by John J. Haas
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The bond (credit) markets – a good time to borrow

As Judy Garland immortalized in the movie *The Wizard of Oz*, “There is nowhere like home!” While the national credit or bond markets continue to seize up due to the credit crunch created by sub-standard lending practices by mortgage companies and other lending institutions, the Kansas bond market continues to do well. If you are a creditworthy Kansas public entity there is money available to be borrowed. This is because as a collective group, Kansans generally don’t go for anything too exotic (put bonds, auction rate bonds, etc.) and Kansans are, for the most part, fiscally conservative. In my 20 years of experience as a financial advisor in Kansas, I am only aware of two instances of a municipality not making good on its debt payments. One needed our help; the other should have known better.

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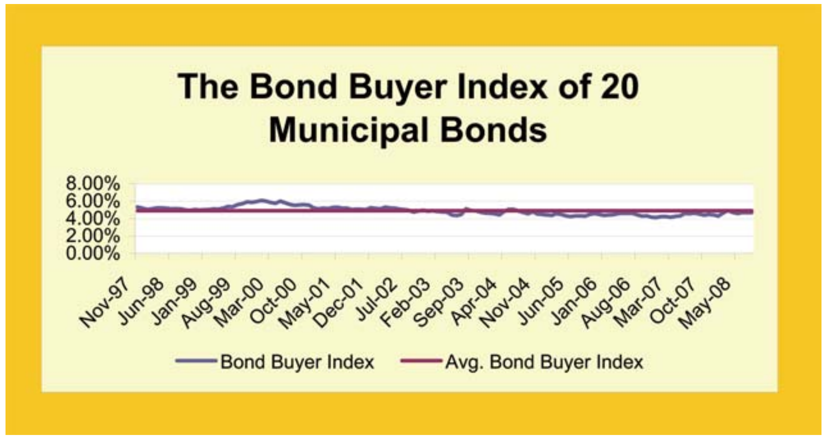
As you may remember the credit crunch was officially recognized in August 2007. The problem with the credit markets has not been interest rates. In August 2008 the Bond Buyer Index of 20 Municipal Bonds (the Index) was at 4.69 percent. Just as a reminder, the Bond Buyer Index of 20 Municipal Bonds is an index of 20 general obligation bonds that are traded in the national market. For August 2007 the Index was 4.67 percent. It doesn’t seem to have moved much (see chart above). However, if you could see the intervening period the Index was down to 4.27 percent in January 2008 and all the way up to 4.93 percent in March 2008; that’s quite a swing for a three-month period. This gyration was due to the Federal Reserve Bank moving around interest rates while trying to figure out how to solve the credit crunch and flight in and out of the municipal bond market. The good news: the Kansas bond market is still in good shape. Plus, at the time this article was written, the Index was still below its average since November 1997 of 4.89 percent. Therefore, it is still a good period to borrow money. The bad news: I do not believe the Federal Reserve Board has figured out how to solve the credit crunch.



Entity	Loss	Entity	Loss
Citigroup	$40.7 billion	Deutsche Bank	$ 7.5 billion
UBS	$38.0 billion	Wachovia	$ 7.3 billion
HSBC	$15.6 billion	Credit Agricole:	$ 6.6 billion
Bank of America	$14.9 billion	Credit Suisse:	$ 6.3 billion
Morgan Stanley	$12.6 billion	Mizuho Financial	$ 5.5 billion
Royal Bank of Scotland	$12.0 billion	Bear Sterns	$ 3.2 billion
JP Morgan Chase	$ 9.7 billion	Barclays	$ 3.2 billion
Washington Mutual	$ 8.3 billion		

No more “no credit” loans

The problem with the credit crunch has been that borrowing institutions nationally have moved from “no credit – no problem” to lending to only the most credit-worthy borrowers; which includes Kansas municipalities. As Will Rogers once said, “I am more interested in return of principal rather than return on principal.” Credit standards needed to be tightened up. But of course the credit markets have over-reacted which has caused other problems. The table shows a scorecard of losses to financial institutions essentially caused by the sub-prime crisis. It was picked up from an article written by BBC News entitled “HSBC in new sub-prime write down”, May 12, 2008.

The losses total more than $191 billion dollars! (See chart on previous page.) These folks are not going to get a return of capital. Of course the big news as of the date of my writing this article is the U.S. Government’s takeover of the mortgage giants Fannie Mae and Freddie Mac. Hold on to your back billfold – here we go again! Remember that a consortium of U.S. banks backed by the U.S. Government announced in October 2007 a “super” fund of $100 billion to purchase mortgage backed securities. In March 2008 Bear Sterns was acquired by JP Morgan Chase to avoid bankruptcy. Of course this acquisition is secured by $30 billion by the Federal Reserve (which is still the public’s money!) to cover possible losses.

On September 8, 2008, it was disclosed that combined, Fannie and Freddie own or guarantee $5.3 trillion-worth of mortgages – nearly half of the U.S. mortgage market. Maybe $191 billion dollars isn’t all that much? The Dow Jones Industrial Average gained 289.78 points or 2.58 percent on September 8, 2008 to close at 11,510.74. The markets liked it. However, looking over the long term, the lack of credit quality created this mess. When will foreign buyers stop acquiring U.S. Government debt due to credit quality issues? I believe this is why Fannie and Freddie were acquired by the U.S. Government. It has always been implied that debt issued by Fannie and Freddie was an obligation of the U.S. Government. The majority of the mortgages purchased or secured by both Freddie and Fannie were secured by the selling of bonds. If this debt would have been allowed to default a general dumping of other U.S. Government securities may have started – which would have redefined the word catastrophic.

Not since the Great Depression have the financial markets been put in such a perilous situation. There is hope because there are people much smarter than me who are in charge of fixing this mess. Like the Great Depression, it will just take some time for this quagmire to be worked out. In the

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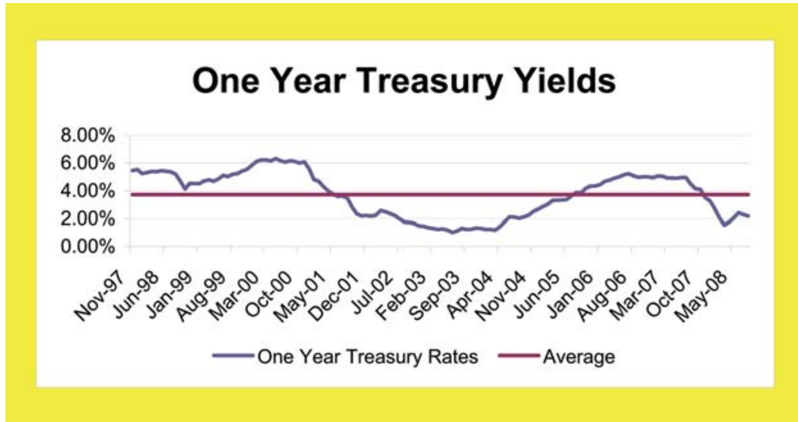
Everyone in business is looking for an end of the credit crunch. The credit crunch may end soon, but the major cause of it will not work its way through the system until 2010. This is when the rates adjust for sub-prime loans made in 2007. The good news is that most Kansans have escaped it. If you happen to be interested in the Great Depression you might want to pick up a book entitled the "Forgotten Man." The book was recently written by a professor of economics. The book is about government intervention in the financial markets during the Great Depression. It definitely didn't take the perspective that I thought it would. It is highly recommended that you read the book and see if you agree with it or not.

Financial crisis as of September 30, 2008

On Monday September 29, 2008 the U.S. Congress voted down a "bail-out" of the corporations and individuals involved in the creation of the mortgage crisis. The President and his staff plus congressional leaders from both parties supported the "bail-out" to prevent the "Armageddon" of the American financial system. At the time the vote was initiated the Dow Jones Industrial Average was down 250 points. At the end of the day it closed down 777 points. Leadership indicated that this loss was an indication of the beginning of the end. The "bail-out" was defeated because the American public made its elected representatives very much aware that they were against it. Only one of the House Members from Kansas supported the measure.

By the way, the Dow Jones Industrial Average closed up more than 485 points the next day, September 30. Does this mean we are out of the woods? No, it is hard to say whether or not the market was up because the government didn't do anything or because the government will try to do something later. This may sound silly, but things are getting better if interest rates continue to go up for U.S. Government securities, as they did on October 1, for an average of 25 basis points. This means that individuals and businesses are no longer flying to safety and are willing to take on more risk. However, if foreign governments start dumping securities or if our government starts borrowing more money interest rates will go up, too. For now, I think interest rates will increase, but it deserves watching.



Does this mean nothing needs to be done? No, there is much to be done. As much as most people would like to punish those who created this mess, government action is needed to prevent the credit system from seizing up. As my grandmother always said, "We cannot throw the baby out with the bath water." Seizing up means that good companies that need to borrow money to fund operations and capital improvements do not have the ability to do so. Everything else is spurious. However, to get past the problem stage, some of the "bad guys" may benefit from the governmental actions to do so. What I would like to see is a government program to guarantee new loans for business and individuals with "old time" credit standards – like monthly income and down payments.

Borrowing v. investing

Kansas municipalities presently borrowing money have good news. However, investing money is a real challenge. Currently, the yield on the one-year Treasury bond (the rate many certificates of deposit are based on) is 2.18 percent. In August 2007 the yield was 4.47 percent (see chart above). The borrowing rate didn't change much, but the investing rate took a dive. The average one-year Treasury bond rate since November 1997 to August 2008 is 3.72 percent. Historically, investment and borrowing rates for tax-exempt borrowers have been about the same. Again, the credit crunch can be blamed for much of this spread. There definitely continues to be an emphasis on liquidity and safety in the financial markets.

The Kansas Public Water Loan Fund

If a city or RWD is seeking financing for a water system project, the Kansas Public Water Supply Loan Fund is a good option. The interest rate is in the range of 3.75 percent. Since inception in 1997, the average interest rate for the Revolving Loan Fund was 3.92 percent. Its all time high was 4.80 percent in March 2000; the all time low was 3.30 percent in April 2007 (see chart at right). The loan fund is available to all Kansas municipalities for those projects that qualify. It has a 20-year amortization and only a one percent loan origination fee. Without a doubt the Public Water Supply Loan Fund is the least expensive way to finance water projects in Kansas (remember the Index for general obligation bonds is currently 4.69 percent; plus there would be fees). The annual savings of using the Loan Fund versus general obligation bonds would be about $6,200 a year per million borrowed or $124,000 over the 20-year life of the borrowing. Rose Mary Saunders and I are available to assist cities or RWDs with the loan application. There is no fee for our assistance. Please give us a call at 316-264-3400 if you have any questions. Or, you may also contact KRWA for referral.