Municipal Strategy

Muni Relative Value

JANNEY FIXED INCOME STRATEGY SEP 29 2009

Identifying relative value in the municipal markets has become a challenging exercise in the wake of the massive ratio and spread compression realized thus far in 2009. We see opportunities in the intermediate part of the municipal curve and expect credit spreads to continue to tighten.

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- Supply & Demand
- Ratios
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Introduction

Investors' perception of municipal market risk has been tested by unprecedented capital markets' events and government bailouts over the course of the past twelve months. The federal government brokered the acquisition of Bear Stearns and bailed out AIG, the Federal Housing Finance Agency took control of Fannie Mae and Freddie Mac and the Troubled Asset Relief Program enabled the U.S. Treasury to buy "troubled assets." The Lehman Brothers bankruptcy filing was the tipping point of the financial crisis and effectively stalled financial markets around the world, with the U.S. municipal market being no exception. Municipal primary market sales and secondary market trading activity were at a fraction of normal levels for months after the bankruptcy filing and those issuers who were forced to sell debt did so at yields well above pre-Lehman bankruptcy levels.

The Federal Reserve battled back by lowering their rate target to between 0.00% and 0.25%. Congress passed the American Recovery and Reinvestment Act (ARRA) in February, in the process creating the taxable Build American Bond program, which allows traditional tax-exempt issuers to sell taxable bonds and receive a government subsidy. In the meantime, all but two Tier I municipal bond insurers— Assured Guaranty/FSA and Berkshire Hathaway Assurance Corp. — were downgraded and the lower rated insurers halted new municipal business. Underlying credit quality came under assault as the rating agencies warned of increasing credit concerns and Moody's placed the entire local government sector on negative outlook. Economic conditions have since improved to the point where even the perennially cautious Ben Bernanke hinted at the end of the Great Recession. Now, we offer a few observations to help investors find their way through the current municipal market and we forecast what they should expect from the "new normal" municipal market after the government's emergency room economic treatments.

Structural Supply & Demand Shifts

Municipal new issue supply was down by 15% over the first half of 2009 versus the same period in 2008. The decline was fueled by a few different variables, starting with the frozen nature of the municipal markets for the first few months of the year. Even well into the second quarter, only higher rated credits came to market because wide credit spreads and high absolute rates made pricing for lower rated credits impractically expensive. Typically, less credit worthy issuers would be able to price more affordably with bond insurance, but a lack of municipal bond insurance kept those issuers from selling debt. Lower availability of liquidity in the form of stand by bond purchase agreements and letters of credit reduced variable rate issues in the first half of 2009.

The elimination and consolidation of investment banks' public finance departments also slowed some issuance. UBS, formerly the second largest underwriter of negotiated municipal issuance dropped their public finance group in June 2008. Bear, Stearns merged into J.P. Morgan and Merrill Lynch was taken in by Bank of America. It takes time for bankers to re-establish relationships as banking professionals move to new firms, become more familiar with their new platforms and try to continue service to their clients. In addition, some issuers' financing schedules were tripped up. Many issuers had to postpone and re-evaluate financing plans due to market conditions and the uncertainty of their underwriting teams.

Despite the fact that high grade municipal interest rates have been near historical lows, refundings were actually down by 35% for the first half of 2009 versus the same period in 2008. We partially attribute an elevated municipal to Treasury yield ratio "M/T ratio" as the driving force behind this decrease. When executing refundings, issuers usually deposit the proceeds of a new bond issue into Treasury investments, which are held in escrow to pay off outstanding bonds. But with Treasury yields falling so far below municipal yields, issuers would be earning less on

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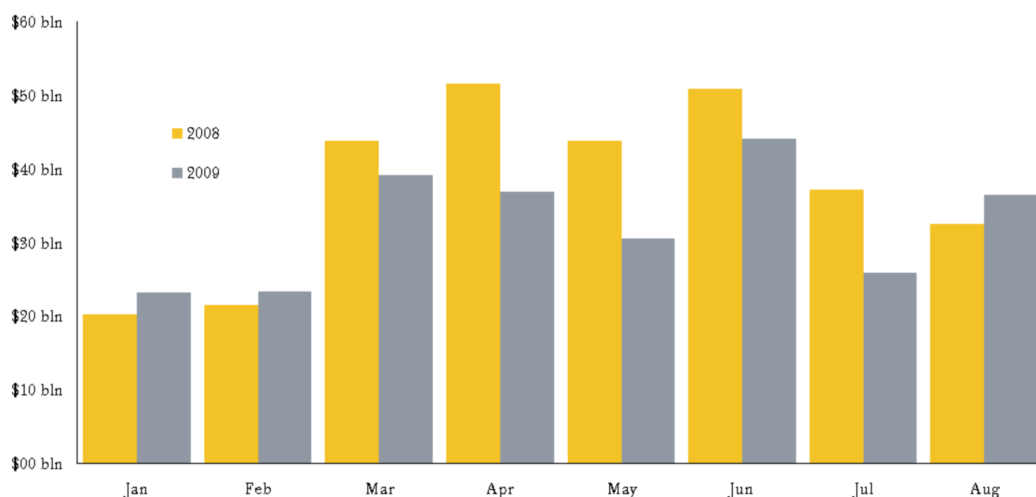
Municipal Market Issuance



Source: Janney FI Strategy; Thompson

Treasury escrow investments and this eliminated much of the refunding savings. A final contributing factor to declining municipal supply was the $30 plus billion of taxable BAB issuance that, pre-ARRA, would have been issued as tax-exempt debt. It should be noted however, that overall August issuance did pick up as issuers finalized financings for first part of the new fiscal year.

> Deepening investor risk aversion in the wake of the financial crisis encouraged a movement of funds out of riskier asset classes (including municipals) into the relative safety of Treasuries.

Increases in investor risk aversion in the wake of the financial crisis encouraged a mass movement of funds out of riskier asset classes (including municipals) into the relative safety of Treasuries. As liquidity risks eased and the economic situation began to stabilize in mid-2009, investors reversed a large portion of that risk aversion attitude and returned to the more attractive yields available in municipals. Prior to the depths of the financial crisis, municipal arbitrage hedge funds and tender option bond (TOB) programs were among the most active institutional buyers of municipal bonds; however, it was exactly these highly leveraged participants which were most impacted by the initial phases of weakening municipal prices in September of 2008, and we hold little expectation that arbitrage fund and TOB demand will return to the sector at the same level as in the 2005 to 2007 boom days. As a result, the story of municipal market demand in recent months has come, in large part, from the return of individual retail investors, either through direct bond purchases or through investment in municipal-focused mutual funds. According to Lipper (formerly AMG Data), investors have entrusted over $56 billion to municipal related bond funds this year, including an average of over $2.5 billion a week over the past four weeks.

Municipal to Treasury Ratios

The municipal to Treasury ratio (M/T ratio), calculated by comparing the yield on a municipal (usually triple A) to the yield on a like-maturity Treasury, is the model indication of the relative value of the municipal bond market in relation to Treasuries. On September 21, the 10 year Treasury was priced at 3.48% while the 10 year triple A municipal priced at 2.69%, for a 10 year M/T ratio of 77%, slightly below the long term average of 80%. Historically, the relationship between the 10 year triple A municipal bond and the 10 year Treasury has been relatively steady, with data in the range of 65% - 95% for the past two decades.

A range of factors can impact municipal ratios, but changes in investor perceptions of credit risk and liquidity risk in the municipal markets rank as, arguably, the two most significant. Treasury securities are considered free from default risk, while municipal bonds sometimes experience defaults. This possibility brings credit risk into the investment equation when considering municipal bonds. Treasury markets are among the most liquid market in the world, while many municipals are thinly traded by comparison. Investors expect to be compensated for this liquidity risk. The financial crisis created a situation in which concerns about both credit and liquidity risk heightened, leading to an outsized jump in ratios. Prompted by the market panic between September 2008 and April 2009, the 10 Year M/T ratio spiked to a high of 186% in December 2008. The M/T ratio has fallen closer to historical levels since the middle of the summer. On the long end of the curve, the 30 year M/T ratio experienced similar volatility and is now returning closer to historical averages.

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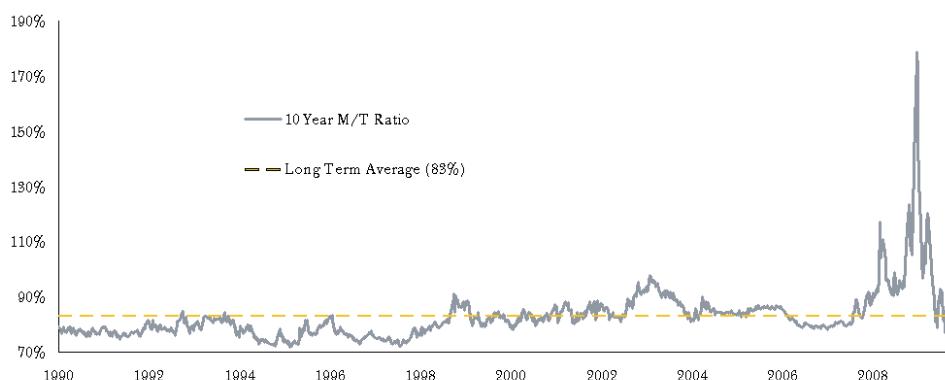
Historical 10yr Muni/Treasury Ratio



Source: Janney FI Strategy; Thompson

In our opinion, strong demand and limited tax-exempt supply have created a situation in which municipals are overvalued on the shorter end of the curve. Low money market yields and decreased short term supply have resulted in heavy investor demand for municipals in the two to five year maturities and this overwhelming demand has depressed ratios to the point where municipals appear quite rich. Given still high levels of credit and liquidity risk, ratios on shorter maturities suggest poor relative value. We are neutral on maturities in the medium part of the curve however, higher ratios on the 20 to 30 year part of the curve suggests that those maturities remain somewhat cheap compared to Treasuries. In addition, we continue to see the potential for the BABs product (which tends to have 10 plus year maturities) to reduce long-end tax exempt supply, which may contribute to tighter longer ratios.

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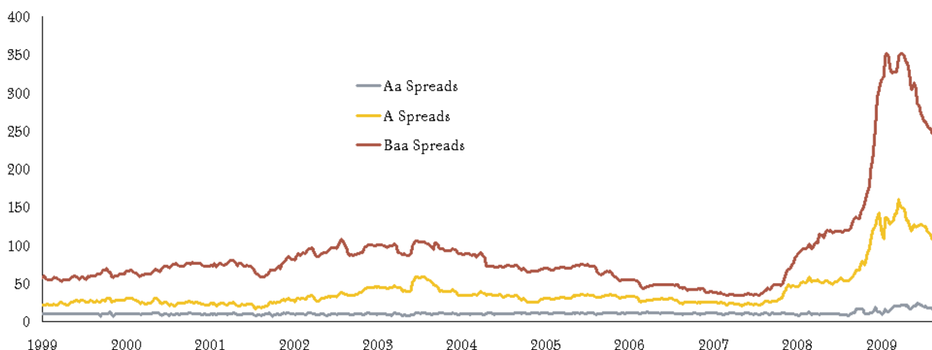
Municipal Credit Spreads

Municipal credit spreads, which are measured by the difference in yield between a triple A rated muni and a lower rated credit, are key variables to consider when assessing relative value within the municipal universe. Just as the M/T ratios partially account for quality of the municipal sector as a whole, credit spreads reflect investors' perception of risk within a particular sector or rating category. Spreads typically widen in a contracting economic environment–as was the case from the end of 2007 until the summer of 2009–and typically tighten during periods of improving economic activity. This relationship is primarily a function of broad-based risk aversion and macro economic factors which increase or decrease the risk of municipal defaults.

Credit spreads at each rating level in the municipal market experienced a structural tightening trend from 2004 until 2007, a trend which we attribute largely to yield chasing from the leveraged institutional buyers as well as generally favorable credit conditions. When announcements of mortgage loan write-downs started in early 2007, credit spreads began to widen and continued to do so until September 2008 when investors' panic fueled an extreme flight to quality, and the spread of a triple A municipal to a triple B municipal increased to as high as 350 basis points (bps). Now, as investor risk aversion is easing, the Dow Jones Industrial Average is creeping up on 10,000, and economic conditions are improving, credit spreads in the municipal market have tightened significantly. Capital is flowing into muni investments as investors are starting to take on more risk, which has resulted in spread compression closer to in line with historical averages.

Historical 10yr Muni Credit Spreads



Source: Janney FI Strategy; Thompson

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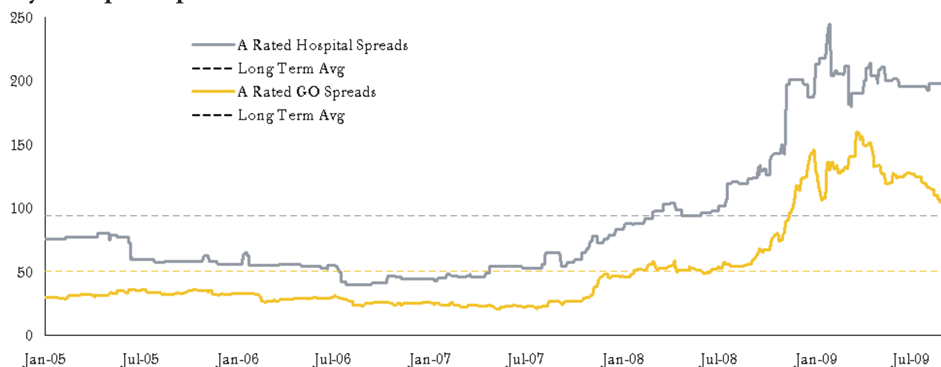
For example, take the A rated municipal healthcare sector, generally considered a higher risk sector within the investment grade municipal market. For 10 year maturities, these credits traded at a 50 to 75 bp spread to triple A municipals before the market panic of 2008, but rapidly widened to the 200 to 250 bp range as economic and financial conditions worsened. Subsequently, as investor risk aversion eased, spreads tightened, though they remain sharply elevated versus levels from a truly stable environment. Credit spreads between high grade municipals and A rated hospitals are showing us that some concerns still remain at this rating level in this sector.

10yr Hospital Spreads



Source: Janney FI Strategy; Thompson

We anticipate that one component of the "new normal" in the municipal space will be structurally wider municipal credit spreads than those we saw in the economic boom days of 2005 to 2007. With the elimination of the yield-chasing leveraged demand and increased amounts of negative credit risk rhetoric, investors are taking more of a fundamental approach to purchases, which should align pricing more closely to ratings agencies' analyses. In the medium term we expect to see spreads continue to compress and settle in a range modestly wider than historical trends.

> In the short to medium term, we expect spreads to continue to compress and to settle into a range that's modestly wider than historical average levels.

Muni Credit Spread History

Rating	Range from 1990-2007	Range from 2008-2009	Mid-Term Janney Forecasts
AA	10-15	15-25	10-20
A	20-40	50-160	30-60
BBB	50-100	100-350	75-150

Source: Janney FI Strategy; Thompson

Conclusions: A "New Normal" Municipal Market

Macro-economic indicators seem to be stabilizing for now. We expect demand for tax-exempt municipals will continue at a strong pace. Individual retail investors will continue to increase their municipal holdings and institutional buyers will continue to add to their portfolios. As municipal credit questions settle down we expect money market funds, which have decreased their holdings of municipals over the first half of 2009 to start buying again. In 2010 we expect municipal supply to pick up. The financial markets are starting to operate at closer to normal levels versus where they were for the first two months of the year. We expect municipal insurance will continue to add value even though the days of the triple A insurer may be over. Municipal insurers are now and will continue to be categorized in tiers, with new firms expected to join the top tier.

Bank consolidations have transitioned, allowing public finance bankers to reconnect with their clients. Issuers are re-establishing their underwriting teams and issuance procedures. Liquidity should become more available, at competitive levels, as banks' financial situations become stronger. More liquidity should result in higher variable rate bond issuance. BAB issuance remains a question as issuance is scheduled to stop at the end of 2010. We expect BABs may be extended but we do not have details from the government about its plan for BABs.

We expect near term M/T ratios will be dictated more by changes in the larger Treasury market as opposed to changes or factors driving the smaller municipal market. In the short term we believe that municipal yields will continue near all time lows in tandem with the all time low Treasury yields. For credit, there will be a "new normal" in the municipal market establishing a credit curve reflecting investors' appetite for risk and concentration on underlying credit. Therefore, "new normal" municipal market credit spreads will be somewhere between the narrower spreads we saw pre-2007 and the 200 bp spread we are seeing now between triple A and triple B municipal credits.

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Positive: Janney FIS believes there are apparent factors which point towards improving issuer credit quality issuer which may result in potential credit ratings upgrades

Stable: Janney FIS believes there are factors which point towards stable issuer 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 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.

Definition of Ratings

Overweight: Janney FIS expects the target asset class or sector to outperform the comparable benchmark (below) in its asset class in terms of total return

Marketweight: Janney FIS expects the target asset class or sector to perform in line with the comparable benchmark (below) in its asset class in terms of total return

Underweight: Janney FIS expects the target asset class or sector to underperform the comparable benchmark (below) in its asset class in terms of total return

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Asset Classes: Janney FIS ratings for domestic fixed income asset classes including Treasuries, Agencies, Mortgages, Investment Grade Credit, High Yield Credit, and Municipals employ the "Barclay's U.S. Aggregate Bond Market Index" as a benchmark.

Treasuries: Janney FIS ratings employ the "Barclay's U.S. Treasury Index" as a benchmark.
Agencies: Janney FIS ratings employ the "Barclay's U.S. Agency Index" as a benchmark.
Mortgages: Janney FIS ratings employ the "Barclay's U.S. MBS Index" as a benchmark.
Investment Grade Credit: Janney FIS ratings employ the "Barclay's U.S. Credit Index" as a benchmark.
High Yield Credit: Janney FIS ratings for employ the "Barclay's U.S. Corporate High Yield Index" as a benchmark.
Municipals: Janney FIS ratings employ the "Barclay's Municipal Bond Index" as a benchmark.

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