



*From the Trading Turret*

## **Big Wave FLASH REPORT**

July 12, 2010

**Many of my readers have holdings in municipal bonds, either through direct holdings or mutual funds.** I am starting to see some danger signs in the muni bond market that we all need to keep an eye on over the next few months. With states like California, New York and Illinois on the brink of all out default...Illinois admitted it cannot pay its bills right now...you would think that muni bond prices would be tumbling as the risk of default measures into the current prices. So far we are not seeing all out price movements lower.

**Maybe it's because everyone knows that higher taxes are coming and muni bonds provide tax free income.** The lure of receiving tax-free income is masking what is a deteriorating situation which the credit quality of the bonds themselves under the surface.

**Foreigners are buying munis at record levels, increasing their holdings of munis to \$71.9 billion in the first quarter of 2010, an 80% increase from the first quarter of 2009 and 10 times as much from the year 2000.**

**And US households are on a muni tear, increasing their holdings to more than \$1 trillion for the first time ever.** I always steer clear of any investment class where the public is rushing in to buy in a manic type panic. Every time buying panics like this end badly. It seems that US investors are buying because they think they are getting a great deal on the last tax free type investment available and one who's tax status will not be changed by the Obama Administration's new regulations. A few years ago, US investors owned billions in munis and that has climbed to trillions in a very short time. Usually, the public and foreigners are the last ones in the door at the investment party and being classically late in this case has proved to be expensive. **These two groups usually end up buying the top tick.**

**At last count, there are 43 states facing "Greek-style deficits".** The cost of insuring muni bonds, the US Municipal bond to US treasury bond swap spread, has premiums to insure munis rising fast. Swap spreads are already wider today than they were at the bottom of the stock market panic in March 2009. This is a warning sign that last occurred in the fall of 2008 right before the equity markets crashed and investors ignored it back then as they are today.

**Even the Wall Street Journal is documenting this with headlines like "Investors Looking Past Red Flags in Muni Market."**

**The main difference today, compared with 2008 is the plunge in total state revenues in 2010.** According to the Rockefeller Institute of Government, state sales and income tax revenue fell for the first time in nearly 50 years over the last 5 quarters. According to the Center on Budget and Policy Priorities, state budget deficits will increase to nearly \$112 billion in the next year. Add in the "new normal" as PIMCO calls the coming slow motion growth in GDP over the next 10 years, the prospect of state revenues growing is very low. Add into this mix, the end of the \$787 billion federal stimulus spending, increasing unemployment costs and depressed and falling real estate values and therefore taxes, and you can see the problems that lie ahead for municipalities continuing to pay their debt service on their bonds.

**In May alone, government and non-profit entities cut over 16,500 jobs, a 12% jump from April which signals how bad this municipal crisis is becoming.** As one employment specialists said, "The budget crisis for many states and municipalities is only getting worse."

**Now, as Elliott Wave International research has reported, many state and local governments are issuing even more debt to bridge the gap between the cash on hand, and what is needed next year.** A sort of bridge loan to nowhere! Total state and local borrowing hit \$2.2 trillion in 2010, a record 22% of GDP. The same total was 15% of GDP in 2000. This compounding of debt and the recent huge increases is nothing

but trouble because you can't possibly service all of this debt PLUS pay for year after year redemptions of old debt by increasing new debt at this rate. When calculating decreasing future revenues against all of this new debt service, a breaking point is not too far away.

**Governments are always last to respond to trend change and this time will be no different. Governments across this nation are still thinking that taking on more debt to help pay for current obligations is the right solution.**

**And now, pension boards are increasing their risk in how they invest their pension funds.** In Illinois, the state pension fund is using derivatives to try and recover returns and try and fix the 60.9% underfunding of their plan. In Detroit, the Police and Fire Pension fund invested millions in a casino venture that has already been downgraded 3 times by ratings agencies. This is how desperate state governments are becoming.

**Here is how Time Magazine put it....**"The collapse of a Wall Street institution like Lehman Brothers looks nothing like the threatened closing of a branch library. But this unfolding economic disaster is in fact a series of variations on a single theme. When times were good and the future seemed bulletproof, all sorts of grand ventures were floated on eaves of debt. Everyone planned to be richer when the bills came due. Only if the bubble burst would the bills become unpayable. How did so many people forget all at once that the bubble always burst?"

**CONCLUSION: If the stock market starts it's protracted wave C decline, then the muni crisis will grow and do so fairly quickly.** I think that the muni bond swap insurance premiums will rise and the trend line that they are on now means they will move above and beyond the 2008 highs. City and state employment payrolls, which have risen from 14 million in 1985 to 20 million today, should see a big decline in the years ahead and state and city pension funds will be rocked by funding shortfalls and pensions will have to be slashed in big ways.

**Lower rated munis should start to see sharp price drops soon.** Muni bonds in states like Illinois, New York and California should start to see price drops as well. **The next big crisis facing America over the next couple of years will be the municipal crisis** and it is imperative that your financial advisor, if recommending any type of muni bond to you, talks more about the underlying safety of the issuer, than the tax free yield on the bond. You should look at the prospectus of your muni fund and see how many bonds in the portfolio are issued from Illinois, New York California or other troubled states. How many are lower rated or non rated? What is the maturity on these bonds?

**It is important now to look for safety first and yield second.** Don't be lured by the tax free yields. **There is a storm coming in the municipal bond market and it could be a doozy.** Again, be prepared, do your homework now, before the storm hits.

**Or, avoid all munis right now before the storm , save your cash and wait until it passes.** By that time, a good deal of these bonds will be on sale at far lower prices and bargains will be everywhere. The public and the foreigners will have sold out by then as losses mount and the public finally throwing in the towel is always the sign of a bottom. The public buying is always a sign of a nearing top. So be patient and wait.

**Cash is king and it will be for a while. Save your cash. Invest in short term stuff if you have to and stay away from situations that could become very fluid and dramatic. Wait for things to go on sale, including munis.**

**There is enough uncertainty and downside risk in the municipal market that it can't be considered the safe tax free haven of the 1990's. Municipalities are in trouble and the crisis is in the beginning stages. This is reason enough to steer clear of this investment class over the coming months.**