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Implications of State and Local Government Financial Stress

While the recession has taken a toll on the entire U.S. economy, it has hit state and local governments especially hard, sparking concerns about their ability to continue providing many programs and services while simultaneously servicing their debt. The financial plight of state and local governments has led to such coverage as:

- Investors fear rising risk of U.S. regional defaults - *Financial Times*, 7/6/10
- Most U.S. states cut jobs as tax collections erode, study says - *Bloomberg*, 7/23/10
- Public pensions put state, cities in crisis - *San Francisco Chronicle*, 7/25/10
- U.S. banks risk 'untold problem' as muni debt swells - *Businessweek*, 7/26/10

Headlines like these are ominous, but there are reasons to believe the situation is not as dire as many fear. First, unlike the federal government, state and local governments are required to balance their budgets at the end of every one or two fiscal years. While this forces tough choices in the short run, it limits their ability to develop long-term debt problems. Second, unlike corporations, state and local governments have a variety of methods that they can employ to balance their budgets. While corporations must service their debt in accordance with their capital structure and can be forced to liquidate their assets, state and local governments can raise taxes or cut programs and services to generate additional revenue and reduce expenses. Finally, state and local governments can sometimes look to the federal government for assistance. In the last two years, municipalities have received considerable support through the American Recovery and Reinvestment Act of 2009 and the issuance of Build America Bonds.

Despite the variety of tools at their disposal, three main questions about state and local government finances continue to concern investors:

- Will state and local cutbacks kill the recovery?
- Will the recession and slow recovery lead to higher default rates on municipal debt?
- Are the financial problems facing state and local governments fundamentally "different this time?"

In this paper, we address each of these questions, as well as other key concerns surrounding municipal finance. Overall, we conclude that while the most recent recession was of unprecedented magnitude and the road to recovery will be difficult, state and local governments will continue to service their debt and eventually contribute to, rather than cripple, the economic recovery.

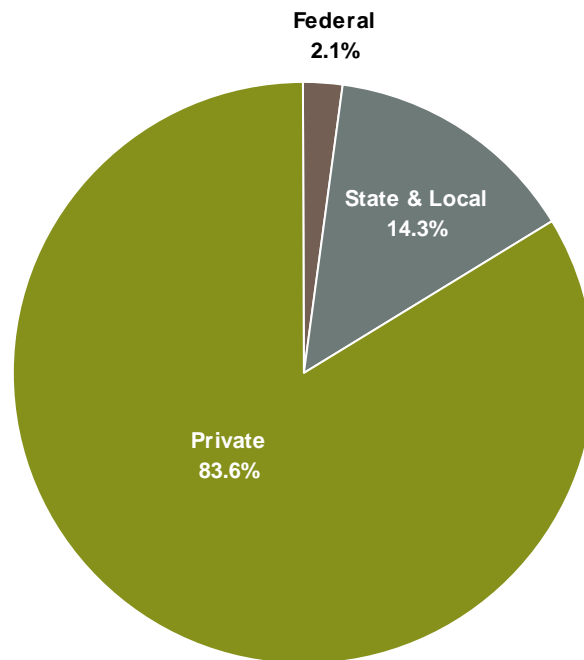


Will public sector cutbacks kill the recovery?

When the recession hit, states faced lower revenues from taxes, forcing them to dip into their “rainy day” funds while simultaneously cutting many of the programs and services that they once provided. The reduced service levels resulted in a decline of the public sector workforce, leading to concerns that these cutbacks might dampen a future recovery. However, as shown in the graph below, state and local governments historically have accounted for only 14.3% of non-farm payrolls¹, so the impact of these workforce reductions on the overall recovery has been significant, but not overwhelming.

National Employment Breakdown

Monthly data, seasonally adjusted, 1970-2009



Source: BLS, J.P. Morgan Asset Management

We have started to see a revival in private sector employment and, since municipalities historically lag the private sector in economic recoveries, the recent uptick in private sector hiring should be a good sign for future public sector employment. While it will take time for improvement to become evident, it appears that the current financial situation of state and local governments is more of a headwind to the economic recovery than a threat to its continuance.

¹ *Employment, Hours, and Earnings from the Current Employment Statistics Survey (National)*. Bureau of Labor Statistics. Seasonally adjusted. Data as of 6/30/10.

Can we expect higher municipal default rates?

When taxes fail to provide sufficient revenue to balance budgets, another course of action must be taken. Most recently, this action has come in the form of cuts to state services and programs, as well as discussion about the possibility of tax hikes if cuts prove to be insufficient. In fact, many people worry that these actions will not be adequate and, as a result, municipalities across the nation will default on their debt.

While the current situation is certainly problematic, only two municipal bond issues rated by Moody's have defaulted so far this year: the Las Vegas Monorail and Lower Bucks Hospital in Bucks County, PA². Although the Las Vegas Monorail project generated \$27.6 million in total revenue in 2009, its operating expenses were \$22.6 million, and the \$5 million of gross revenue was insufficient to fund the \$34.4 million of debt scheduled for repayment that year. Additionally, while \$4.8 million of net revenue is expected in 2010, \$37.4 million in interest and principal is due, and, according to Fitch, the monorail is not expected to generate sufficient revenue to pay off the debt in the future³. The second case of default, Lower Bucks Hospital, defaulted on its debt due to a decrease in patient service revenues because of the recession, along with rising costs⁴.

While both of these defaults were unfortunate, the important point is that the bonds were going to be paid with revenue generated by the project, rather than tax revenue. While it may be possible for some municipal bonds that are serviced with tax revenues to default, these streams of revenue are much more predictable. Defaults this year have generally involved bonds for which the issuer planned to make payments based on revenue streams and, therefore, were dependent on the success of the project.

Additionally, as evidenced in the charts below and on the following page, the number of defaults over the past three years, as well as the average cumulative defaults for municipal bonds, have both been quite low, especially when compared to corporate bonds.

Corporate vs. Municipal Defaults: 2007-2009

Year	Number of Corporate Defaults	Number of Municipal Defaults
2007	18	2
2008	102	5
2009	261	2

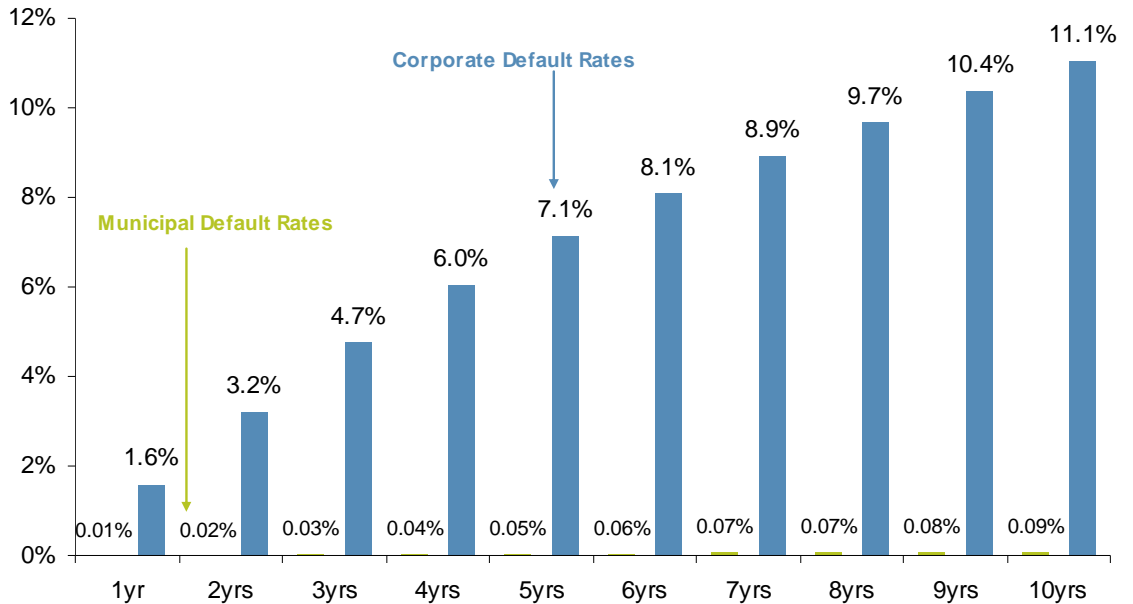
Source: Moody's, J.P. Morgan Asset Management

² Moody's, 7/27/10.

³ Seymour, Dan. *Las Vegas Monorail Is a Mess*. http://www.bondbuyer.com/issues/119_252/las-vegas-monorail-problems-1005715-1.html. 1/6/10.

⁴ Lower Bucks Hospital Bankruptcy Affidavit. http://media.philly.com/documents/Lower_Bucks_affidavitpdf.pdf. United States Bankruptcy Court for the Eastern District of Pennsylvania. 1/13/10.

Average Cumulative Default Rates by Number of Years Since Issuance
Municipal bonds vs. Corporate bonds, 1970-2009



Source: Moody's, J.P. Morgan Asset Management.

It is also important to note that the logistics associated with a municipal default are difficult. While a corporation can default and its assets can be liquidated to compensate investors, cities and states cannot just disappear: their governments would almost always rather find a way to service the debt than be forced to liquidate a portion of their assets.

Nevertheless, there have been instances of municipalities filing for Chapter 9. One famous example is Orange County, CA, which, as a result of a bad bet on the direction of interest rates, defaulted on its debt in 1994. Even in this case, however, investors recovered 100% of their principal and Orange County exited bankruptcy in less than two years, reestablishing its investment-grade rating in under three years⁵.

Interestingly, when the rare option of default is taken, investors have historically recovered the majority of their initial investment. From 1970 to 2009, the average price of a municipal bond 30 days after going into default has been almost 60 cents on the dollar, compared to a mere 37.5 cents on the dollar for corporate bonds. While not all defaults see a full recovery in principal, over the 1970 to 2009 period, the average ultimate recovery for municipal bonds was 67 cents on the dollar (median: 85 cents), while the average ultimate recovery for corporate debt ranged from 16 cents to 64 cents on the dollar, depending on where the debt lay within the company's capital structure⁶.

⁵ Wells Fargo Fixed Income. *Keeping Municipal Default Risk in Perspective*. Wells Fargo Funds Management. 3/31/10.

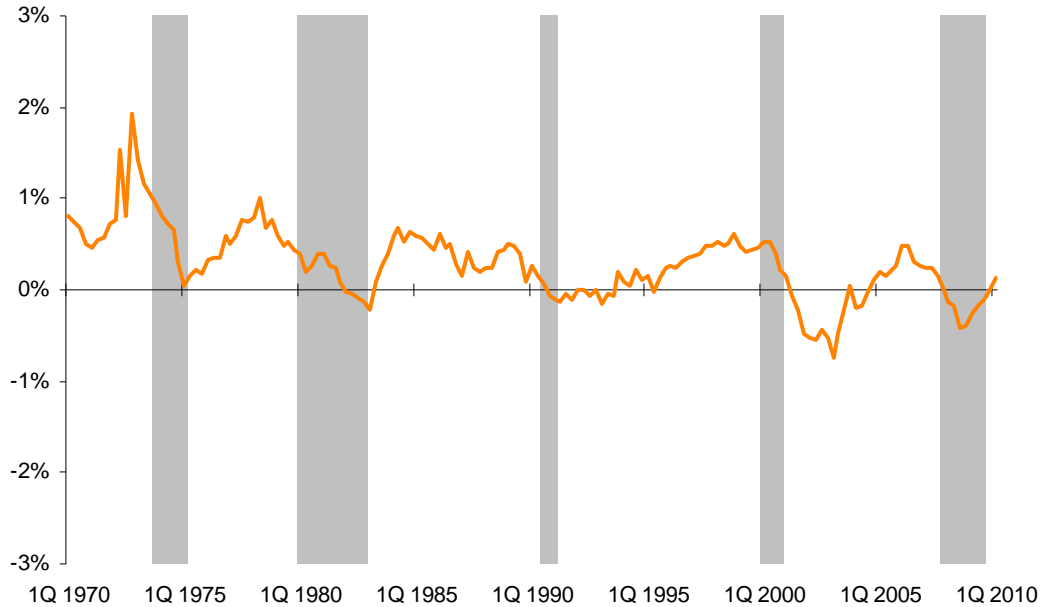
⁶ Tennant, Jennifer, Emery, Kenneth, Van Pragh, Anne, and Sussman, Gail. Special Comment: *U.S. Municipal Bond Defaults and Recoveries, 1970-2009*. Moody's Investors Service. 2/10; in Wells Fargo Fixed Income. *Keeping Municipal Default Risk in Perspective*. Wells Fargo Funds Management. 3/31/10.

In general, however, municipalities try to avoid bankruptcy at all costs, acknowledging their need for continued funding and the negative impact that default would have on the cost of selling their debt in the future. Thus, while recovery will not be immediate and likely will be painful, fears about widespread municipal default do not appear to be warranted at this time.

Is it different this time?

Given the unprecedented nature of the financial crisis, which triggered the most recent recession, many people wonder if this recovery will be different. During past recessions, state and local governments have, to a limited extent, allowed spending to grow faster than revenues. The graph below shows current receipts less current expenditures for state and local governments as a percent of gross domestic product (GDP), on a quarterly basis since 1970, with recessions highlighted by the gray shaded areas.

State and Local Government Surplus
Recessions are shown by gray bars



Source: BEA, J.P. Morgan Asset Management.

As the graph above illustrates, state and local surpluses decline during recessions, yet they also account for a very small percentage of GDP. This trend remained evident during the most recent recession; however, it has since reversed, with state revenues rising slowly and deficits beginning to moderate beginning early in 2009⁷, despite a continued expansion in expenditures. Perhaps the most important aspect of municipal finance is what hasn't changed—

⁷ NIPA Table 3.3, State and Local Government Receipts and Expenditures. Bureau of Economic Analysis. Data as of 6/25/10.

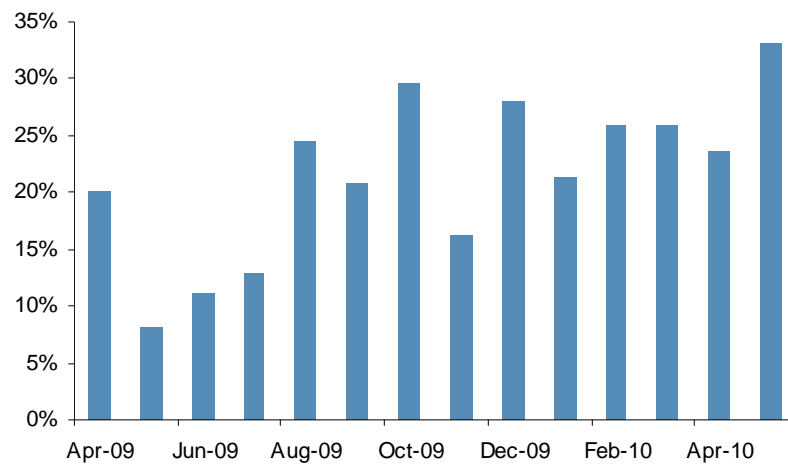
state and local governments are required to balance their budgets. While accounting issues may lead to small deficits in tough times, generally the swings in state and local deficits shouldn't have much impact on national economic growth.

While the macroeconomic behavior of state and local governments in the recession has not been unusual, the impact of the federal government on states and localities has been different.

The American Recovery and Reinvestment Act (ARRA), which was signed into law in February of 2009, allocated \$787 billion of federal funds to help jump-start the economy. Since its enactment, state and local governments have been awarded over \$201 billion and received over \$61 billion of this funding⁸. In conjunction with a \$75 billion cut in general spending over the past two years, this federal funding has allowed state and local governments to offset large declines in tax revenues and come closer to balancing their budgets. In addition, as of June 2010, there was still \$47 billion of unspent discretionary aid, suggesting that state and local governments may actually be in better shape than many people believe⁹.

ARRA also created Build America Bonds, which were designed to provide state and local issuers with a 35% subsidy on interest costs from the U.S. government if they sell the bonds on a taxable basis, providing cheaper financing than otherwise would be available using the traditional tax-exempt market. The first graph below shows that Build America Bonds have accounted for up to a third of overall municipal bond issuance each month, and 21% of overall municipal bond issuance, since their inception¹⁰. The second graph, on the following page, highlights the growth of the municipal bond market due to an increase in taxable bond issues, especially Build America Bonds, coming to the market.

Build America Bond Issuance as a Percent of the Total Municipal Bond Market



Source: U.S. Treasury, J.P. Morgan Asset Management.

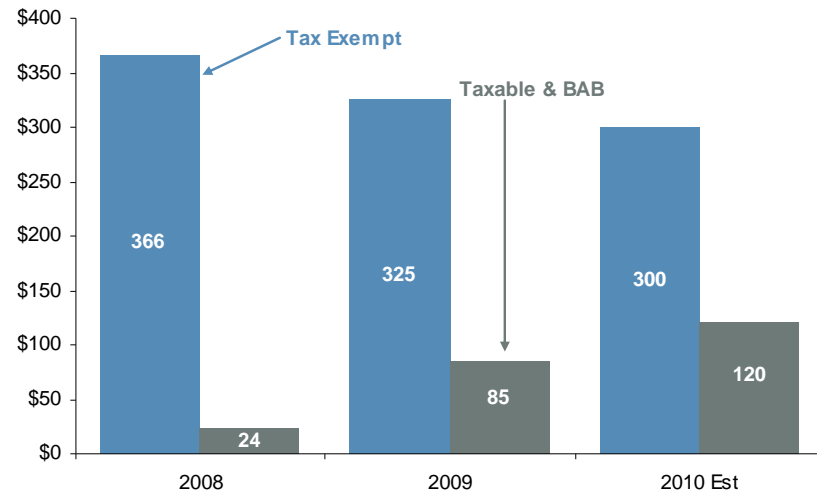
⁸ Recovery.gov. 7/2010.

⁹ Clifton, Daniel and Karasmeighan, Elizabeth. *State(s) of Confusion: Dispelling the Myths About State & Local Government Finances*. Strategas Research Partners. Policy Outlook. 6/22/10.

¹⁰ TG-733 – Treasury Releases New Build America Bonds Data: Table 1. US Treasury Department. <http://www.ustreas.gov/press/releases/tg733.htm>. 6/02/10.

The Taxable Municipal Bond Market is Growing

New supply (billions USD), taxable issuance includes BABs



Source: J.P. Morgan Securities, J.P. Morgan Asset Management

At the end of the first quarter of 2010, approximately \$90 billion of Build America Bonds had been issued, with the Treasury estimating that the program saved state and local governments approximately \$12 billion¹¹, or 4% of their first-quarter tax revenue¹², relative to what they would have paid in interest on tax-exempt issues. Since these are taxable bonds, they have seen increased demand from overseas parties, as there is no longer a tax advantage that applies only to U.S. residents who purchase the securities.

The future of Build America Bonds is now in question, as an attempt to extend the program for another two years did not pass the Senate in June. This may hurt the recovery, since the sale of these bonds allowed state and local governments to obtain cheaper financing for public works projects and create jobs, giving residents more money to spend and indirectly generating tax revenue. Although the program is set to expire at the end of 2010 and renewal remains in question, there is still time for state and local governments to benefit from these bonds and provide additional stimulus to their economies through the end of the year.

A final topic that warrants consideration is state pension plans. Approximately 40 states have “non-impairment” clauses that guarantee pension distributions regardless of a government’s fiscal state¹³. However, as state and local government finances deteriorated, they deferred some payments to their pension funds. While this was done in the past without incident, the current drop in revenue has made it more difficult for state and local governments to continue

¹¹ Treasury Analysis of Build America Bonds and Issuer Net Borrowing Costs. US Treasury Department. 4/2/10.

¹² Calculated from NIPA Table 3.3, State and Local Government Receipts and Expenditures. Bureau of Economic Analysis. Data as of 6/25/10.

¹³ Mattoon, Richard H. *Issues facing state and local government pensions*. Economic Perspectives. The Federal Reserve Bank of Chicago, 3Q2007.

contributing to their pension funds and puts their ability to make future distributions in question. Although pension plans can be restructured for future recipients, it is not possible to do so for existing ones, which forces governments to find other ways to make the required distributions¹⁴.

While we anticipate that revenue streams will strengthen and state and local governments will be able to direct more funding toward their pension funds in the future, the most recent recession has highlighted the fact that the current pension model may be unsustainable. Some states have recognized issues with their current pension funding methods and have chosen to employ a variety of reforms to address these problems. In February, the Pew Center on the States released a paper on state and local pension plans that suggested five ways to improve the current pension funding system and cited specific examples of states that had successfully implemented these new standards in recent years. The first reform would require states to pay the full amount required to fund their pension funds each year. While difficult to do when the budget is under financial stress, Connecticut successfully issued a \$2 billion bond to fund its teachers' pension system in 2008 and 2009, with the requirement that the state fully fund the pension as long as the bonds were outstanding. In addition, states such as Kentucky, Nevada, New York and Texas have either reduced benefits for new employees or raised the minimum retirement age. As of January, Nevada began calculating annual pension benefits using a new formula, decreasing the "multiplier" used to determine the percentage of a worker's final salary that would be replaced by pension benefits. Other suggested pension reforms include sharing investment risk with employees (Wisconsin - 2009), increasing employee contributions (Nebraska - 2009) and improving governance and oversight (Illinois - 2009)¹⁵. Not all of these reforms have resulted in decreased benefits to retirees, but all do improve the way pension systems are funded and, in some cases, how they are distributed.

While the pension problem will continue to complicate the financial position of state and local governments, particularly given the still very depressed national economy, it seems probable that states will be able to continue to make their required pension distributions, avoid serious and long-lasting fiscal damage and, hopefully, adopt more sustainable practices for funding pensions in the future.

Conclusion

While great uncertainty remains about the fiscal outlook for state and local governments, there are some hopeful signs. A moderate national economic recovery is now entering its second year, with retail sales beginning to recover from their recession lows, average home prices and the real estate market beginning to stabilize, and tax revenues, specifically at the state and local level, steadily increasing for the past year.

Although some states are clearly in better financial shape than others, all should benefit from an improving national economy, while still taking advantage of emergency programs

¹⁴ Ibid.

¹⁵ *The Trillion Dollar Gap*. The Pew Center on the States.
http://downloads.pewcenteronthestates.org/The_Trillion_Dollar_Gap_final.pdf. 2/2010.

established by the federal government. In addition, the need for state and local governments to balance their budgets every one or two years, while requiring very tough decisions in the short run, leaves them well positioned to benefit from a rebound. Overall, state and local government financial stress, while contributing to current economic and market concerns, does not look intense enough either to derail an economic recovery or inflict significant damage on the majority of investors in municipal bonds.

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