



Insights from Northern Trust

Commentary from Timothy McGregor, Director, Municipal Fixed Income Management

January 25, 2011

Tim McGregor addresses some of the recent negative municipal market headlines and re-addresses his short- and long-term views on the health of that market. This issue covers the suggested need for new legislation allowing states to file for bankruptcy; cessation of the successful Build America Bond program; whether the Bush tax cuts will dampen demand for municipal bonds; and an outlook for 2011.

Q: *The New York Times* recently ran an article suggesting bankruptcy as a potential solution for cash-strapped states unable to meet their future fiscal obligations. Do you believe passage of such legislation is likely in 2011, and what impact would it have on municipal investors and the market overall?

A: As the article noted, at this point there is not even a draft of a bill, and such a plan would face political as well as constitutional questions. The option is being discussed as an alternative to the other strategies – reducing expenses and raising revenues – that are already being successfully applied to many budget challenges at all levels of state and local governments. We currently see passage of something along these lines as a remote possibility, but it gives us one more reason to focus our proprietary credit research on diligently and independently evaluating issuers and the terms of specific bonds.

Municipal debt obligations are a very modest portion of most budgets for the issuers we hold. We do not expect that bond payments are the items that would most likely lead these issuers into financial difficulty. The most likely source of near-term budget woes would appear to be farther down the payment hierarchy, such as appropriation-dependent debt or project-specific bonds.

Q: Other than the discussion of municipal bankruptcies, what other key factors have been affecting the muni market? Do you think these are factors that will weigh on munis throughout 2011?

A: Volatility in the tax-exempt market was one defining feature of 2010 and, in our opinion, will continue to run at much higher-than-historical levels. Uncertainty around future tax rates and the scheduled expiration of the Build America Bond (BAB) program had certainly weighed on the market last year, as did the unexpected increase in rates generally based on the Federal Reserve's recent quantitative easing program and some improved economic growth data.

Credit concerns, more press coverage of budget stresses and the reversal of flows to municipal mutual funds also have challenged the muni market. The market's sensitivity to credit and budget factors is unlikely to abate in 2011 and may actually increase as specific, localized situations capture the attention of the popular press (such as in Harrisburg, Pennsylvania, for example).



An additional and less-discussed factor contributing to this higher volatility is that risk tolerance in the broker/dealer community (and thus liquidity in the muni bond market) appears to be well below pre-crisis levels. Their appetite for using capital to support bond inventories has shrunk dramatically. This reduced inventory and lower liquidity has magnified supply-demand imbalances, contributing to volatility. While not limited to muni bond inventories, the variety and diversity of issuers and structures in this market exposes it to illiquidity stresses.

Q: What impact has the BAB program had on the municipal market? Now that new issuance has expired, effective January 1, how do you expect the municipal market to respond? What do you think is the likelihood that the federal government would provide a backstop in case of default?

A: The BAB program was a very successful alternative source of about \$200 billion of financing for municipal issuers. It was particularly valuable for long-term issues and lower-rated issuers. While a modified version of BABs may reappear in 2011, we believe that is unlikely unless the economy takes a sharp turn for the worse. BABs may have allowed some issuers to prefund certain borrowing needs, drawing issuance forward from future periods, but we do not foresee a dramatic shrinkage in overall municipal supply.

The BAB program only allowed for funding of a prescribed set of uses (not refundings, for example), and we believe the scale and scope of the municipal market will find a diverse array of issuers and issues.

We always have been highly selective with regard to credit, structure and geography. Rather than identifying specific issuers to avoid, we have focused on proactively identifying situations with highly positive attributes: general obligations from issuers with strong tax bases, modest reliance on funding from other levels and so on.

Any market with more than 50,000 issuers and more than 1.5 million outstanding issues may have an array of good, bad and ugly credit profiles, and our proprietary credit research process is designed to make sure we know and act on those distinctions.

We do not invest on the assumption that the federal government will bail out an issuer, but program-specific assistance such as Medicaid or unemployment fund support has been seen in the past.

Q: Do you think the extension of the Bush tax cuts for investors at all income levels will dampen demand for municipal bonds? Why or why not?

A: We think the municipal bond market will continue drawing many investors. Strong demographic trends, the attractiveness of after-tax income and the (selectively) strong credit profile of munis should support demand.

The Baby Boomer generation has started turning 65, and even if many work longer than they had expected, advisors may still recommend increasing their exposure to fixed-income investments for both income and reduced volatility. Municipal bonds may not necessarily be the only fixed-income category used to achieve that allocation goal, but it is likely to attract new investors as this aging cohort marches into its graying years, 10,000 individuals per day.

While federal tax rates have been frozen for two more years, many state and local governments are combining tax increases with expense reductions to address their balanced budget requirements. In that



sense, the overall tax rates for many individuals are – and will be – rising; therefore, this should enhance the attractiveness of munis.

Q: What is Northern Trust’s outlook for the municipal market in 2011?

A: While individual issuer problems likely may crop up in 2011, and we expect another year of difficult budget negotiations, we believe many state and local governments have displayed credible fiscal discipline through a combination of spending cuts and tax increases. We do expect the credit environment to remain challenging and want to “stay at the top of the budget” (selectively owning essential service revenue bonds and general obligation bonds) as opposed to “being at the bottom of the budget” (appropriation bonds or leases).

The current municipal yield curve is historically steep, so investors are being rewarded for extending duration. In this market, we’d rather extend duration to increase income than take on additional credit risk, favoring AAA- and AA-rated securities.

Well-researched municipal bonds, we believe, continue to offer the benefits of favorable tax-exempt income and diversification in a larger portfolio.

Important Information

Past performance is not a guide to the future. There are risks involved in investing including possible loss of principal.

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