

2012 MUNI CREDIT OUTLOOK

JANNEY FIXED INCOME RESEARCH

DECEMBER 8, 2011



Core municipal sector has been slowed by recession induced revenue declines. Most issuers remain resilient.

THE GREAT RECESSION HANGOVER

- Both core and peripheral municipal credits were impacted by the Great Recession, with Moody's rating downgrades outpacing upgrades by 5 to 1 ratio in third quarter.
- We see no surge in municipal defaults, especially in the core state and local government sectors, although rating downgrades will still outweigh upgrades in 2012.
- Municipal issuers are resilient, in most cases reducing expense and raising revenue as needed.

Municipal bond issuers have been challenged in the aftermath of the Great Recession, as have most parts of the national economy. Much municipal issuance is secured by taxes of various kinds, with income and sales taxes providing the bulk of state revenue, while local government is heavily reliant on real estate taxes. As noted in the graph, after sagging during the recession, state tax revenue is on the rebound, but local taxes, which peaked in 2010, are showing signs of weakness.

Non-tax backed sectors are reliant on various revenue streams, nearly all of which were negatively impacted by the recession. Some revenue, such as that from essential purpose utilities in the water/sewer and public power sectors, although stressed, have been generally steady. Even in tough times, utility bills are typically a priority for residential users. Utility revenues from business users are more related to the economy, and are thus more cyclical. Other revenue sources such as those supporting toll roads and airports are closely correlated to the level of economic activity, showing improvement recently as the economy grows.

Municipal sectors, such as healthcare and higher education, are generally not core functions of state and municipal government. Healthcare faces great uncertainty as changes mandated by the Affordable Care Act of 2010 (ACA) roll out. The upcoming Supreme Court arguments and decisions on portions of ACA could further change the landscape. Future levels of federal support for Medicare and state and federal support of Medicaid, important revenue sources for most healthcare organizations, will be closely monitored.

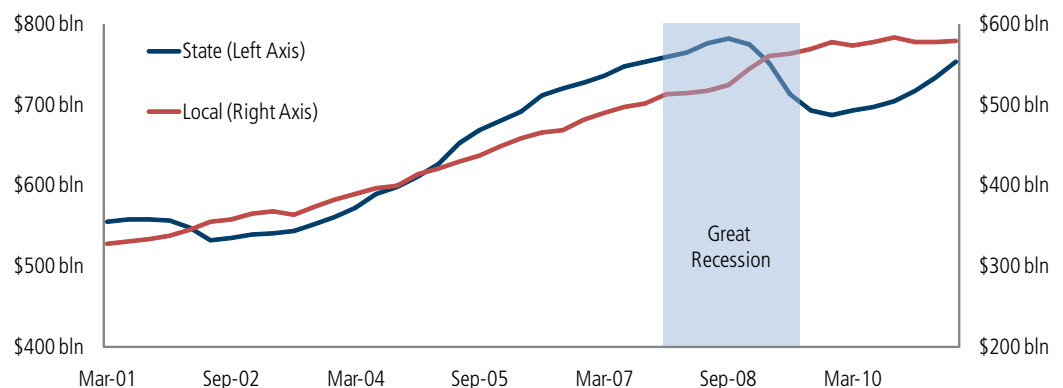
This report is largely excerpted from Janney Fixed Income Strategy 2012 Outlook dated December 6, 2011.

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State Tax Revenues Are Rebounding, But Local Revenues Are Lagging



Source: Census Bureau; Janney Fixed Income Strategy

Outlook is Mixed Across Municipal Sectors

Sector	Janney Outlook	Barclay's 12 Month Return	Key Sector Trends
Municipal Bond Index	-	6.53%	Barclay's Muni Index, 46k issues
State Government	Stable	6.85%	Possess flexibility and autonomy
Local Government	Cautious	6.79%	Reduced tax revenue and state aid cuts continue.
School Districts	Stable	-	State support is a plus
Airports	Cautious	6.93%	Enplanements continue higher
Higher Education	Cautious	6.90%	Public schools have pricing advantage
Health Care	Cautious	7.91%	Bigger is better, but uncertainty continues
Housing	Stable	6.49%	Strong fundamentals and relative value
Public Power (Elec.)	Stable	6.29%	Essential purpose nature enhances stability
Tobacco	Cautious	4.05%	2012 could see improvement
Toll Facilities	Stable	6.93%	Some usage is leveling off, still near 2004 levels
Water and Sewer	Stable	6.87%	Key essentiality factor remains

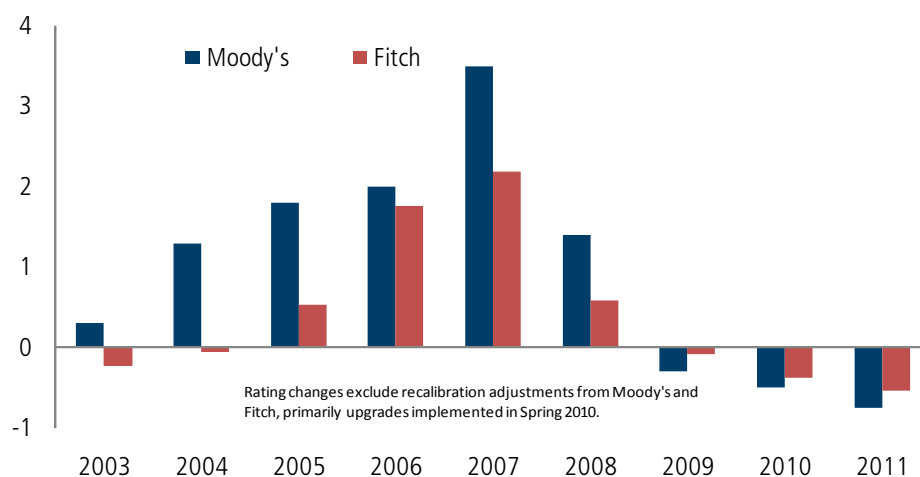
Source: Barclays; Janney Fixed Income Strategy

Diversification across sectors is prudent for most municipal investors. Each sector has stronger and weaker credits, so sector outlooks notwithstanding, specific issuer selection is important. See Janney Fixed Income Strategy 2012 Outlook for more specific information about sectors.

ISSUER SELECTION IS KEY

The rating agencies publish quarterly reports of rating activity. Beginning in 2009, the ratio of net rating changes turned negative. In the third quarter of this year, Moody's reported 5.3 downgrades for each rating upgrade, the highest ratio since the onset of the financial crisis, but these downgrades accounted for less than 1% of Moody's rated municipal universe. We expect downgrades to continue to outpace upgrades through 2012 and into 2013, a reflection of the slow economic recovery, still struggling real estate market and uncertainty related to federal budget initiatives. In this environment, issuer selection remains important.

Net Upgrade/Downgrade Ratios Have Dipped into the Negative



Source: Moody's; Fitch; Janney Fixed Income Strategy

We expect downgrades to continue to outpace upgrades through 2012.

Municipal Defaults Remain Few and Actually Declined in 2011

	2011		2010		2009	
	Number	Amt	Number	Amt	Number	Amt
1st Q	28	\$518 MM	32	\$1,347 MM	36	\$961 MM
2nd Q	29	\$583 MM	47	\$1,339 MM	114	\$3,831 MM
3rd Q	27	\$384 MM	29	\$880 MM	34	\$937 MM
4th Q	10	\$1,338 MM	31	\$861 MM	59	\$2,894 MM
Totals	94	\$2,823 MM	139	\$4,427 MM	243	\$8,623 MM

Source: Income Security Advisors: Janney Fixed Income Strategy

NO SURGE IN MUNI DEFAULTS

Despite the alarms raised over the past year, municipal bond defaults are tracking below recent years through November 2011. That being said, the market is not out of the woods yet. We don't expect a resurgence of defaults, but certainly there are more to come. There is a lag effect. Revenues do not usually just disappear, but rather diminish over time. Troubled issuers typically eat through debt service reserve funds before missing a debt service payment. The source of the table's default statistics, Income Securities Advisor, notes that final numbers, even for past years, are subject to revision having "much to do with the lax reporting standards for municipal defaults." Between the October and November newsletters, the totals for 2010 went from 95 defaults totaling \$3.4 billion to 139 for \$4.4 billion.

The vast majority of these defaults are in peripheral areas of the municipal market, such as retirement and multi-family housing bonds, most initially issued with no rating. Land secured bonds, such as so-called Florida dirt bonds, were structured using an "if we finance it they will come" approach, which did not work so well when the real estate bubble burst. Data from Municipal Market Advisors, compiled beginning in July 2009, indicates, as of late November, only five issuers in the core municipal sector are in default on \$27 million in debt. Another 51 issuers representing \$7.6 billion have some type of impairment such as notification that a debt service reserve fund has been accessed to make interest or principal payments. Of course as noted earlier, lax municipal reporting standards make it challenging to be completely up to date on every default or impairment situation. However, in the context of total municipal debt outstanding of well over \$3 trillion, the municipal market default record is one to be envied by fixed income sectors such as corporate bonds or mortgage backed securities.

Most Municipal Defaults Have Been in Peripheral Areas - Not Muni Government

Par (and #) of Outstanding Muni Bonds With an Uncured Default, Reserve Draw, or Other Impairment (\$MM)					
Sector	Last Wk	All Notices	DEFAULT	Support	Other
ALL	\$8,680 (23)	\$37,434 (676)	\$8,977 (330)	\$19,933 (220)	\$8,525 (126)
Land Secured	\$145 (9)	\$4,900 (274)	\$2,987 (156)	\$1,456 (104)	\$456 (14)
Tribal	none	\$940 (4)	\$940 (4)	none	none
IDB	\$2 (1)	\$1,194 (31)	\$893 (13)	\$294 (16)	\$7 (2)
Toll Road/Transit	none	\$4,648 (7)	\$889 (4)	\$1,402 (1)	\$2,358 (2)
Retirement	\$26 (1)	\$2,196 (69)	\$748 (29)	\$284 (12)	\$1,165 (28)
Housing	\$39 (2)	\$820 (70)	\$677 (53)	\$76 (9)	\$67 (8)
Hotel	none	\$715 (13)	\$422 (8)	\$194 (4)	\$98 (1)
Other Risky Sectors	\$8,468 (9)	\$14,423 (152)	\$1,394 (57)	\$11,330 (57)	\$1,700 (38)
Safe Sectors (GO,Wtr/Swr,SalesTx)	none	\$7,598 (56)	\$27 (6)	\$4,896 (17)	\$2,675 (33)
Initially Non-Rated Bonds	\$500 (18)	\$11,192 (485)	\$6,201 (276)	\$3,072 (146)	\$1,919 (63)
Initially Insured/LOC Bonds	\$2,300 (2)	\$14,726 (89)	\$541 (5)	\$9,392 (47)	\$4,794 (37)
Initially Rated, Uninsured Bonds	\$5,880 (3)	\$10,664 (61)	\$1,743 (24)	\$7,250 (21)	\$1,671 (16)

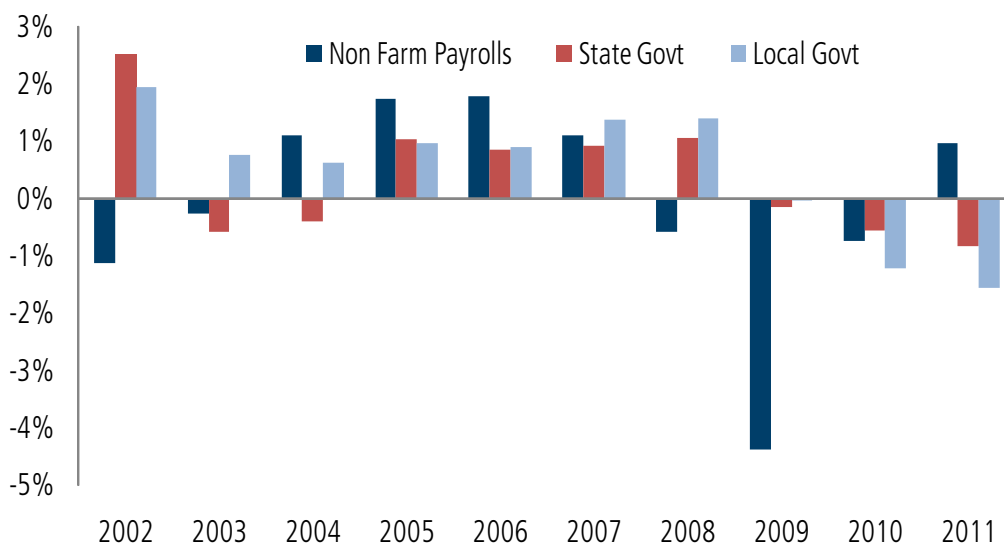
Source: Municipal Market Advisors Report dated December 5, 2011

The vast majority of municipal defaults are in peripheral areas of the municipal market, such as retirement and multi-family housing bonds, most initially issued with no rating.

MUNICIPAL ISSUERS REMAIN RESILIENT

Most municipal governments are weathering the storm well, cutting expense and raising revenue, although these actions have tended to lag the economic downturn. As national employment rolls turned the corner and began to grow in 4Q 2010, state and local government employment contracted, with the pace of decline accelerating in 2011. This stands in contrast to the early decade recession that saw state employee rolls drop slightly, while local employment continued to grow, although at a slower pace.

State and Local Govt is Reducing Payroll to Cut Expense



Source: Department of Labor: Janney Fixed Income Strategy

We see the local government ship gradually turning, and although rating downgrades will continue to outpace upgrades, the down/up ratios should begin to decline in 2012. State revenues are improving, so cuts in state aid should be less severe. Mayors, commissioners, school boards and legislators have gained the experience needed to operate in today's challenging environment.

A state's approach to supporting local government is an important investor consideration. Pennsylvania's capital city, Harrisburg, has been a headline item for several years now, including its recent attempt to file for bankruptcy. The backstory is the state's Act 47 legislation for helping distressed governments, and the ongoing and increasing state involvement in seeking solutions. Harrisburg's bankruptcy filing was dismissed, and the state moved forward with appointment of a receiver to determine and apply a recovery plan. The state's strong action is a positive harbinger for bondholders of other Pennsylvania cities' debt. State receivers have been appointed in Central Fall, RI and Flint, MI. Finances of Nassau County in New York are supervised by a state appointed interim finance board. Although there is no guarantee that holders of bonds issued by these cities will be completely insulated from problems, the involvement of the states is a credit plus. These actions stand in sharp contrast to the thus far hands off approach exhibited by Alabama state legislators in the multi-year saga of Jefferson County.

Another important form of state support is found in the bond enhancement programs used by about half of the states. Primarily directed at school districts, these programs add state structural support to local bond issues, in many cases earning the borrower a higher rating and degree of creditworthiness than the local government alone would earn. Local borrowers can typically incur lower interest costs with use of these state programs. See Janney's report, State Credit Enhancement, dated November 22, 2011, for more information.

We are cautious on the municipal sector because the post recession financial impact is still working its way through budgets, especially at the local level. Issue selection will remain important since rating downgrades will continue to outweigh upgrades in 2012. A stable or positive outlook for a rating is a plus. The vast majority of local governments will continue to pay their bills, particularly bond debt service, with defaults being few and episodic.

A state's approach to supporting local government is an important investor consideration.

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