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www.noyescapital.com
973-267-8120

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Why You Should Avoid NJ Municipal Bonds

By Scott P. Noyes, CFA® CFP®

The State of New Jersey faces a deficit of as much as $8 billion for the fiscal year beginning July 1, 2009. Many NJ municipalities face similar problems. Christie, the new Governor, has said he'll seek as much as $6 billion in spending curbs to close the gap. We wish him good luck.

Due to the decline in property values and loss of income tax revenues, municipal bond ratings for New Jersey towns are being reduced at a faster rate than any other state in the nation, according to Bloomberg news. In early December, Moody's downgraded some debt issued by Woodbridge Township, the state's sixth-largest municipality from Aa3 to A1. The rating for a new Irvington bond was lowered from Baa3 to Ba1, a notch below investment grade. Cities across the state are facing looming budget shortfalls, service cuts and staff layoffs. Pension liabilities are a growing problem. The good times are over for NJ municipalities.

I expect further downgrades after the various municipal entities report their financial budgets for 2010. Typically, NJ municipalities have a July to June fiscal cycle but prepare the year-end report and budget about six months later. Expect service cuts, personnel reductions and tax increases to be proposed in the 1st quarter of 2010. Downgrading the municipal bond ratings for some NJ cities and towns are likely to follow in the March to June time frame. This typically results in a decline in principal value for the downgraded bond and related issues.

As a portfolio manager, I have sold off many NJ municipal bonds and NJ bond funds and replaced them with national bond funds, individual bonds of safer states or taxable securities. In particular I like two funds: American Fund Tax Exempt Bond fund in an F-2 share class (TEAFX) and the Baird Intermediate Municipal Bond Fund (BMBIX) which has a large component of high quality bonds. I prefer to spread out my bond risk across the country rather than have all of the exposure in one state.

What is this strategy costing my clients? Not much. Given the low level of interest rates, the value of the NJ bond interest exemption is lower than in periods of higher rates. In my judgment, when comparing the cost of higher NJ taxes versus the potential value of greater principal protection, moving out of NJ bonds appears to be an easy decision. The price of improved principal safety is low. Once this risk of downgrades has been better priced into the market, I would consider moving back into NJ bonds and bond funds.

In my judgment, municipal bond credit downgrades are one of the biggest investor risks for 2010. This same logic applies to all the fiscally impaired states including New Jersey, New York, Illinois and California. Until municipal governments are able to find solutions to their budget problems, their credit ratings and bond values will be suspect.

Scott P. Noyes, CFA®, CFP® is the President of Noyes Capital Management, LLC, an independent fee-only wealth management firm based in New Vernon, New Jersey. www.noyescapital.com.
