than a single exchange rate. In particular (Congress, please copy), for the economy of the People's Republic, there are other exchange rates besides renminbi-dollar. Did you know, Sen. Chuck Schumer, that a trade-weighted index of China's exchange rate has actually increased by 5% in the past two years?

China's real exchange rate is appreciating because, on the mainland as in few other places in the world, the measured rate of inflation is rising. And a good thing, too, America's central bankers might judge in a moment of candor; it was only a year ago that the People's Republic was in deflation. But while the CPI is higher by just 3.1% from the year-earlier reading, food prices are up by 6.1%, and various intermediate goods indices are rising even faster. Year-over-year, China's purchasing price index is up by 12.1%, its producer price index by 7.1%. The recent bout of labor activism at Chinese factories could be a catalyst for faster wage inflation. The World Bank estimates that rural incomes (a proxy for migrant wages) increased by 16.4% year-over-year in the first quarter.

"Given real exchange-rate appreciation," colleague Ian McCulley writes, "it's worth asking if the RMB/USD exchange rate is, in fact, so undervalued? The People's Bank suggests in certain and idiomatic English that it is not. 'The basis for a large-scale RMB appreciation does not exist as the RMB exchange rate is moving closer to its equilibrium level,' it says on its Web site, and China's external accounts imply as much. So far in 2010, imports have risen by 57.5%, exports by only 33.2%. The Peterson Institute for International Economics estimates that the fair value of the renminbi is 5.5 to the dollar, stronger but not dramatically so if one allows a decent interval—say, five years—for adjustment.

"Perhaps, though," McCulley winds up, "the renminbi bulls have looked at the actions of the Swiss National Bank and thrown up their hands. Maybe they've decided that what a central bank thinks is ultimately irrelevant. Thus, after spending nearly CHF150 billion so far this year to weaken the franc against the euro, the SNB last week admitted defeat. Despite the massive intervention, the Swissie has still appreciated by 9% against the euro in 2010. *The Wall Street Journal* attributed the failure to 'currency markets . . . grown so large that it is hard for any single player to have a decisive impact.' So the arms of the gnomes are too short to box with God."

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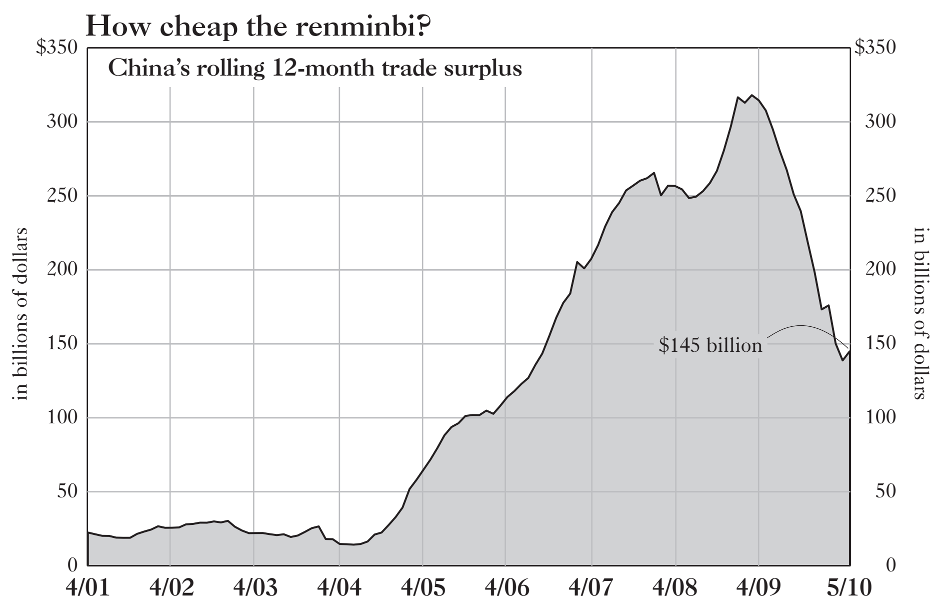

source: The Bloomberg