Payden&Rygel

How Risky Are Municipal Bonds? (Part I)

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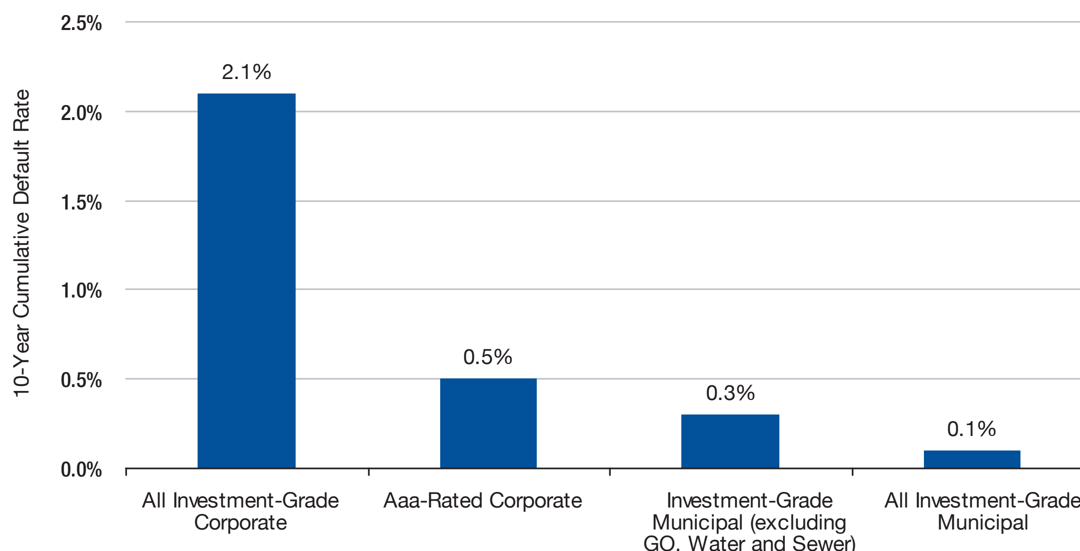
10-Year Cumulative Default Rates of Moody's Investment Grade Municipal Bonds versus Corporate Bonds



Source: The US Municipal Bond Rating Scale: Mapping to the Global Rating Scale and Assigning Global Scale Ratings to Municipal Obligations," Moody's Public Finance Credit Committee, March 2007.

The question we have fielded the most about municipal bonds in 2009: will California default? This is closely followed by questions on other states and municipalities. To frame the discussion, we will cover defaults in multiple parts to cover two big themes: *empirical* (because that tells us what has happened before) and *theoretical* (because that forces us to think about what could happen). In the post-2008 world, we want to consider any and all possible outcomes. In this first part of *Market Perspectives,* we will address the empirical case.

The empirical question: how have municipal bonds fared historically? Based on a study of the period from 1970 to 2006 by Moody's, the answer is clear: municipal bonds have a phenomenal track record. In fact, the 10-year cumulative default rate on investment grade municipal bonds is just 0.1%, compared to 2.1% for investment grade corporate bonds. Even better, if we *exclude* the highest quality segments of the municipal market—general obligation (GO) bonds, water/sewer revenue bonds—the default rate on municipal bonds was just 0.3%. To put this figure in perspective, consider that it is *still* below the overall investment grade corporate default rate (2.1%) and below the Aaa-rated corporate default rate of 0.5%.

Where do municipal bond defaults occur? Typically in the lower-rated (or non-rated!) sections of the market, not in high grade GOs or essential services revenue bonds. While we expect the severe nature of the economic downturn to force some issuers toward default (see our January 2009 presentation, "*Too Big To Fail: The Credit Crisis and its Impact on the Municipal Bond Market*"), municipal bonds are very safe relative to other sectors of the market. What's more, with over 50,000 different issuers and multiple market sectors, it is not helpful to think of "municipal bonds" as one homogenous market. Finally, consider that in America's Great Depression, when the economy contracted by one-third and unemployment rate surged to 25%, only one state defaulted on its GO debt—Arkansas. But the state ultimately paid investors back, 100 cents on the dollar.

In our next *Market Perspectives,* we will address the *theoretical* case of municipal default.

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