DIVER By Lumesis

High Yield Bonds and State and Local Government Finances

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What do high yield bond funds and State and local government finances have to do with one another? This is not a trick question nor one which I had given much thought until this weekend. A chance conversation over a beer and then reading Alan Abelson's article, "High Yield, High Risk", Barron's August 20, 2012, brought the question into focus (did my bar mate have an advanced copy?).

While the article speaks of a coming (or already existent) bubble in junk bonds and extensively cites a recent commentary by Stephanie Pomboy of MacroMavens, the focus on the impact of this bubble bursting caught my attention.

> The very folks driving the bubble's inflation – those most desperate for yield – pension funds, insurance companies and retail investors, will be hit the hardest. Id., citing, Pomboy.

The Pew Center's know familiar report is referenced putting the actuarially accrued liability of State and local governments unfunded pension liability at $766 billion. It then points out, based on Pomboy's report, **the $766 billion jumps to $2.2 trillion if one were to ascribe a more realistic rate of return of 5.5% v. an average 8%**.

The article goes on to point out that, given the extent of the unfunded liabilities and fiscal stress, absent reductions in future pension obligations (unions and their members agreeing to changes), "spending will have to be cut [further in many cases] and/or taxes raised to make the necessary pension contributions." Id. So far, somewhat familiar consequences. In fact, you can argue nothing new, this is what is going on today.

Here's the "aha" moment (at least for me):

> Imagine, [Pomboy] asks, what the drag will be when the bubble pops and the pension funds go from earning 5% to 6% returns to losing 10% to 20%. Id.

Given pension funds generally do not provide a list of their investments that are "high yield", we took an unscientific sampling looking at Corporate Bonds (v. Cash, Short Term and Federal Government Investments) using 2010 data from the US Census Bureau. Before looking at a few States, it is important to note that $43 billion has been invested in high yield this year. In context, that is 130% more than the existing full year record. Id.

	Corporate Bonds	Cash, Short-Term Investments	Fed. Gov't Investments
US Average	15.88%	3.91%	8.61%
California	19.33%	3.96%	4.32%
Illinois	16.18%	4.13%	7.69%
Texas	8.61%	7.12%	16.00%
New York	9.99%	3.08%	14.30%
Florida	13.33%	5.04%	12.20%
Michigan	17.45%	1.07%	1.52%

Source: DIVER by Lumesis, US Census Bureau.

Given the heightened sense of scrutiny regarding pension funds, funded ratios, assumed rates of return and the like, this is another factor worth seriously considering if Ms. Pomroy's junk bond bubble hypothesis resonates with you. In Abelson's words, she is "a keen-eyed bubble spotter from way back."

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