

NOVEMBER 12, 2009

*Municipals Remain “Stalled” as  
Year End Approaches*

# Municipal Bond Monthly

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## Municipal Market Summary and Conclusions

- The municipal bond market now appears stalled, after a rally which began in the second quarter of 2009.
- The stall may continue into January of 2010 as trading desks and money managers become conservative to protect a positive calendar year.
- The impact of the Build America Bond program has been profound, and the roots of the 2009 municipal bond market rally can be tracked to the week of the first BAB deal. Whether the program is extended remains a question on the minds of many pundits, including us.
- Despite State and Local governments being challenged by the recession, widespread defaults on rated general obligation debt is not anticipated.
- Our target maturity range has been moved to 5 to 10 years.
- Tax Swaps may prove to be very difficult to execute in late 2009, as most of the “in demand” bond have rallied year to date.
- We favor:
  - **State general obligation and State appropriated paper.**
  - **Essential service revenue bonds**



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## MUNICIPALS REMAIN “STALLED” AS YEAR-END APPROACHES

Following an impressive price rally that began early in the second quarter and encompassed much of 2009, the municipal bond market now appears “stalled” at a crossroads reached just before the early October sell-off. As discussed in our last edition, we do believe that the pause/pullback is indeed temporary. Unfortunately, the combination of oversupply concerns for US Treasuries (and related expectation of subsequent benchmark yield increases), coupled with continuing headline risk regarding recurring state and local government budget shortfalls, may prove difficult for many prospective market participants to overlook.

The “temporary” pause may endure through calendar year-end and into mid-January, as money managers and dealer desks seek to limit risk taking in their final quarter after a very profitable year. The new issue calendar appears significant, and the combination mentioned above may also mean a slowing of the powerful mutual fund inflows that had fueled the market rally. Meanwhile the burgeoning Build America Bond (BAB) program (which may become more than a 2009-2010 phenomenon) continues to impact supply.

We are reigning in our maturity focus to the 5 to 10 year range vs. our previous range of 5 to 15 years, which had been in place since before the rally began. The change is in response to an interest rate risk/reward dynamic that we find somewhat opaque at this juncture. It is important to note that our decision to limit our maturity range is not driven by concerns regarding municipal credit quality; even though the market’s inability to rally, or even recapture recently lost ground, may well be caused by such credit concerns. We may revisit extending our maturity focus to capture dislocations should the lack of conviction we expect through year-end turn into another severe sell-off.

### STRENGTH UP FRONT, WEAKER OUT BACK....

Since the dramatic sell off abated in mid-October, we have seen a fairly consistent pattern of outperformance for municipal bond maturities shorter than the 10 to 12 year maturity range. In contrast, there continues to be a mild “slippage” in yield (trending higher) for longer maturities, especially those beyond 18 years. We attribute this dichotomy to two reasons. The first is the market’s growing unease with the FOMC’s desire to keep the fed funds rate on hold (voiced in last week’s meeting statement) at the current record low for an extended period. While this is clearly an inflation-related concern for many investors (a concern we believe is actually overstated), the prospect of a vastly increased supply of US Treasury issuance and, importantly, the absence of the Fed as a buyer, may well drive an increase in benchmark US Treasury rates just the same. Taking a look at Morgan Stanley’s latest US Economic and Interest Rate Forecast, we see evidence of just that expectation, with headline Consumer Price Index (CPI) remaining largely subdued at +2.5% for both 2010 and 2011. Meanwhile, the forecast for the 10-year Treasury yield hits 4.00% during the first quarter of 2010 and trends steadily up to 5.50% by year-end, maintaining that 5.50% through 2011... a far cry from today’s circa 3.50% 10-year US Treasury. The forecast for the 30-year Treasury takes us out to 6.25% in the fourth quarter of 2010.

The second reason is that mutual fund inflows have recently slowed considerably in the wake of the October market rout,

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which was uniquely a municipal event. Looking at the four-week moving average of all municipal bond fund flows according to Lipper/AMG, we see that inflows, while still positive, have steadily declined since the 2009 peak in early-October. Without the benefit of tender option bond programs, which have been largely absent from the municipal market since 2008, it may be difficult for the long end to find a “natural” buyer away from the municipal bond mutual fund industry, which, in turn, could make it difficult for the long end to absorb even a BAB impacted supply...which is considerably lower than it would likely be without that government program.

### BABS: ZERO TO FIFTY...IN LESS THEN 6 MONTHS

Speaking of the Build America Bond program, new issuance data according to The Bond Buyer indicates that the stimulus package program drove the taxable municipal bond component of the market to comprise approximately 37% of total new issue municipal bonds during October. According to Bloomberg data, aggregate issuance as of 11.09.09 stands at over \$51bn since the inaugural mid-April issue. There is no question that this program has been a hit with issuers and thus a big success, as evidenced by the trajectory of its growth. Accordingly, the BAB impact on the tax-exempt landscape has been profound. In fact, one can trace the roots of the powerful 2009 municipal bond market rally directly back to the week of the first BAB deal. According to its enabling legislation as part of The American Recovery and Reinvestment Act of 2009, authorization spans 2009 and 2010. But a major question on the minds of many market pundits, including ourselves, is whether the program will be extended beyond that sunset date or expanded to include refunding bonds and other non-stimulus related financings.

Based on a late-October joint study published by the Congressional Budget Office and the Joint Committee on Taxation, there appear to be grounds for this train of thought. The report repeatedly highlights the “inefficiencies” of the current tax-exempt bond market, in existence for almost 100 years, while extolling the virtues of other methods including the largely untested method of issuing tax credit bonds and the currently in vogue direct-pay credit bonds (the BAB program). One comment made while discussing the “efficiencies” of these new funding alternatives was “By adjusting the credit amount, the Congress effectively can exempt more or less of each dollar of interest income on a bond and tailor the federal subsidy to the public benefit the Congress expects to derive from the project being subsidized.” This could potentially mean that Congress, or a muni “czar” could decide what is in the public interest and set the tax preference accordingly. Separately, President Obama’s nominee to be assistant secretary for tax policy at the Treasury Department was quoted by the press telling the Senate Finance Committee that the BAB program is proving “too successful to allow to go away.” While we don’t think that the tax-exempt status of municipal bonds will become a thing of the past, and certainly not on bonds already issued and outstanding, the real question is would they even need to get rid of the exemption. With BAB’s already representing over 30% of municipal issuance during each of the last 3 months, they may not have to. Congress has been proposing alternatives to tax exemption for municipal bonds for over 40 years, but none of the proposals have been nearly as popular as the BAB program now in effect.

Interestingly, the BAB program comes at a time when taxpayers in the highest federal tax brackets, the core

municipal bond buyers, are facing rising marginal tax rates. With the Bush tax cuts scheduled to sunset after 2010, the "new" starting point will be 39.6%. Depending on the size and scope of federal spending programs, including healthcare reform, it is valid to say it may trend higher from there. Obviously the timing couldn't be worse for top taxpayers interested in securing tax exempt fixed income.

#### THE \$2.8 TRILLION QUESTION

In our opinion the future of the BAB program is the most important question facing the municipal bond market today. The landscape could be permanently altered by an extension and/or expansion of the program. The answer to this question may dictate whether municipal bond yields are dragged higher with rising US treasury yields if the program is not altered from its current authorization and tax exempt supply returns; or significantly outperform its US Treasury brethren if the BAB program is extended/expanded and tax exempt supply continues to dwindle. For example, the long-term (since 1981) low municipal percentage of corresponding maturity US Treasuries for 10-year bonds is 65% according to Municipal Market Data Co. The long term average is 81%. Using today's 10-year Aaa municipal yield of 3.03%, these two relationships indicate lower yields (and thus potential price gains) by 82 and 28 basis points, obviously, getting this right could make a big difference. Using the same logic for lower rated bonds such as "A" and "BBB" rated GOs would also entail "layering" on spread movements between now and the fourth quarter of 2010. We believe such spreads, now more than double the long term average, will be tighter than where they reside today, thereby limiting downside risks despite rising benchmark yields.

#### WHAT ABOUT CREDIT CONCERNS?

Aside from the usual ebbs and flows of municipal market supply and pricing, prospective and current municipal bond buyers have also had to process a number of negative articles, some of which were well placed, regarding municipal credit quality and the prospect of rampant or high profile defaults. While we certainly don't dispute that state and local government finances are severely challenged by the recession's impact and that retiree benefits is indeed an issue that needs to be addressed, there are other factors that should also be considered. These factors include an impending higher tax structure (Federal and likely state and local) for those in the top tax brackets (the core municipal buyer) and the potential for the Build America Bond program to continue to encroach on tax exempt supply; especially if extended or expanded from its current 2009-2010 authorization (which seems to be a real possibility).

On the credit front, history has shown that there is a great deal more flexibility for general obligation bonds (especially at the state level) than many critics are willing to acknowledge. State and Local Governments, forced to ponder further expenditure reductions, may look first to out-of-the-box thinking, one-shot revenue fixes and even some deficit financings. Governments cannot be run like corporations and it is unrealistic to expect swift and deep cost cuts (though substantial expenditure reductions do need to occur over time). But as for actual defaults on general obligation bonds, there have been very few instances of rated bonds defaulting during the post-war period. Accordingly, we do not anticipate widespread defaults on rated securities, but do expect select defaults to occur in non-rated bonds and bonds with narrow revenue streams, such as land-

based, special district bonds, small ports, distressed hospitals, etc. Essential service revenue bonds like water & sewer and basic need issuances like schools, prisons, courts, police, fire, etc. also have solid track records for payment and appropriation, where applicable. To be sure, revenues have declined significantly and many municipalities did not cut expenditures early enough or deeply enough to avoid budget gaps. It is also true that municipal revenues tend to lag national economic indicators, which means that we expect negative ratings pressure and headline risk to potentially last another 18 to 24 months. That said we urge investors to keep the headlines in perspective and maintain composure when digesting breaking municipal "news."

Regarding retiree benefits, we started following this developing story more than a few years ago, but the issue has since been largely forced to the back burner due to municipalities and market participants dealing with "today's problems." While the total tab for these liabilities often provide eye-opening fodder for local papers (as they have been almost universally funded on a pay-as-you go basis), it is important to remember that under Government Accounting Standards Board (GASB) rule 45 (enacted approximately 3 years ago), the total liability for current and retired workers can be amortized over 30 years with the issuer needing to fund only an "ARC," or annually required contribution each year.

There is no question that this is a serious issue, but not one that we believe is insurmountable. Federally taxable bonding can also be used to satisfy part, or in some cases all, of the liability in a similar fashion as taxable pension obligation bonds were used by some issuers years ago. But unlike the "old" taxable municipal market that was characterized by high rates and scant liquidity, today's taxable municipal market has been growing exponentially and maturing courtesy of the Build America Bond Program. We also expect more issuers to explore leasing toll roads, public-private partnerships and other non-traditional revenue generation to address the need for "other post employment benefit" (OPEB) funding. It is also crucial that states and local governments migrate toward defined contribution plans and away from defined benefit plans, a process that already appears well under way.

#### THE MOST WONDERFUL TIME OF THE YEAR...

We may be a bit premature in breaking out the eggnog and Andy Williams records, but despite the lack of holiday cheer, the municipal market already appears to be in year-end mode following a profitable year for many participants and the desire not to "trip" (incur losses) before the finish line. This inactivity may spell diminishing liquidity and an inability for the market to build upon successful new issue sales. In fact, it is quite possible that the municipal market remains rather unsettled (at which point we should go shopping...for bonds!) through the end of the calendar year and into mid-January when participants may return with renewed vigor and conviction.

On a final note, tax swaps will likely be difficult to execute in late 2009, as most of the bonds on buyers' "wish list" have rallied forcefully year to date. Of course, there are always the bonds that are out of favor and thus have a considerably lower bid/market value, but generally speaking we would not likely be a seller into a liquidity constrained marketplace and would advocate waiting until stability returns. Aside from our shortened maturity focus, other strategies remain intact. Happy Thanksgiving to you and yours (we couldn't just skip it!)

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