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Technology

Whitney Municipal-Bond Apocalypse Short on Specifics

Max Abelson and Michael McDonald
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“There’s not a doubt in my mind that you will see a spate of municipal-bond defaults,” the banking analyst Meredith Whitney, nodding her head, said on a Dec. 19 segment of CBS Corp.’s “60 Minutes.”

“How many is a spate?” correspondent Steve Kroft asked.

“You could see 50 sizable defaults, 50 to 100 sizable defaults, more,” said Whitney, 41, who made her name covering bank stocks. “This will amount to hundreds of billions of dollars’ worth of defaults.”

Those two sentences set off a month of fireworks. California Treasurer Bill Lockyer called the prediction “apocalyptic arm-waving,” the National League of Cities’ research director cited her “stunning lack of understanding,” and Pacific Investment Management Co.’s Bill Gross, who runs the world’s biggest bond fund, simply said he doesn’t subscribe to the “theory.”

Whitney doesn't have specific numbers backing up her now-famous prediction, she said in a Jan. 30 interview. "Quantifying is a guesstimate at this point," she said. "I was giving an approximation of a magnitude that will bear out to be correct."

Meanwhile, investors pulled about $4 billion from municipal-bond mutual funds in the week ended Jan. 19, the most since Lipper US Fund Flows started compiling the data in 1992. The withdrawals marked the 10th-straight week of net redemptions, totaling $20.6 billion, according to Denver-based Lipper. Returns on municipal securities fell the most in 16 years in the 2010 fourth quarter, according to a Merrill Lynch Municipal Master Index. The cost for AAA-rated issuers to borrow for 30 years climbed by almost a third, to 5.09 percent on Jan. 17, from 3.85 percent Nov. 1.

'Terrified Clients'

"The Whitney virus can be seen replacing the bird flu virus," David Kotok, chief investment officer at Cumberland Advisors Inc. in Vineland, New Jersey, said in a Jan. 20 telephone interview. The firm manages more than $1.5 billion. "We've got terrified clients who call constantly and want reassurance because Meredith said there's going to be hundreds of billions of dollars of defaults."

The "60 Minutes" segment said Whitney and her colleagues spent "two years and thousands of man hours" researching the fiscal condition of the 15 largest states. On Sept. 28, Meredith Whitney Advisory Group LLC, the New York-based firm she started after becoming famous for correctly predicting Citigroup Inc.'s 2008 dividend cut, produced a report for clients called "Tragedy of the Commons." The company, which charges at least $100,000 a year for its research, declined to provide a copy to Bloomberg News in September.

Report Doesn't Mention

A copy of the 43-page report obtained since then doesn't mention sizable defaults amounting to hundreds of billions of dollars. A person who has seen a long addendum that profiles the 15 top states said that the longer portion doesn't, either.

"We are not calling for any specific defaults within the scope of this report," the document says on page 42. An opening summary says there will "invariably" be local defaults, without elaborating.

"A lot of this is, You know it, but can you prove it?" Whitney said Jan. 30 over a breakfast of scrambled egg whites with a chicken-apple sausage, a side of salsa and peppermint tea at the Four Seasons Hotel in Midtown Manhattan. "There are fifth-derivative dimensions that I don't think I need to spell out to my clients," she said.

Whitney, who was a contributor on Fox News from 2003 to 2007, has become a media luminary. The Sept. 28 report was greeted with a Fortune magazine interview that called her "the superstar analyst." An appearance on CNBC that day called the work "a very, very sophisticated and smart report."

Bailouts Under Way

On Nov. 3, Whitney wrote a Wall Street Journal article saying state bailouts had already begun, because Build America Bonds were "subsidized by the federal government." Under the Build America program, part of President Barack Obama's economic-stimulus measure in 2009, the government covers 35 percent of the issuer's interest costs. Two weeks later, in a video interview with the Financial Times, she said defaults would spark "panic in the muni markets."

The "60 Minutes" program that included Whitney was the third-most watched show of the week, reaching more than 18 million viewers, according to Nielsen Co. ratings. After the appearance, on CNBC Dec. 21, Whitney warned of indiscriminate selling. "It's going to look like Europe in terms of when programs that are cut," she said then, using the phrase "social unrest" twice.

Doesn't Recollect

At the Four Seasons, she said she didn't remember using the word "panic," and that the phrase "social unrest" now "seems very loaded" because of the unrest sweeping Egypt. "I don't think regrets do you much good," she said when asked if she regretted the terminology.

Between the Wall Street Journal article and the Financial Times video, Whitney had a Nov. 10 meeting with U.S. Securities and Exchange Commission Chairman Mary Schapiro to discuss her company's application to become a nationally recognized statistical rating organization, which would let her compete with Standard & Poor's and Moody's Investors Service.

She said Jan. 30 she plans to build a ratings service for which she'll hire "hundreds of people" for municipal securities. She would also rate corporate debt and structured products, she said, adding that her business model would be a hybrid that includes fees paid by issuers.

Lack of Credibility

Among key points at the SEC meeting, according to a regulatory filing, was that the "construct of rating agencies has little to no credibility, is not trusted, and ineffective." Asked Jan. 30 what improved credibility she could bring to ratings, she said she has "an untarnished track record."

Bloomberg News reported in October that about two-thirds of her stock picks since starting her company in 2009 had fared worse than market indexes. Visa Inc. fell 14 percent after she called it her "single best buy," and Capital One Financial Corp. tripled after she urged clients to sell.

"Those are not fundamental calls," she said in the Jan. 30 interview. "You want to play, let's play," she said, handing over documents dated from 2001 to 2009, on topics from Goldman Sachs Group Inc. to consumer spending. Following a discussion of the highlights of the documents, she said, "I never give myself credit."

A 2008 Fortune cover story ranked Whitney 1,205th out of 1,919 equity analysts the previous year, based on stock picking. The magazine said that "evaluating Whitney solely on the timing of her buys and sells misses the point," because her arguments are interesting.

Earlier Experience

A graduate of Brown University in Providence, Rhode Island, Whitney previously worked as an analyst for Wachovia Corp. and Oppenheimer & Co. Just as Whitney wasn't the first bank analyst to take a contrarian position on Citigroup, which came two weeks after a "sell" recommendation from Michael Mayo, then a Deutsche Bank AG analyst, there have been warnings about state and local government finances for years. Richard Ravitch, then New York's lieutenant governor, cautioned about "cracks in the municipal-bond market" in 2009.

Whitney, as a former Fox commentator, has a media presence that Ravitch and Mayo don't, and it goes beyond mere visibility. "This is why I write op-ed pieces, why I go beyond servicing my clients to provide solutions. It's to be a good American," she told New York magazine in 2009.

Refined a Wrestler

Her husband, John Layfield, was a World Wrestling Entertainment Inc. star modeled on the J.R. Ewing character in the "Dallas" television series. They met when both appeared on a Fox

Television broadcast, the New York Times said in a story about their 2005 wedding. He told the Times then that she'd "refined" him.

Another New York Times story, about a Halloween event at Whitney's company, described the chief executive as dressed to resemble Paris Hilton, the socialite. Discussing her media appearances, Whitney said that occasional television broadcasts can be the "equivalent of copyright," a way to keep others from mimicking her work. "I kept looking behind my back: They weren't, no copying."

Still, other analysts appear on television and don't get magazine covers. Whitney said what sets her apart is "high conviction, because I've done the work," and a desire to "empower" others.

Whitney's predictions came at an inopportune time for the market, according to George Friedlander, Citigroup's municipal strategist in New York. In November, the Federal Reserve started buying U.S. government debt under its quantitative easing policy, boosting Treasury yields, Friedlander said. Other forces affecting the market as the year drew to a close were the threat of higher levies in 2011 from the alternative minimum tax and a rush to sell federally subsidized debt before a year-end deadline, he said.

Build America Sales

The Build America Bonds program, which generated sales of $187 billion of securities, was coming to an end. The rush by state and local governments to issue the taxable securities siphoned away demand for traditional tax-exempt debt, depressing prices. Mutual-fund managers have been forced to unload securities to redeem shares for individual investors who want out, Friedlander said.

"The professionals on the Street kept saying, 'These default numbers make no sense,' and investors are saying, 'All right, if you are correct, why is my portfolio down?'" Friedlander said by telephone on Jan. 21. "The belief in this thesis of imminent mass default was dramatically increased by the fact that munis were falling."

Short Interest Gains

Short interest, or bets on price declines, in Pimco's Municipal Income Fund III jumped more than fivefold from the end of October to Dec. 31. In the same period, short interest in SPDR Nuveen Barclays Capital Municipal Bond exchange-traded fund climbed almost fivefold from Oct.

29 to Dec. 15. In a short sale, speculators sell borrowed securities with the hope of profiting by buying them back later at a lower price.

Investors also boosted bets in the credit-default swap market. The contracts provide insurance against an issuer's failure to pay its debts. They can also be used as a way to speculate on an issuer's credit quality. The net notional amount of contracts in a basket of municipal CDS reached a record $4.2 billion last month, according to a report from Markit Group Ltd.

Whitney's report from Sept. 28 rates California, New Jersey, Illinois, Ohio and Michigan "Negative," out of the 15 states it examined. Three are given "Neutral/Negative Bias," three "Neutral," and two get "Neutral/Positive Bias" grades. Texas and Virginia are marked "Positive." Her thesis is that struggling states will cut aid to their local governments. "It has to happen," she said on Sept. 28.

Trickle Down

A trickle-down problem, when states encounter fiscal difficulties and cut local aid, doesn't necessarily mean city and town governments will default, said Christopher Hoene, research director at the nonprofit National League of Cities in Washington. "It sounded good on television," he said.

Municipalities rarely fail to make their principal and interest payments to investors, according to Moody's, which counted 54 bond defaults over a 39-year period in a report last year on securities it rates. More than three-quarters, 42, were standalone housing and health-care projects, while just three involved general-obligation debt, Moody's said.

There were $2.7 billion of municipal defaults last year, including unrated debt, according to Richard Lehmann, the Miami Lakes, Florida-based publisher of Distressed Debt Securities newsletter. That was down from a record $8.5 billion in 2008.

Fitch Report

On Nov. 16, the day of the Financial Times "panic" interview, a Fitch Ratings report said that even if there are more defaults than in recent years, they will "continue to be isolated situations." It lists reasons like captive tax bases and bondholders' strong claims on revenue for most debt. It adds that "debt service is a relatively small part of most budgets, so not paying it does not do much to solve fiscal problems (particularly as compared to the costs of such an action)."

A headline in Barclays Capital's "2011 Municipal Market Outlook" says, "The Municipal Default Rate Should Not Rise Materially." Back-to-back years of general-fund spending cuts, the Dec. 10 report said, were the first consecutive contractions since the National Association of State Budget Officers began keeping records in 1979.

"She's trying to shock the market into a panic mode," said Thomas G. Doe, chief executive officer of Municipal Market Advisors, a research company in Concord, Massachusetts, said in a Jan. 20 telephone interview. "Nothing makes sense."

Interviewed in Context

Whitney's prominence on Wall Street and the context in which she appeared were cited by Kevin Tedesco, a "60 Minutes" spokesman, when asked whether the program had asked for research to back up her assertions. Her comments bracketed an interview with New Jersey Governor Chris Christie, a Republican who faces closing a fiscal 2012 deficit of as much as a third of the current $29.4 billion budget and whose state's unfunded pension liabilities are projected to be almost $54 billion.

"I think folks that are saying I'm wrong are making a bigger call than I am," Whitney said Jan. 30. "Because they're saying munis are safe. And that, I think, will prove to be a regrettable tack," she said. "That's a bigger call. That's a much bigger call."

When Whitney was asked to explain her "60 Minutes" predictions during a Jan. 12 CNBC appearance, she said her hundreds of billions in defaults call is "not that much," emphasizing the three words, since there is almost $3 trillion in outstanding municipal debt. Her critics are "municipal-bond brokers" who have a lot to lose, she said.

Defining Default

Whitney's definition of "default" differs from the one used by industry experts such as Lehmann, the Distressed Debt publisher, who said in an interview that it occurs when a borrower fails to make a payment due on a bond.

A so-called technical default happens when a borrower fails to abide by a condition, or covenant, of the bond agreement, Lehmann said, such as failing to maintain an adequate cash reserve or insurance even if this has no affect on repayment.

Whitney discussed her prediction during a Dec. 21 CNBC interview. “When I say default,” she said, “I also mean not the technical definition of default.” Asked about her figures, she added: “It was a matter of speech. I said 50 to 100 or more.”

Her report, on page 2, says “debt service at the state level is not something we believe is at risk,” and adds that “states have and will continue to default on social contracts in the form of reduced spending” on things including education and transportation. In the Jan. 30 interview, she added that “a restructuring certainly counts as a default.”

Hedge Funds

In a 2009 profile, Whitney told New York magazine that it was “offensive” to suggest she was a puppet of short-selling hedge funds. “I don’t need a bear market to stay in business,” she said, according to the magazine.

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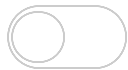

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“As far as munis are concerned, we’re not municipal bond investors,” FrontPoint Partners LLC hedge-fund manager Porter Collins said in a telephone interview. Whitney describes his colleague, Steven Eisman, as a mentor figure from their time together at Oppenheimer. “We’ve always used her research, going back to when she was at Oppenheimer, and we think she does excellent work on financial services,” Collins said. While the firm may read her research on municipal securities, he added, “we don’t actively use it.”

Whitney wouldn’t discuss clients. She said she has “never met” Jim Chanos, president of Kynikos Associates LP, a short-selling hedge-fund company, who said the “cracking of state and local municipalities is coming,” according to a 2009 Barron’s article. He didn’t return four e-mailed messages and a telephone call seeking comment.

Gingrich on Bankruptcy

Newt Gingrich, the Georgia Republican and former speaker of the U.S. House of Representatives who has said he may run for president in 2012, is pressing to change U.S. law to give states a bankruptcy option, to provide them with more leverage to renegotiate labor contracts.

"I've had a lot of people contact me," Whitney said. "If people call, I call them back."

She said she hasn't talked to Gingrich, and that she had delayed a trip to South Africa to meet with New Jersey's Christie "at a private breakfast." They discussed state issues, she said, adding, "I was more interested to hear what he had to say than talk." She wouldn't elaborate. Christie declined to answer questions as he walked into a bill signing yesterday in Trenton, the state capital.

The criticism about her defaults predictions "doesn't feel good," she said. "What are you going to do," she shrugged. She said she believes she's in "great company," mentioning former President Bill Clinton, who told CNBC on Jan. 27 he suspects that in the next 60 to 90 days people across America will be trying to figure out ways to restructure local debt. A day earlier, George Soros told the network that state and local finance will provide "the drama of the next year or so."

Roubini Recalled

Jim Bianco, the president of Bianco Research LLC in Chicago, compared the widespread criticism of Whitney to the fury directed at New York University economist Nouriel Roubini, who predicted the financial crisis in 2006. "Everybody was lining up to tell us why Roubini was wrong, and he wasn't," Bianco said by telephone Jan. 24.

As for Whitney, she said, "I don't think July's going to roll around without defaults." If she's wrong, she said, she'll "adjust."

(Updates to add quote on stature in 26th paragraph.)

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