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BURKE
FINANCIAL STRATEGIES
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New Jersey Municipal Bonds - The Good, the Bad and the Ugly

For many investors, a "laddered" bond portfolio is an integral component of a balanced, diversified portfolio. A laddered portfolio consists of bonds that mature sequentially and periodically, often in annual increments. Such a portfolio combines longer term, higher yielding bonds, with bonds that will mature sooner. Such shorter term bonds provide liquidity if needed, or the ability to reinvest at higher interest rates in a rising rate environment.

Bonds generally come in two types: corporate bonds that pay taxable interest and municipal bonds that generally pay tax exempt interest. Tax exempt municipal bonds (which may be subject to state, local and alternative minimum tax) are issued by state or municipal governments or agencies. The tax exempt status of municipal bonds allows issuers (borrowers) to offer bonds at interest rates lower than taxable bonds. Investors are rightfully focused on "after-tax" yields. With the highest combined tax rates approaching 50% in some states, municipal governments can issue bonds at significantly lower rates than corporations, and still offer a higher after-tax yield to investors.

Many of our clients own municipal bonds in their taxable accounts. Other than certain municipal bonds that are in fact taxable (i.e. Build America Bonds), these bonds are exempt from federal income tax. If issued by the home/resident state, then these bonds are also exempt from state income tax. This is why we will usually search for New York municipal bonds for New York residents, New Jersey bonds for New Jersey residents, and so on. Unfortunately, the current state of affairs in Trenton, New Jersey has given us pause.

On September 8, 2014, Fitch Ratings, an independent credit rating agency, downgraded the State of New Jersey's General Obligation and related bonds to A (upper medium investment grade). This was the second downgrade this year by Fitch, whose New Jersey rating started the year at AA- (high investment grade). Moody's and S&P also downgraded New Jersey's debt this year. Each of the credit agencies downgraded New Jersey bonds in 2011 as well. New Jersey joins Illinois and California in the bottom tier among the 50 states. With all three rating agencies currently maintaining a negative outlook, it would not be unrealistic to see the rating decline further over the next six to nine months, which could move state supported appropriation debt into the Baa/BBB (lower medium investment grade) category.[1]

Lower bond ratings matter. The obvious concern is an increased risk of default by the issuer. Another reason is that the lower the credit rating, the higher the interest rate New Jersey has to pay on its debt. And New Jersey's debt is a whopping $41.4 billion, behind only New York and California, and ahead of more populous states like Texas, Pennsylvania and Florida.[2] Higher interest payments only exacerbate the less than ideal financial position that prompted the downgrade in the first place. And budget problems can trickle down to municipalities and agencies that count on state aid, potentially putting at risk those issuers' bonds. As a result, many New Jersey municipalities and agencies have also been downgraded, to ratings that are lower than that of the State of New Jersey.

Beyond the impact on state and agency bonds, downgrades portend a decline in the long-term stability of the state, as well as the state's ability to provide for its citizens and employees. The rating agencies have identified what they believe to be a structural imbalance in the state's annual budget. Specific concerns raised by the ratings agencies are:[1]

- continued growth of the state's unfunded pension and retiree health benefit liabilities
- slower than expected revenue growth
- failure to increase the state's liquidity (surplus) position
- the state's growing dependence on "one shot" non-recurring budget solutions
- a state economy that lags the national average in economic growth

Depending upon one's perspective and political persuasion, New Jersey's budget problems can be attributed to various causes. Without choosing sides, it's fair to say that decisions made by prior and current administrations have all contributed in some way to the state's financial condition. Our hyper-partisan political environment will likely limit any structural improvement in the near term.

For all these reasons, we will stay attuned to New Jersey's finances, and on the municipal bonds issued within the state. For clients for whom these investments are suitable, we are not generally recommending the sale of these holdings, but we will remain vigilant. We are also limiting our purchase of additional New Jersey municipals to those that are less affected by the state's financial issues. While state tax deductibility is significant, the potential tax savings would be dwarfed by a prospective default, or even a reduction in market value that would presumably accompany further downgrades.

Sincerely,

Steven Criscuolo, CPA
Financial Advisor

[1] Raymond James Municipal Bond Investor Weekly, September 8, 2014
[2] Why NJ's Bond Rating Was Downgraded, and Why It Matters,
NJSpotlight, www.njspotlight.com/stories/14/05/19/explainer-why-new-jersey-s-bond-rating-was-downgraded-and-why-it-matters/