

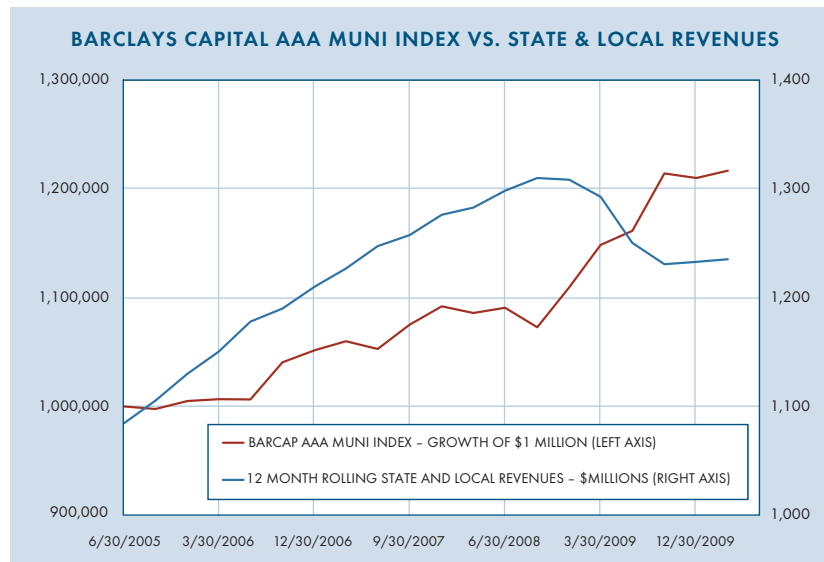
MUNICIPAL BONDS: MUCH HEALTHIER THAN FEARED



How have municipal bonds performed so well during a period when states are struggling mightily to balance budgets and the overall economic picture remains “unusually uncertain”? Northern Trust’s Chief Investment Strategist, Jim McDonald discusses the situation in this commentary.

Jim McDonald
Northern Trust
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Long an investment favored for portfolio stability and tax-advantaged interest income, municipal bonds have generated a lot more worry of late. If one only read the newspapers, with no access to financial market information, you could be excused for thinking that municipals have probably been a lousy investment. High-profile budget problems in states such as California, Illinois and New Jersey highlight the significant challenges state and local governments face, and watching the state budget and legislative process unfold makes sausage-making look attractive. Yet municipal bonds have performed very well during this period, reconfirming their role in a diversified portfolio. The chart below highlights how the value of a municipal bond portfolio (as represented by the Barclays Capital AAA Muni Index) has continued to increase over the last five years, even during the period when state and local budgets were pressured by falling tax revenues.



Source: Barclays Live, Bloomberg. Quarterly data through 3/31/2010.

WHAT'S BEHIND FAVORABLE MUNICIPAL PERFORMANCE?

How have municipals performed so well during a period when states are struggling mightily to balance budgets and the overall economic picture remains “unusually uncertain”? You need to scrutinize the true drivers of municipal bond prices and also take a view on the outlook for these factors. Most importantly, market interest rates drive municipal bond prices. Second, credit risk affects bond prices as investors seek to discount the risk of default. Finally, technical factors such as tax policy, economic policy and demographics influence the pricing of muni bonds.

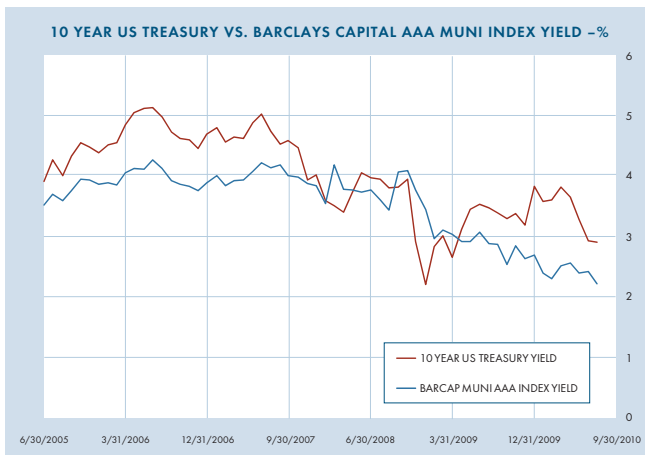
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Northern Trust Investments

POSITIVE INTEREST RATE ENVIRONMENT – A CATALYST

The strong performance of municipal bonds has been heavily influenced by a very positive interest rate environment. As interest rates fall, the value of outstanding bonds rises (as their stated interest rate is now more attractive in a lower interest rate environment). Not only have interest rates been falling of late, but the 10-year Treasury has been in a 30-year bull market after peaking near 16% in 1981. A secular decline in consumer price inflation has underpinned the fall in rates, as inflation peaked at 14.8% in March 1980 and was reported at a 1.1% rate for June 2010. Lower rates have also been sustained in recent years by a lower growth outlook for the advanced economies. Finally, rates in certain countries such as the United States, Germany and Japan have fallen as global investors have “de-risked” their portfolios by buying safe-haven assets. Municipal rates, on a longer-term basis, follow U.S. Treasury rates and therefore have benefitted from this environment. (See chart below.)

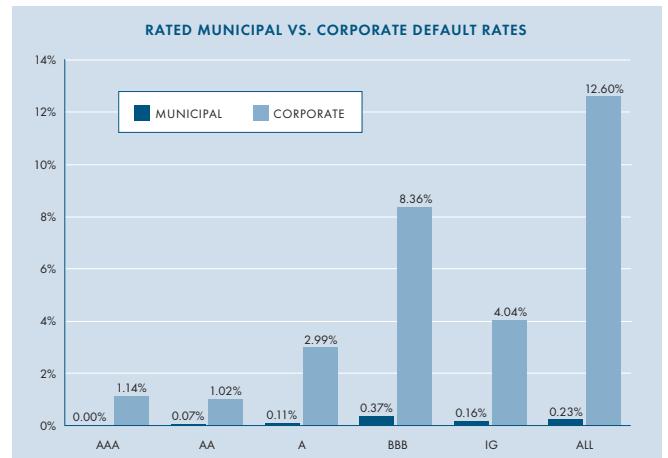


Source: Barclays Live, Bloomberg. Monthly data through 7/31/2010.

A careful review of the graph comparing municipal interest rates with U.S. Treasuries shows that typically, municipal yields are lower than yields for comparable U.S. Treasuries due to their tax advantaged nature. On very rare occasions, there are periods of dislocation – such as during the financial crisis – where municipals can go to a yield premium because of stress in the muni market. The second key input to determining municipal bond prices is credit risk. The severity of the recession, along with a surge in debt outstanding, clearly raises the stakes for municipal issuers.

MUNICIPAL DEFAULTS RISK – HAS BEEN HISTORICALLY LOW

However, across the entire municipal bond universe, the risk of default has historically been quite low. According to Moody’s, there were 54 municipal bond defaults of rated issuers between 1970 and 2007, compared with 1,707 rated corporate defaults. Of these municipal bond defaults, 78% were from health care and housing project finance issuers – so sector selection and credit analysis can go a long way. The following chart shows the infrequency of default rates in municipal bonds, especially in the highest credit quality.



Source: Chapman and Cutler LLP. Corporate default rates from 1989-2009; municipal default rates from 1986-2008.

STATE BUDGETS – OUR THOUGHTS

As states have struggled with the falloff in tax revenues from the financial crisis and ensuing recession, they have had very difficult budgeting processes. Despite these difficulties, almost all the states began the 2011 fiscal year with approved budgets, California being the primary exception. Nearly all the states are cutting spending, some are raising taxes and as many as 20 states have begun to tackle their massive pension problems by modifying program terms.

The quality of these budgets, though, is far from uniform. One area of uncertainty in the state budgets is what the legislatures included for Medicare funding from the federal government. Some states, such as Louisiana, Minnesota, Missouri, Ohio and Texas haven’t budgeted for Medicare funding increases and would benefit if it happened. Other states, such as California, Florida, Illinois, New York and Pennsylvania are counting on this increase and therefore are more vulnerable to a negative surprise.

STATE BUDGETS (CONTINUED)

We think that Illinois, California and Arizona are the three states with the most challenged financial outlook and aren't recommending new purchases of bonds from these states. Arizona has been seriously hurt by the real estate downturn, and, in addition, their bonds are appropriation debt (as opposed to general obligation) so they are more vulnerable to political whims. California is a state we continue to watch carefully to determine whether further portfolio actions are required. They haven't fixed their dysfunctional form of budgeting and are vulnerable to a stalemate between the governor and legislature. Finally, Illinois lost a chance to gain some budgeting credibility when the legislature threw the budgetary problems back in the lap of the governor. In addition, Illinois' pension plan has the worst funding status of any state. We think the severity of the difficulties in Illinois warrants a reduction in exposure to its outstanding bonds.

We think that careful credit analysis can reduce the risks involved in municipal bond investing to a very manageable level. With respect to the types of municipal bonds we currently favor, we are focusing on three main areas: unlimited tax general obligation bonds, dedicated essential service revenue bonds and pre-refunded bonds. General obligation bonds are backed by the full faith and credit of the issuer, who has unlimited real property taxing power, and generally represent a very high credit profile. Essential service bonds are supported by dedicated revenue streams from projects like water or sewer, public power or transportation. Finally, pre-refunded bonds have a high credit profile due to collateralization by U.S. Treasuries given during a refinancing.

MUNICIPAL BOND PRICE DRIVERS

The third major driver of municipal bond prices falls into the category of technical factors (pretty much everything that isn't tied to interest rates or credit risk). A primary factor here is the tax-advantaged nature of municipal bonds – a mainstay of their attractiveness. One of the underpinnings of muni bond prices of late has been the expectation of higher income tax rates for higher income Americans. An additional factor that has supported prices, due to a decrease in supply, is the issuance of Build America Bonds (BABs), which were introduced by the U.S. Treasury in April 2009 to assist financing efforts by state and local governments. The

U.S. government pays 35% of the interest cost of the bond, and they are not tax-exempt. While this has opened up new sources of capital for these governments, it has reduced new issue supply of traditional tax-advantaged bonds to the municipal market. On a longer-term basis, we expect continued strong demand for municipal bonds due to the aging of the baby-boomer generation and expectations of higher taxes for upper-income taxpayers.

Our review of the key drivers of municipal bonds highlights why they have performed so well despite the very difficult economic environment. Going forward, we expect interest rates to only increase modestly over the next five years, given expectations that growth will be moderate and inflation will remain tame. We expect the yield on the 10-year Treasury to average 4.75% over the next five years (compared with around 3.0% today) and municipal bonds to generate a return of approximately 3%. We expect continued pressure on state and local credit quality, as governments face declining revenues, rising expenses, dysfunctional political structures and rising voter resistance to tax hikes. This could increase volatility in the muni market as individual issuers have credit problems, and it continues to mandate a strong focus on credit research and portfolio construction to reduce credit risk. Finally, we expect to see continued strong demand for municipals due to demographic trends and the outlook for tax rates. A risk to municipal valuations exists with the BAB program; any material reduction in this program could lead to a jump in traditional muni bond issuance, which could pressure bond prices. In summary, we think the municipal bonds have been tested through the financial crisis and have shown that a well-researched and constructed municipal bond portfolio should be a mainstay of most high-net-worth investors.

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