Municipal Bond Funds: Assessing the Impact

**KEY POINTS**

- This note serves as a broader follow-up to our comments yesterday morning regarding the likely impact of last Tuesday's tragic events on the closed-end municipal bond fund sector. We believe our assessment will evolve as the week progresses.

- It is rather difficult to get back to work and focus on what may seem rather unimportant after the catastrophic and unconscionable events that took place on September 11th, but we have been given the task of assessing the impact that the recent events will have on our sector. With the closing of the stock exchanges for the better part of last week, trading of closed-end funds was halted as well and resumed yesterday at 9:30 a.m. EST. The bond market resumed trading last Thursday and was in positive territory, which may have boosted the NAVs of the funds.

- By all indications, the closed-end municipal bond fund market has held up well in the first day of trading. We believe the overall higher credit quality of the underlying portfolios has attracted investors to the closed-end municipal bond fund sector. While volatility and economic uncertainty continue to weigh on equity markets, we believe this positive trend in the closed-end municipal bond fund sector will continue in the short term. We believe that the longer-term themes for leveraged closed-end municipal funds will continue to be dominated by lower interest rates and investors’ “flight to quality.”

**FLIGHT TO QUALITY**

Initially, we expect that the recent long-term trends in the municipal market will only be magnified by last Tuesday’s events. The closed-end municipal bond fund market has rallied for the better part of 2001 on growing economic concerns and investors’ “flight to quality.” Last Tuesday’s events will only serve to increase investors’ concerns, and municipal bond funds could see this “flight to quality” continue as evidenced by the rally in the Treasury market following the opening of the bond markets last week. A possible negative impact on the municipal bond market, and possibly the fixed income market on the whole, is that as a result of the large claims liability insurance companies will have as a result of the catastrophe, insurance companies may have to liquidate current bond positions or have less to invest going forward.

**FEDERAL RESERVE POLICY**

Owing to last Tuesday’s tragic events, UBS Warburg’s Strategy group believes “even more aggressive and faster easing by the U.S. Fed are considered to be high.” And in fact that is the case, as the Fed has eased another 50 basis points yesterday morning. The leverage costs for closed-end municipal bond funds have been low in recent months and with anticipation they will go lower, earnings seem to be in good shape.

What is more, UBS Warburg’s Economic Group now expects a year-end Federal Fund’s rate of 2.5% versus a pre-September 11 forecast of 3%. Lower interest rates should only serve to further enhance the earnings of leveraged municipal closed-end funds.

**EXPOSURE TO NEW YORK**

We are currently examining closed-end fund portfolios within our coverage universe to assess the impact of last Tuesday’s events on net assets of the funds. We were particularly cautious on funds with exposure to the Port Authority of New York/New Jersey, which owns the World Trade Center complex. The likely impact on those assets has not yet been fully disclosed, but initially we believe their servicing of this debt will not be affected.

In July, the Port Authority leased the World Trade Center to a group of private real estate investors for a term of 99 years. The lease agreement calls for annual lease payments of $100 million. These short-term lease payments are insured against acts of terrorism. What is more, the World Trade Center accounted for less than 5% of the Port Authority’s total annual revenue; the Port Authority’s main source of revenue is generated through tolls. Therefore, we do not see significant risk to funds within our coverage universe owing directly to the Port Authority of New York/New Jersey.

While New York City will incur sizeable one-time expenses owing to the recovery and clean-up, we believe the city will likely receive substantial support from the Federal Government. Congress has already approved $40 billion in aid in addition to aid from FEMA and other government and private agencies. In addition, New York City ended last fiscal year with a roughly $2.5 billion surplus.
Therefore, near-term effects of last Tuesday’s tragedy should not materially impact the City’s ability to meet near-term obligations.

Longer term, New York City may face slowing revenue owing to factors which could include lower tourism revenue, potential relocation of large employers, and possibly depressed commercial real estate values.

However, we do not believe that the recent weakness in New York municipal closed-end funds is justified given the near-term impact of last Tuesday’s events.

**EXPOSURE TO AIRPORTS**

Municipal bond funds within our coverage universe certainly have exposure to Airport Authority municipal bonds. We are currently assessing the impact that the events of September 11th will have on the credit outlook of these issuers. However, our initial reaction is that while prices in the near term may be negatively affected, the likelihood of default is minimal. Airports and air travel are a vital cog in the U.S. economy, and as such, we believe that Federal intervention would take place to fend off any possibility of defaults. Therefore, closed-end fund exposure to this sector should be fairly well insulated from a default perspective, although NAVs may be impacted by near-term skittishness.

**Additional information available upon request.**