

Municipal Bond Commentary – 2Q 2010

United States Gross Domestic Product (GDP) for the first quarter of 2010 was downwardly revised to 2.7 percent growth from 3.0 percent. This was unexpected and, although the economy is expanding, GDP growth did not break the 3.0 percent threshold that is considered necessary by economists for significant job growth. The official unemployment rate fell to 9.5 percent in June from 9.7 percent in May, which was due mainly to the fact that many people have once again given up looking for work. It is estimated that job growth will more steadily pick up for the remainder of the year and accelerate in 2011, however the official unemployment rate will likely hover around 10 percent for some time as workers re-enter the labor market. Leading indicators for businesses for the months of May and June were not very promising. New orders for durable manufactured goods fell 1.1 percent in May. The decline was led by a drop in transportation equipment orders. Consumer indicators were largely either flat or in negative territory over the past two months. The Federal Open Market Committee (FOMC) met toward the end of June and once again kept the fed funds target rate at between zero and 0.25 percent.

The recovery of the United States' economy may have softened as it copes with the fall-out effects from Europe's sovereign debt crisis. State tax revenues have declined in the past few years creating chronic budget deficits and leading to decreased financial flexibility and liquidity. The close of second quarter coincides with fiscal year end for many states which calls for a balanced and approved budget for the upcoming year. Despite an approximately 1 percent increase in state and local tax receipts during the first quarter of 2010, many states have been forced to enact drastic measures to balance their budgets. Funds that were provided under the American Recovery and Reinvestment Act are set to expire at the end of 2010 and states must find a way to plug this hole. Governor Christie of New Jersey passed a budget which cuts school aid by \$830 million and lays off 1,000 state workers. Illinois, which has been reluctant to raise tax rates, has resorted to one-time measures such as cash flow borrowing to rectify its budget. To combat substantial unfunded pension liabilities some states are debating raising the eligibility age for retirement benefits, increasing participant costs, reducing state contributions, and lowering cost of living adjustments. However, rates are historically low which increases the appeal of issuing debt. With abundant negative headlines regarding municipal bankruptcies and pension funding challenges, we recognize that municipal bond risk is elevated, however, the sector continues to be relatively safe with a low incidence of default. Debt-service payments generally constitute a small portion of general fund revenues and are high in a state's priority of payments and expenditures.

The municipal bond market felt a bit sluggish during the second quarter of 2010 and lagged the flight to quality rally of the US treasury market. Long maturity tax-exempt yields approached four percent, a resistance point for retail investors, and there were few market participants willing the push rates lower. Primary market supply for the year is closing in on a robust \$200 billion, however tax-exempt supply is down approximately 20 percent versus one ago. Build-America-Bonds (BABs) have accounted for

approximately 28 percent of the year-to-date municipal bond issuance, thus lowering supply, and anchoring yields at historically low levels. Tax-exempt mutual fund inflows were positive during the quarter but have slowed versus the same period one year ago. The Barclay's Municipal Bond Index returned 2.03 percent in the second quarter, according to Barclay's Capital. The municipal yield curve (from 1-30 years) flattened during the period from 385 basis points to 372 basis points. The yield on 30-year AAA-GOs decreased by 15 basis points during the period, while 10-yr yields decreased by 30 basis points. Tax-exempt bonds underperformed the flight to quality rally within US treasury market which pushed the ratio of 30-year tax-exempt yields to 30-year treasury yields from 88.3 percent at the start of the quarter up to 103.1 percent at quarter-end.

Investors shied away from risk towards the end of the quarter which caused some credit spread to widening, with scattered returns for lower-rated credit. Returns data show that investors favored securities with intermediate maturities as long maturity yields approached record lows. According to Barclays Capital, single-A rated bonds underperformed the general index by 16 basis points and BBB rated bonds outperformed the index by 82 basis points. High-yield tax-exempt spreads compressed during the quarter and the Barclay's municipal non-investment grade index outperformed the investment grade index by 107 basis points in the second quarter.

Both Moody's and Fitch recalibrated their municipal bond ratings to a global ratings scale. This change does not reflect an improving credit picture but does place municipal bonds ratings on the same scale as other asset classes. The new ratings scales take into consideration the probability of default along with the recovery rate given default for municipal issuers. Many municipal bond sectors were upgraded as a result of the recalibrations with general obligation bonds and essential service bonds being the largest beneficiaries.