MMA The Power of Independence

JANUARY 2011

GAIN INSIGHT ON HOW TO NAVIGATE THE COMPLEX MUNICIPAL BOND MARKET

ABOUT US

Municipal Market Advisors is a leading independent strategy, research and consulting firm in the municipal bond industry. MMA's subscription services provide *clarity* and *insight* into the complex world of municipal bond investing. Our independence facilitates objective analysis and distinctive views of the issues confronting investors so informed investment decisions can be made.

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MARKET SUMMARY

LOSSES CONTINUED, CREATING VALUE FOR INVESTORS

The municipal market posted losses for another month. The **MMA** municipal price index fell -2.3%. However, through January 18, the market's price decline was -3.6%, so that in the last 9 sessions of the month, 36% of the month's losses were reclaimed. Investors began to take notice of the 8% taxable equivalent yield available in 30-years as AAA tax-exempt yield rose above 5%. In addition, the **MMA** index edged into positive territory. Unfortunately, since Labor Day 2010, the municipal market has been unable to sustain a positive price trend. The downward price pressure has correctly been attributed to the sizeable redemptions from the mutual bond funds over the past 3 1/2 months, in excess of $25B. The dealer community has simply not had the capital or distribution mechanisms to provide adequate liquidity to stabilize prices. The defining moment during the 4 month decline of municipal prices (and rise in yields) was the S&P downgrade of 50% of the tobacco sector on November 11, which in turn roiled the high-yield fund sector, most of which has led returns through 2010. Subsequently, Meredith Whitney's "*campaign of fear*" received heightened media attention to further drive yields higher as more investors became fearful of improbable defaults in the safest sectors of the municipal market. Fortunately toward January's end, the municipal industry - analysts, dealers, institutional investors and issuers - seized knowledgeable control of the credit issue and provided a needed salve to the wounds of the industry, **Figure 1**. Municipal issuance was $12.2B in January marking the lowest primary activity for the first month of the year since 2001's $12.5B. In 2001, total municipal issuance was $289B. The absence of a robust calendar allowed dealers to manage some of the secondary congestion. Daily bids-wanted par routinely exceeded $1B, and the 10-day average reached $982M, a level only surpassed in December 2010 (in November 2008 the 10-average peaked at $931M). The discord created by the illiquid conditions was exemplified by the pricing challenges of the $923 million school facilities construction bonds for the New Jersey Economic Development Authority on January 13 (**APPENDIX**). The issue had to be re-priced to higher yields twice as the price discovery process and indications of institutional demand were crippled. In addi-

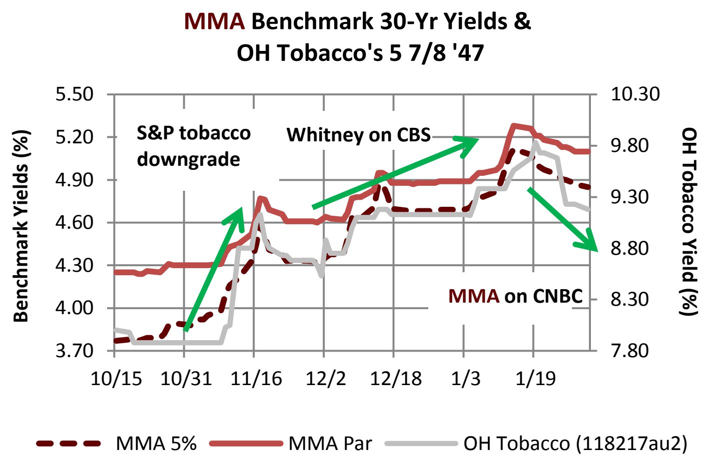

Figure 1: Since the S&P tobacco downgrade, municipal yields have steadily risen. However, by January 20 some stability emerged though its duration remained uncertain.

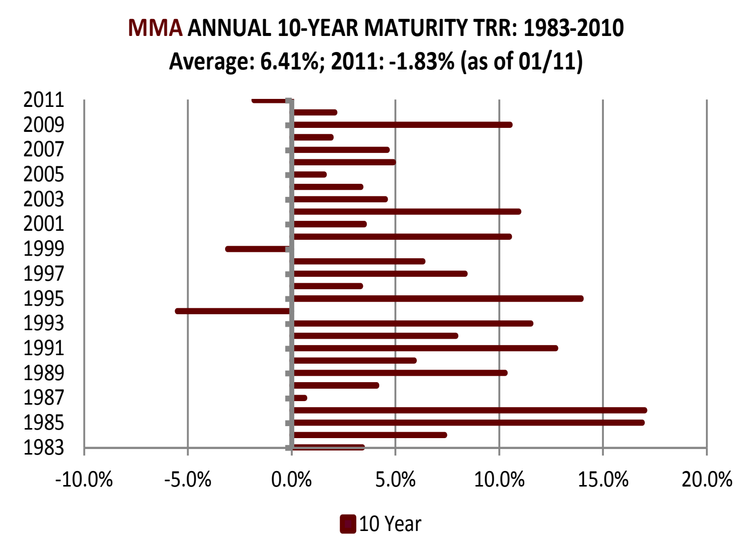

*Figure 2: **MMA**'s municipal 10-year maturity index has posted annual losses only twice (1994 and 1999) since 1983.*

tion, the pricing of the issue reflected the sensitivity of investors and the broader market to headlines regarding bondholder's rights. The exploration of federal legislation allowing states to pursue bankruptcy legislation, regardless of its ill-conceived nature and the states and municipalities absence of demand for the mechanism, increased the difficulty to reassure investors that the legal strength of the bondholder agreement was sound. The championing of the bankruptcy option by Newt Gingrich and some Tea-party elements has led to congressional hearings on the topic in which **MMA** is expected to participate in February. Municipal bond investors were also distracted by the ascent of the US equity market which posted strong gains in January. The cautious optimism drawn from corporate earnings and US economic data encouraged investors to seek the growth opportunities offered by equities, while also increasing inflationary fears and expectations of weakened bond returns for 2011. US Corporations sought record access to the debt markets in January, issuing more than $158B. The improved prospects for the US economy also translated into improved tax receipts for US states. The Nelson A. Rockefeller Institute preliminary reported that 4Q10 showed a 6.9% YOY increase in tax revenue—the 4th straight quarter of increase and the largest quarterly gain since 2Q06. While fiscal pressure will persist, leading states to bold spending cuts, pension reform and higher taxes, indications of a slow US economic recovery are encouraging. Finally, while January's municipal losses were sobering, **MMA**'s 10-year index has only posted a negative total rate of return in two years since 1983 (1994 and 1999), **Figure 2**.

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