

MUNICIPAL BOND MARKET INSIGHTS



MUNI BONDS MAY BENEFIT FROM FAVORABLE LONG-TERM TRENDS

Shrinking supply, demographics, savings rates and taxes may provide a positive long-term backdrop for munis.

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Not surprisingly, the most profitable investment trends tend to be those with the most staying power. That could be particularly good news for investors in municipal bonds, since structural forces are in place that may make tax-free bonds — and the income they generate — even more valuable in the years to come. And while no one can say with certainty how long a trend will endure, there are reasons to believe that municipals may be in the early stages of a long-term, or secular, bull market.

Like most asset classes, municipals were buffeted by negative events during the global financial crisis. These included a stampede to the safety of Treasury debt and a glut of supply after the auction-rate securities market was crippled. The failure of monoline insurers and the abrupt de-leveraging of hedge funds to meet margin calls also undermined tax-free bond prices. By December 2008, yields on 20-year general obligation bonds reached an astounding 175% of similar-maturity Treasuries; that same spread averaged just 89% between 1994 and 2007.¹ Since then, conditions in the municipal bond market gradually drifted toward normal as the global financial system stabilized and the Great Recession weakened its grip.

FAVORABLE SECULAR TRENDS

Over the short-term, of course, bond prices fluctuate in response to the daily onslaught of statistical minutia. Seasonal factors also create fleeting imbalances between supply and demand, thereby pushing bond prices (and interest rates, which move inversely to prices) higher or lower. Experienced traders and portfolio managers seek to exploit those temporary imbalances to gain favorable entry or exit prices for a security.

It is important to note that a resurgence of inflation could adversely affect municipal bond prices. Yet while some of the extraordinary measures undertaken by the Federal Reserve to rescue the economy are potentially inflationary, there remains significant excess capacity in both the product and labor markets. The Fed also appears sensitive to the need to eventually enact an exit strategy from its policy of monetary accommodation, and that would drain excess liquidity from the financial system. These factors suggest that inflation likely will remain subdued, especially with the odds strongly favoring a sub-par economic recovery.

What matters most for long-term investors, however, is that conditions exist that may help grow and sustain demand for municipal bonds. The following trends appear to be both long-term in nature and potentially supportive of tax-free bond prices:

- **The “Silver Tsunami.”** At one second past midnight on January 1, 1946, Kathleen Casey of New Jersey became the nation’s first Baby Boomer.² Over the next 18 years, 79 million Americans joined Casey, making hers the largest generation in U.S. history. Now that the first Boomers are either in or nearing

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retirement, demographics could play a powerful role in underwriting a secular bull market in fixed income. An estimated 10,000 Baby Boomers will reach retirement age every day for nearly the next two decades,³ and it seems likely that many of those new retirees will convert some of their holdings from stocks to bonds. The fact that many Americans have not saved enough to finance the lifestyle they want in retirement also could compel a shift toward income-producing investments, especially given the demise of traditional defined-benefit pension plans. Increased longevity also might play a role in maintaining demand for income-producing investments.

- **Higher taxes.** According to the non-partisan Congressional Budget Office, aggregate federal budget deficits will surpass \$7 trillion over the next decade, assuming a continuation of current fiscal policy.⁴ A White House estimate issued in late August 2009 acknowledged that the total budgetary shortfall could reach \$9.05 trillion over that same period if Congress enacted the administration's spending proposals.⁵ Deficits of that magnitude would probably exceed 5% of gross domestic product for the decade,⁶ an amount that is widely viewed as unsustainable and untenable.

Though raising taxes is always politically problematic, financial markets could demand that Uncle Sam raise additional revenue or face sharply escalating financing costs and/or a weaker dollar. Already, the Obama administration has proposed raising the top marginal tax bracket to 39.6%, and there is ample precedent for even higher rates on upper-income Americans. During the 1950s and early 1960s, the top rate was 92%; as recently as the mid-1980s, the highest tax bracket was still 50%.⁷ As taxes rise, municipal bonds become even more attractive, since the income they generate is generally exempt from federal income tax. And you don't necessarily have to be in the highest marginal tax bracket to benefit from owning municipals. Historically, a 10-year high-quality municipal bond has yielded about 90% of a comparable-maturity Treasury security,⁸ suggesting that even taxpayers in the 15% income tax bracket might come out ahead on an after-tax basis.

- **Regaining the savings habit.** In 2006, the U.S. savings rate dropped to -1%, the second consecutive year that Americans spent more than they earned and the lowest figure since 1933.⁹ But history suggests that a meager savings rate is the exception rather than the rule.

Between 1959 and 1992, personal savings as a percentage of disposable income averaged a healthy 7.4%¹⁰ and never fell below 5% between 1940 and 1993.¹¹

Americans responded to the recent financial crisis and to the multi-trillion-dollar declines in their net worth that followed by regaining the savings habit. By May 2009, the nation's savings rate had climbed back to 6.9%, the highest level in 15 years.¹² Given the strong likelihood that the labor market will remain weak for the foreseeable future, it is reasonable to assume that households will continue to repair their finances, a process that could possibly funnel more money into financial assets like municipal bonds.

- **Shrinking supply.** Demand for tax-free fixed-income investments may increase in coming years, but the supply of municipal debt seems likely to decline. That's because of the introduction of so-called Build America Bonds, which were part of the Obama administration's fiscal stimulus package approved by Congress in February 2009. Though interest on Build America Bonds is taxable, thereby requiring the issuing municipality to pay a higher interest rate to attract investors, the federal government subsidizes 35% of the interest cost. As such, Build America Bonds actually lower the net borrowing cost for municipalities, many of which already have responded by issuing less traditional municipal debt. Less supply, when coupled with equal or rising demand, generally means higher prices.

So far, Build America Bonds have been favorably received by a wide array of investors, including deep-pocketed pension and sovereign wealth funds. About \$100 billion of Build America Bonds are expected to be sold in 2010. Since total annual issuance in the traditional municipal market is only about \$350 billion, such a dramatic reduction in supply potentially could have a very positive impact on municipal bond prices, especially at the long end of the yield curve where the bulk of Build America Bonds issuance is concentrated.

CHOOSE WISELY

While municipal bonds as an asset class may be positioned to benefit from the favorable secular trends noted above, that does not mean that bond investors should put their tax-free portfolios on autopilot. Far from it.

There are more than 50,000 issuers of municipal debt nationwide and more than 1 million individual issues on the market. Just as with stocks, some securities represent

exceptional value, others are fairly priced and still others fail to reward investors for the various risks they represent. And though default rates within the municipal sector are generally quite low compared even to high-quality corporate bonds, sound credit analysis is crucial, especially since the recession severely stressed state and local government finances.

The diversification and professional management available through mutual funds can help to mitigate credit risk.* Funds also make it easier to access all parts of the yield curve, which tends to mitigate a portfolio's

interest rate risk. For example, a skilled bond manager could structure a portfolio in various ways, including some that would generate the same amount of income as a "laddered" structure but with less vulnerability to rising rates. So-called cushion bonds seek to provide the best of both worlds: the elevated income streams available at the longer end of the yield curve with the price stability of shorter-duration bonds. Other portfolio management techniques, such as a "barbell" structure, also are designed to wring the most income out of a portfolio per unit of risk.

Municipal Bond Yield Comparison

Federal Income Tax Bracket	3%	4%	5%	6%	7%
	<i>Taxable Bond Yield Required to Match After-Tax Muni Yield</i>				
10%	3.33%	4.44%	5.56%	6.67%	7.78%
15%	3.53%	4.71%	5.88%	7.06%	8.24%
25%	4.00%	5.33%	6.67%	8.00%	9.33%
28%	4.17%	5.56%	6.94%	8.33%	9.72%
33%	4.48%	5.97%	7.46%	8.96%	10.45%
35%	4.62%	6.15%	7.69%	9.23%	10.77%
40%	5.00%	6.67%	8.33%	10.00%	11.67%
45%	5.45%	7.27%	9.09%	10.91%	12.73%
50%	6.00%	8.00%	10.00%	12.00%	14.00%

Rates apply to ordinary income, not capital gains. Does not take into consideration state or local taxes, or rates under the alternative minimum tax. For illustrative purposes only. This is not meant to predict any future tax rates.

COMMITTED TO INDEPENDENT ANALYSIS

Northern Trust managed \$279.9 billion in fixed-income assets for individual and institutional investors, including over \$40 billion in the municipal market, as of March 31, 2010. Besides a broad-based tax-exempt fund, we offer a short-intermediate fund, an intermediate fund, a high yield fund, state-specific funds and a variety of tax-exempt money market funds.

These tax-exempt funds are conservatively managed and reflect Northern Trust's commitment to exhaustive and independent credit analysis. A strong credit culture defines what we do and who we are. We have never relied on ratings agencies for the final word on creditworthiness and place no significant value on bond insurance.

SECULAR TRENDS AT-A-GLANCE

Municipal bonds appear positioned to potentially benefit from the following secular trends in coming years.

- **Demographics.** The graying of America, as exemplified by the looming retirement of the huge baby-boomer generation, implies rising demand for fixed-income investments.
- **Higher taxes.** The need to reduce trillion-dollar federal budget deficits will likely cause tax rates to rise, especially for upper-income taxpayers. Higher tax rates make tax-exempt income more desirable.
- **More savings.** Americans have responded to job insecurity and sharp reductions to their net worth by boosting savings. Given the magnitude of the damage to household balance sheets, we expect this trend to continue, thereby possibly funneling more money into financial assets like municipal bonds.
- **Less supply.** The introduction of Build America Bonds as part of the recent stimulus legislation could limit the issuance of traditional municipal debt.

- 1 Yield on Bond Buyer General Obligation 20-Bond Municipal Bond Index, 20 years to maturity, mixed quality; yield on 20-year Treasury bonds, constant maturity.
- 2 Social Security Administration, October 15, 2007.
- 3 *ibid*
- 4 Office of Management and Budget, Mid-Session Review, August 25, 2009.
- 5 *ibid*
- 6 *ibid*
- 7 Internal Revenue Service, SOI Bulletin, June 2002.
- 8 Northern Trust, August 19, 2009.
- 9 U.S. Commerce Department, February 1, 2007.
- 10 Author's calculation using data from U.S. Bureau of Economic Analysis.
- 11 U.S. Bureau of Economic Analysis, "Alternative Measures of Personal Saving," Marshall B. Reinsdorf, February 2007.
- 12 U.S. Bureau of Economic Analysis, June 26, 2009.

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