

# MUNICIPAL BOND MARKET NOTE

## JANNEY FIXED INCOME STRATEGY

December 21, 2010



Suggestions of factors stressing the municipal market have been excessively overblown throughout 2010.

The worst thing fixed income investors could do now is panic.

## There is Not a Looming Municipal Market Crisis, Although Many Factors are Stressing Issuers

Although the 2011 municipal market landscape will be volatile there will not be a municipal market crisis and we do not expect a "spate" of local government defaults, as predicted during Sunday night's episode of 60 Minutes. Suggestions of factors stressing the municipal market have been excessively overblown throughout 2010 and Sunday night was no exception. The broadcast included a biased portrayal, strongly toward the negative, of current factors. During the report, titled "Day of Reckoning," Steve Kroft interviewed Meredith Whitney, a former banking sector analyst, who recently began her own independent research and rating firm. In summary, arguments reported states are facing an environment where they must drastically cut support payments to local government issuers. Although it was noted that states are not in danger of missing debt service payments, an imprudent prediction that local government defaults will rise well above historical experience was made.

Investors' anxiety levels are currently very high, especially in the wake of the most recent financial crisis. Keeping that in mind, we should remember the U.S. has been through two world wars, the Great Depression, the stock market crash of 1987, September 11, 2001, the Great Recession and countless other events and calamities over the last 100 years. The worst thing fixed income investors could do now is panic because of inexpert advice. We know that it is difficult to tell the difference, especially when a major news network places so much emphasis behind a biased opinion. That is why Janney's team of experienced advisors is available to help investors navigate through the uncertainty.

### Let's Set the Record Straight

It is important to approach any investing decision from a fair and balanced perspective. When considering the future of the municipal market it is important to debate the strengths and weaknesses of state and local governments' financial positions. Therefore, we include below Janney's responses to certain mis-representations in order to balance the argument:

**The 60 Minutes segment argued some cities and counties will default and uses the situation in Harrisburg, PA as an example.** A participant also contended that over the next 12 months we could see 50 to 100 sizeable defaults of local governments and that this would amount to hundreds of billions of dollars worth of defaults.

**Janney Response-** While past experience does not necessarily result in future performance, we do not see any facts leading us to think default experience will be excessively higher in 2011. Municipal market defaults and bankruptcies remained low during 2010. Annual Chapter 9 filings were limited to 5, versus 10 in 2009 and they were restricted mainly to situations with mitigating conditions. The situation in Harrisburg is not reflective of the overall state of local governments' fiscal circumstances. Defaults were also minimal. Since the middle of 2009 only 3 municipal issues in the "safe" sectors, which are characterized as general obligation, tax backed and essential services, defaulted, according to Municipal Market Advisor's data. A chief reason for the small number of bankruptcies and defaults is the numerous levers state and local governments can pull in order to fend off non-payment. Pennsylvania's Act 47 oversight program is an example. The downside is that there are a considerable number of factors currently stressing local governments including: lower revenues, lack of political will to accept the current economic reality, rising pension and health-care expenses, exposure to competitive enterprise risk, bank facility renewal risk and unanticipated high costs of swap terminations. But, we do not think that exposure to these stresses will result in 50 to 100 high profile defaults.

**A case was made inferring state and local governments' fiscal woes have not been taken seriously.** A guest reasoned, "The most alarming thing about the state issue is the level of complacency."

**Janney Response-** The current financial status of U.S. state and local government has not caught anyone in the industry by surprise. Higher risk states' ratings have been downgraded and are trading

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We do not think that exposure to these stresses will result in 50 to 100 high profile defaults.

Diversifying into different states or sectors may be a prudent strategy to consider if a portfolio is too highly concentrated.

at wide spreads to the municipal high grade index. Additionally, Janney lowered the local government sector outlook to "Cautious" from "Stable," based on expectations that states would be lowering aid payments. Janney took this action back in the summer of 2009 around the time when Moody's also placed all local governments on "negative watch."

In addition to not recognizing the timing there are also fundamental mistakes analysts make when not familiar with municipal market credits. They often do not recognize key differences between corporate and municipal credits. One difference is that unlike corporations, municipalities cannot be liquidated, even in times of severe financial distress. A local government entity will continue to exist, although a merger with an adjoining municipality is possible, so it can continue to provide basic services to their citizens. Secondly, local governments have stronger, but not unlimited, revenue raising resources. They also have the ability to lease or sell off assets.

### Investor Recommendation

In an environment where weaker municipal market credits may be vulnerable to certain credit factors we recommend investors regularly review the quality of their holdings to ensure they are consistent with their individual risk profiles. Investors should not panic and sell-off municipal holdings. However, diversifying into different states or sectors may be a prudent strategy to consider if a portfolio is too highly concentrated. We also advise investors to review Janney's municipal market related research for more detail about the factors actually stressing the municipal market.

### Analyst Certification

I, Tom Kozlik, the Primarily Responsible Analyst for this report, hereby certify that all of the views expressed in this report accurately reflect my personal views about any and all of the subject sectors, industries, securities, and issuers. No part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report.

**Definition of Outlooks-** Positive: Janney FIS believes there are apparent factors which point towards improving issuer or sector credit quality which may result in potential credit ratings upgrades. Stable: Janney FIS believes there are factors which point towards stable issuer or sector credit quality which are unlikely to result in either potential credit ratings upgrades or downgrades. Cautious: Janney FIS believes there are factors which introduce the potential for declines in issuer or sector credit quality that may result in potential credit ratings downgrades. Negative: Janney FIS believes there are factors which point towards weakening in issuer credit quality that will likely result in credit ratings downgrades.

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## Janney Municipal Bond Market Publications

Title	Date	Pub	Notes
Munis Attractive, Credit Pressures	December 20, 2010	Outlook	Mixed performance, mixed messages and metaphors
North Shore Long Island Health Tobacco Bonds	December 9, 2010	Credit	Dominant provider in its area is rated Baa1/A-/A-
Inexpert Advice Continues	December 6, 2010	Note	Downgrades and lower consumption, IL Railsplitter
For-Profit Entities TE Debt	December 6, 2010	Weekly	Doomsday forecasts continue
Heavy New Issue Supply	November 19, 2010	Note	Private companies sometimes sell tax-exempt debt
BABS Last Year? Marcellus Shale	November 18, 2010	Note	Municipal yields moved sharply higher
Muni Bond Insurance Update	November 12, 2010	Monthly	Odds of BABs at 50% and local govt sector review
PA Turnpike	November 3, 2010	Note	The end of the AAA era- Assured downgraded
State Taxes Were Stronger	October 5, 2010	Credit	New Special Sub debt maintains Aa3/NR/AA ratings
Brethren Village, PA	September 21, 2010	Monthly	Harrisburg side-stepped a default and NJ charged
Tobacco Sector and PA Act 47	August 30, 2010	Credit	A PA CCRC with lower than expected occupancy
NYC TFA	August 13, 2010	Monthly	We lowered our tobacco outlook and explain PA Act 47
Harrisburg Update	July 22, 2010	Credit	Bondholders have first priority, 10x dsc
The Truth Shall Set You Free	July 15, 2010	Note	Officials are addressing the city's weak finances
The Front of the Line	July 14, 2010	Monthly	Municipal Myths and Truths
Detroit- Dist. State Aid	July 7, 2010	Note	New types of bonds with enhanced security
COFINA	July 7, 2010	Credit	Details the strong security mechanism
Factors Stressing the MBM	June 29, 2010	Credit	Strongest of the Puerto Rico credits
Battle Uncertainty with Diver.	June 15, 2010	Note	There is not going to be a "Municipal Meltdown"
Harrisburg Update	June 7, 2010	Monthly	Battle uncertainty, CA will not be the next Greece
CIFG Insurance	April 30, 2010	Note	Harrisburg May 1, 2010 payment will not be made
DC Ballpark	April 30, 2010	Note	Details of CIFG insured bonds remain uncertain
In Like a Lamb Out Like	April 22, 2010	Credit	DC Ballpark possesses strong ds coverage
Moody's Rating Changes	April 9, 2010	Monthly	Health-care reform impact mixed; Rtgs recalibration
Historical Defaults are Low	March 17, 2010	Note	Moody's ratings may be "recalibrated" higher
Montgomery County, PA	March 5, 2010	Monthly	Low Ratios; Exaggerated risk of defaults and Chp 9
Pitt. & Allgh. Hotel Tax	March 3, 2010	Credit	One of the handful of Aaa rated PA issuers
Recession Weakens States	March 3, 2010	Credit	Review of the Hotel Room Excise Tax Rev Bonds
Harrisburg Update	February 12, 2010	Monthly	IL, NJ, NY, RI, CA & PR experiencing fiscal stress
Miami-Dade County	February 4, 2010	Note	City Council reviewing options including bankruptcy
2010 Municipal Outlook	January 20, 2010	Note	S&P lower its outlook to negative from stable
2009 Municipal Review	January 1, 2010	Outlook	Expectations for 2010 in the municipal market
New Jersey Tobacco	December 1, 2009	Review	Review of municipal market in 2009
Long Island Power Auth	December 9, 2009	Credit	Tobacco Settlement Asset-Backed Bonds
Miami-Dade County	October 19, 2009	Credit	Credit will remain strong in the near term
Hackensack U Med Center	October 15, 2009	Credit	Stress in short intermediate term
Review of 1H 2009	October 8, 2009	Credit	Some near term questions
Insured Bond Review	September 29, 2009	Note	A "New Normal" municipal market
E. Stroudsburg, PA Stu Hsg	September 18, 2009	Note	Your insured bonds may now be unrated
Insurer Update	August 31, 2009	Credit	Low cost, high qual ed should secure enrollment
Municipal Sect Scorecard	August 19, 2009	Note	Only four insurers are rated above invest grade
PA School District Intercept	August 17, 2009	Note	Janney's municipal sector outlooks
Slippery Rock, PA Stu Hsg	July 27, 2009	Credit	Intercept is based on PA's rating
Build America Bonds	July 23, 2009	Credit	If enrollment is high, occupancy should remain high
Florida Hurricane Fund	July 21, 2009	Note	Build America Bond Update
Maryland CDA Hsg	July 15, 2009	Credit	Strong credit despite uncertainties
Penn College of Tech, PA	July 9, 2009	Credit	Facing pressure but management is committed
Local Government Outlook	April 3, 2009	Credit	Expect continued favorable results
	April 1, 2009	Note	Moody's assigned neg outlook to local govt

Source: Janney Fixed Income Strategy.