

# MUNICIPAL BONDS: STATE OF THE TAX-EXEMPT MARKET

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## EXECUTIVE SUMMARY

- There has been significant dislocation in municipal markets as indicated by relative value to treasuries, decreased issuance, risk aversion, and liquidity concerns. Thus far in 2009, we've seen municipal bonds rally and new issuance resume, but investors are still wary of anything but the highest-quality municipal bonds. Manager focus has changed from interest rate strategies to upgrading the quality of municipal portfolios.
- Investors are concerned with the possibility of broad municipal defaults given the virtual extinction of bond insurance, the increase in unemployment, the decrease in economic activity, and depressed real estate property values. These factors result in lower state and local government revenues and heightened budgetary challenges.
- The municipal bond asset class still offers investors a high-quality alternative to its corporate bond counterparts, historically high yields relative to treasuries, and a history of protecting bondholders in difficult economic times.
- Continued monitoring of this asset class and managers' portfolio holdings for significant credit deterioration and interest rate strategies is appropriate given the economic crisis facing the country.

## MUNICIPAL BOND MARKET UPDATE

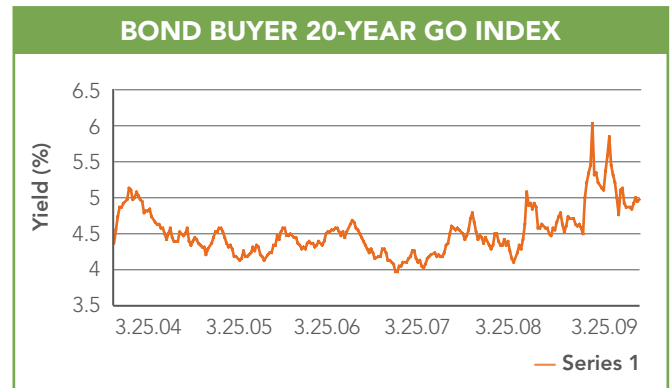
### Broad Market Difficulties Negatively Affect Municipal Bonds

In 2008, municipal bonds posted their worst calendar-year performance since 1994 with the Barclays Capital Municipal Bond Index posting a -2.47% return. The municipal bond market was under significant pressure caused by the fallout of the bond insurance industry, the upheaval of a global credit crisis, and looming recessionary fears. Municipal bonds, like other asset classes, faced immense technical dislocation caused by forced selling by leveraged institutions and a general lack of liquidity. Market liquidity was a major technical concern among investors with very little new issuance, broad risk aversion, fewer secondary dealers, and smaller dealer inventory positions. While new issuance has increased in the first quarter of 2009 for the highest-quality issuers and secondary trading has begun to normalize, the municipal market landscape has changed. We've seen the major municipal bond dealers, such as Lehman, Merrill Lynch, and Bear Stearns, fall by the wayside amid difficulties for the financial industry. Also, the market is experiencing a shift from an institutional market to a retail-oriented market.

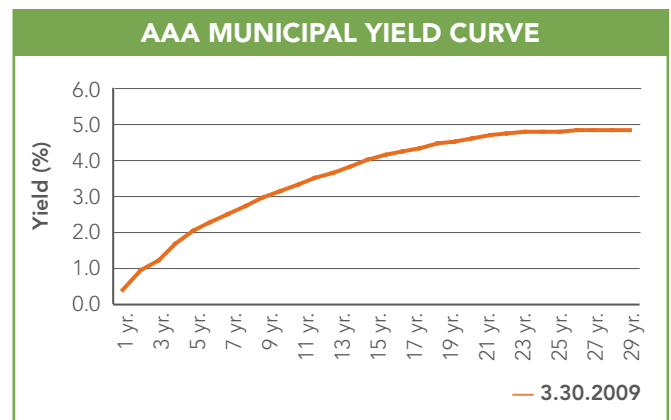
### Municipal Fundamentals Give Strength to Market Rebound

Most asset classes, other than treasuries, were severely punished due to the economic challenges we faced. However, despite the technical dislocation and poor performance, municipal bond fundamentals remain relatively strong. Yield ratios between municipal bonds and comparable maturity treasuries have not yet fallen consistently below 100%, which is often cited as an indicator that municipal bonds are relatively undervalued compared to treasuries. For example, municipal bonds have historically traded at approximately 80%-90% of treasuries, whereby today's market offers AAA tax-exempt municipal bonds at yields up to 135% of federally taxable treasuries. These attractive after tax yields have led investors back into the municipal bond market, albeit slowly, but enough to rally short-end municipals in December 2008. This momentum carried over into 2009 with broad market municipal performance up 4.16% year-to-date (March 31, 2009) according to the

Barclays Capital 10-Year Municipal Bond Index. The chart below shows the Bond Buyer 20-Year GO Index, which measures the effective yields of 20-year general obligation bonds. You can see that the yield of this index rose significantly in 2008. The year-over-year index yield went from 4.42% in December 2007 to 5.56% in December 2008. As of March 25, 2009, the index closed at 5.00%, indicating that investors have been willing to take on the risk of moving further out on the curve this year to take advantage of attractive after-tax yields offered on longer-term municipal bonds.



Source: Bloomberg



Source: Municipal Market Data

Despite the recovery of the municipal bond market, fundamental issues still exist as investors have become increasingly concerned that the unprecedented events of the last year and a half will lead to broad credit deterioration of state and local municipalities.

## UNDERLYING CREDIT QUALITY IS PARAMOUNT AS BOND INSURERS FACE DIFFICULTIES

### The Safety Net for Municipal Investors Is All But Gone

The existence of municipal bond insurance has been almost completely discounted in the market with the exception of issues trading with insurance from FSA, Assured Guaranty®, and Berkshire Hathaway, Inc. These three firms are the only remaining AAA issuers that exist today. Because of the fallout of firms like MBIA, Inc., FGIC, and AMBAC and the overall skepticism surrounding insurance ratings, new and secondary issues continue to be evaluated by managers solely based on the underlying credit quality of the issuer. Even if bond insurance is an added enhancement, investors are primarily focused on the issuer's direct ability to repay principal and interest on the loan. The following table shows the current ratings of the major bond insurance companies with their respective ratings outlook:

### Current Bond Insurance Ratings: Outlook in Question

Insurance Company	Moody's	Moody's Outlook	S&P	S&P Outlook	Fitch	Fitch Outlook
AMBAC	Ba3	Developing	A	Negative	—	Withdrawn
Assured Guaranty	Aa2	Stable	AAA	Stable	AAA	Stable
Berkshire Hathaway	Aa1	Stable	AAA	Stable	AAA	Negative
CIFG	Ba3	Developing	B	Developing	CCC	Evolving
FGIC	—	Withdrawn	BB	Negative	—	Withdrawn
FSA	Aa3	Developing	AAA	Negative	AAA	Negative
MBIA	B3	Developing	BBB+	Negative	—	Withdrawn
Radian	Ba1	Stable	BBB+	Negative	—	Withdrawn

Source: Stone & Youngberg (as of April 13, 2009)

How will the general lack of a viable municipal bond insurance industry affect the municipal market going forward? In our opinion, it seems that municipal bond investors have already adjusted to the notion of having to place all credit emphasis on the fundamentals of the underlying issuer. Investors and managers are placing much more emphasis on higher-quality general obligation and essential purpose revenue bonds. In the past, an investor might not consider an A-rated underlying bond without insurance, but the investor bought issues with a AAA insurance wrap without regard to underlying credit quality. Today, investors closely analyze current underlying ratings of an issuer along with their outlook for stability. There were strong signs of forced selling in the marketplace last year due likely to the unwinding of positions by investors and managers that could no longer hold securities that were not insured or rated AAA; the market has adjusted relatively well. Consequently, state and local municipalities can no longer rely on bond insurance to provide lower financing costs associated with AAA ratings; this increased cost of financing will place additional financial stress on the issuers.

### Independent Research and Monitoring

Managers have teams of dedicated municipal research analysts that utilize their own in-house rating system for an issuer's debt, without regard to the opinions of the major ratings agencies. It is often a source of value in a security when in-house ratings differ from those of Moody's, S&P, or Fitch. Managers also monitor ongoing changes to the overall market that may affect the quality of a state and local municipality and make investment decisions accordingly.

## GENERAL OBLIGATIONS AND ESSENTIAL REVENUE BONDS BECOME FOCUS

### Understand Municipal Bond Alternatives: Municipal Bond Types

Municipal bonds can typically be separated into distinct sectors: general obligation, essential purpose revenue, non-essential purpose revenue bonds, and other. These are as follows:

- General Obligations
  - Limited Tax General Obligations
  - Unlimited Tax General Obligations (Schools, Capital Improvements)
- Revenue
  - Essential Purpose (Water, Sewer, Utilities)
  - State Appropriation (Transportation, Revenue Sharing)
  - Higher Education (Colleges, Universities)
- Non-Essential Purpose Revenue
  - Healthcare (Hospitals, Nursing Homes)
  - Charter Schools
  - Quasi-Corporate Bonds (Industrial Development Bonds, Pollution Control Revenue Bonds)
- Other
  - Pre-Refunded Bonds (U.S. Government-Backed)
  - Tax Allocation Bonds
  - Certificates of Participation

General obligation bonds have historically been considered the safest type of municipal bonds at issuance (pre-refunded bonds, discussed below, are backed by U.S. Treasury securities), explicitly backed by the full faith and credit of the taxing municipal authority. Essential purpose revenue bonds such as water, sewer, and public utilities are considered very safe, backed by a dedicated stream of revenues from a customer base in which the authority has the ability to raise rates on its constituents to meet debt service obligations. Also, customers tend to stay current on their bills for essential services. Lastly, non-essential purpose revenue bonds are considered riskier, backed by a revenue stream contingent upon economic cycles and possibly a corporate guarantee. These bonds include healthcare facilities, charter schools, and “quasi-corporate” bonds such as industrial develop-

ment bonds. Some of these issuers can be in the high yield category depending on the issuer’s current credit rating. Non-essential purpose revenue bonds have historically suffered higher default rates.

### U.S. Treasury-Backed Pre-Refunded Bonds Provide Ultimate Safety

It’s worth noting that pre-refunded bonds have been given a great deal of attention due to the sector’s high-quality characteristics and relative value to treasuries. Pre-refunded bonds represent a security that has been refinanced and escrowed with U.S. Treasuries or State and Local Government Securities (SLUGS) from the bond proceeds of a new issue. These bonds are generally escrowed to their shortest call date or maturity. As a result of the recent economic crisis, investors’ flight to quality has spurred increased demand for pre-refunded bonds. As of March 31, 2009, pre-refunded bonds trade at tax-exempt yields of .45% for a one-year maturity and 2.09% for a five-year, compared to federally taxable treasury yields of .54% and 1.85%, respectively. Many managers own pre-refunded bonds as a quality hedge, but consider these highly liquid to allow them flexibility to take advantage of higher-yielding opportunities.

## DIVERSE ISSUES EXPERIENCED BY INDIVIDUAL STATES

### National Perspective of Municipal Market

There is plenty of concern among investors given the news across the nation with respect to the current economic crisis, specifically among states and regions considered at risk. These states include those most affected by the economic downturn, thereby facing larger budgetary challenges given the nature of their economic base. The states most often noted include California, New York, Florida, Michigan, Ohio, and Nevada. According to a February 2009 report by Moody’s, states anticipate budgetary pressures in the face of revenue shortfalls and a diminished capacity to raise capital. Moody’s has recently assigned a negative outlook to the U.S. local government sector; this broad assignment of a negative outlook to this sector is a first for Moody’s. This is not reflective of individual issuers since each municipality is experiencing different

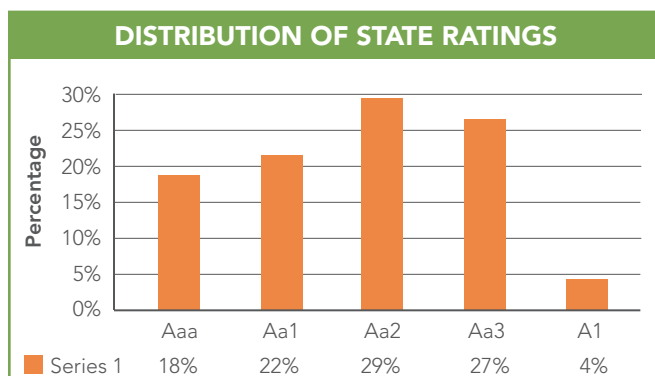
challenges to the current environment. Moody's cites the following reasons for this outlook:

- Declining real estate tax revenues due to declining property values.
- Declining income and sales and use tax revenues.
- Credit market volatility – decreased ability to access credit markets.
- Industry and revenue concentrations.
- Increased spending due to recessionary pressures such as the demand for social services as a result of increased unemployment and other legally mandated expenditures.

Mitigating factors expected to have a positive impact on the financial challenges of municipalities:

- Increased budget reserves during the housing boom.
- The recent U.S. economic stimulus plan is expected to temper the current budgetary pressures with money from this package going directly to state and local governments.
- States still have broad taxing and spending powers and should have little problem covering debt service; the issue will be the ability of municipalities to issue new debt for capital expenditures.

Moody's reports six states that currently have a negative outlook, which means that there is a greater than 50% chance of being downgraded over the medium term. These states are Florida (Aa1), Kentucky (Aa2), Nevada (Aa1), Ohio (Aa1), Rhode Island (Aa3), and Wisconsin (Aa3). California, currently rated A3, is on the watchlist for a possible downgrade. The following chart illustrates the current ratings distribution of state general obligation bonds:



Source: Moody's

RATING'S GUIDE		
Moody's	Standard & Poor's	Definition
<b>Investment-Grade</b>		
Aaa	AAA	Prime, Maximum Safety
Aa1, Aa2, Aa3	AA+, AA, AA-	Very High-Grade, High-Quality
A1, A2, A3	A+, A, A-	Upper Medium-Grade
Baa1, Baa2, Baa3	BBB+, BBB, BBB-	Lower Medium-Grade
<b>Speculative-Grade</b>		
Ba1, Ba2, Ba3	BB+, BB, BB-	Low-Grade, Speculative
B1, B2, B3	B+, B, B-	Highly Speculative
Caa through C	CCC+ through C	Substantial Risk, In Default
—	D	Default

Source: "Handbook of Fixed Income Securities," Fabozzi, Frank J., (1991)

### Market Places Greater Emphasis on Regional and Local Issues

There are also regional considerations as certain areas of the country are negatively affected by specific industries currently out of favor. Housing value decreases have hit markets particularly hard that experienced significant increase in housing values during the 2004-2007 boom. Another example is the downturn in the tourism industry, which has negatively affected states such as Nevada, California, and Florida. The Midwest has been adversely affected by its concentration in manufacturing, particularly states that have a strong automotive base. A decrease in gaming activity has negatively impacted states that rely on gambling. Lastly, regions dependent on the financial industry will see a significant reduction in its revenues due to widespread layoffs and decreased profits.

While the story has yet to unfold, state and local governments must remain diligent in their efforts to be fiscally responsible through a combination of spending cuts, increased taxes, and increased financing in an effort to balance budgets. Meanwhile, it is not widely expected that any states will default on its general obligation debt, but budgetary pressures will certainly flow down to local municipalities. Local governments must do the same belt-tightening that is being done on a state level, but with possibly less effectiveness given the less diverse nature of local municipalities. All levels of government will be forced to postpone major infrastructure projects and evaluate priority spending initiatives in an effort to survive the effects of the current economic downturn.

The municipal bond benchmarks that many fund managers follow have approximately 60% of its holdings exposed to 10 states considered the largest issuers of municipal debt. States such as California, New York, and Texas issue massive amounts of debt every year as their budgetary demands are consistently larger than those of smaller states.

Moody's recently issued a report entitled "Impact of the Recession and State Budget on California Local Governments," which emphasized the opinion that California's current situation is proving difficult with the anticipation of additional fiscal pressures on local municipalities. However, Moody's expects these municipalities to maintain their financial viability. Additionally, the diverse nature of California's economy may provide a better backdrop for a quicker recovery as compared to states that have a more concentrated economic base.

## THE EFFECT OF GOVERNMENT STIMULUS ON MUNICIPALITIES

### Obama Administration's Stimulus Plan Aids State and Local Municipalities

The following highlights come from a presentation on February 20, 2009, by Moody's Investors Service on "Federal Stimulus Legislation & the U.S. Municipal Market." While much of this stimulus is expected to happen in 2009 and 2010, it is not expected to be a long-term solution. It is, however, expected to provide relief to state and local governments while positively impacting the municipal bond market.

- Of the \$787B stimulus package passed by Congress, \$270B will benefit U.S. municipalities, including healthcare provisions. Most of the funding will be directed to state governments which will benefit education and healthcare.
- Major provisions include Medicaid, budget stabilization, highway funds, COBRA health insurance, education credits, school construction, and other initiatives.
- The funding is primarily intended to bridge the short-term budget gaps that exist while longer-term

initiatives, such as pensions, stock market support, and unemployment, will have to come about as a result of a growing economy.

- The stimulus will likely reduce the need for near-term new issuance of debt by state and local governments and other infrastructure-heavy issuers such as airports, public power agencies, state revolving funds, and transportation-related endeavors.
- Additionally, higher education and healthcare facilities will receive relief from tuition hikes and healthcare-related expenses through extension and enhancement of federally-sponsored insurance programs.

## MUNICIPAL BONDS HAVE HISTORICALLY PROTECTED BONDHOLDERS

### Recent Default History

Historically, municipal defaults have been extremely low. According to a 2007 Moody's report on municipal defaults, since the 1970s (through 2006) municipal issuers have experienced defaults of only one in every 10,000 bonds issued for the entire municipal market. During this period, no Moody's-rated general obligation or essential purpose revenue issuer defaulted on its debt. Defaults experienced were from non-essential purpose revenue bonds such as hospitals or "quasi-corporate" bonds such as industrial revenue bonds. Results of separate studies by the three major rating agencies on municipal defaults were reported as follows:

- Moody's (1970-2006): Average annual default rate was one in 10,000
- Standard & Poor's (1986-2008): Average annual default rate was one in 10,000
- Fitch (1987-2002): Average annual default rate was two in 10,000

The Moody's study reported the following cumulative default history between 1970 and 2006:

Cumulative Historic Municipal Defaults (in percent)	
Rating Categories	Moody's
Aaa/AAA	0.00
Aa/AA	0.06
A/A	0.03
Baa/BBB	0.13
Ba/BB	2.65
B/B	11.86
Caa-C/CCC-C	16.58
Investment Grade	0.07
Non-Investment Grade	4.29
All	0.10

Source: Moody's

Historical default rates in recent history were very low for high-quality issuers rated BBB and higher. For issuers rated B and below, the municipal market experienced double-digit cumulative default rates during the period of 1970-2006.

According to a 2002 Moody's published report, the average recovery rates between the years of 1970 and 2000 on all defaulted municipal bonds has been 68% (compared to 42% for all corporate bonds). Consequently, municipal investors have a higher probability of a greater recovery with nearly 50% of defaulted bonds recovering 75%-100% of par. These estimates likely should be adjusted downward in the current economic environment.

Additionally, a January 2007 report by Fitch Ratings showed only one Fitch-rated municipal issuer, a long-term care facility, defaulted since 2003. Bondholders eventually received 100% recovery on this issue. Standard & Poor's reported 39 total defaults between 1992 and 2008, 37 of which were non-investment grade.

The real question lies in the future and the magnitude of risk in the current municipal market. While history is a useful guide, the memories of investors are short and this economic cycle has seen unprecedented devaluation in almost every asset class, including traditionally safe investment vehicles such as municipal bonds.

### Municipal Bonds and Depression Era Defaults

The Great Depression of the 1930s is considered the worst economic period in U.S. history. While the

municipal bond market has changed and each economic cycle is different, it's useful to revisit the credit risk of municipalities during this difficult era. In general during the 1930s, defaults in municipal sectors were rising but still relatively low. Many factors contributed to the municipal defaults of the Great Depression. There was a sharp increase in issuance of municipal debt from approximately \$2.0B outstanding in 1900 to more than \$17.5B in 1932; this was a period of rapid expansion that required capital expenditures for infrastructure and real estate development. When the stock market crashed in 1929 and the government refused to intervene, banks collapsed, investment values declined, and unemployment rose to 25%. According to a study by Professor George H. Hempel of Washington University, during the period of 1929 through 1937, outstanding municipal bonds defaulted at a rate of 1.80% per year (16.20% cumulatively), of which 96.90% was eventually repaid. Reclamation districts, special districts, and real estate bonds accounted for one-third of the defaulted bonds. Among the lowest default rates were school districts and townships.

Why is this history important? During one of the worst economic periods in the history of the United States, municipal defaults only averaged 1.80% per year with a 96.90% recovery rate based on average outstanding debt. While we see occasional defaults today, it's important to note that municipal bonds remained relatively safe during the worst economic environment in the past 100 years.

### Default Outlook in Unprecedented Times

Will this economic environment put enough strain on municipalities where we will experience significant defaults? It is unlikely that a state GO bond will experience default since most states' constitutions prohibit the state from filing bankruptcy, thereby protecting bondholders. There is a likelihood that some local municipalities will default on its debt, especially during this difficult time when state and local municipalities are experiencing fiscal challenges. However, investment managers that tend to concentrate on the high-quality spectrum of the municipal universe are expected to provide downside protection for bondholders and be better positioned for a recovery.

## CONCLUSION AND OUTLOOK

Municipal bonds have proven to be relatively safe investments from a credit perspective. Today, state and local municipalities are faced with difficult budgetary challenges. Strong credit quality, low default rates, and high recovery rates have historically provided adequate protection for municipal bondholders. Despite the recent fallout from the bond insurance industry and a difficult economic environment, municipal bonds still offer high-credit quality to investors. Managers have become more selective with their investments with stricter investment parameters but tactically taking advantage of bonds that have become dislocated and offer higher-yielding opportunities. Investment professionals who manage quality portfolios are positioned with a high average credit quality and diversification across sectors and states. Of note, fund managers recommended by PMFA are selected not only on their past performance, but their research capabilities to select and monitor the underlying credit quality of each issuer. The recent government stimulus package provided aid directly to state and local governments; it is expected that municipalities can withstand current budget challenges until the

economy improves. We anticipate that there will be some defaults at the local government level, but it remains highly unlikely defaults will occur for state general obligation debt. Managers that are typically recommended by PMFA attempt to achieve diversification among states and do not vary significantly from the state sector weighting of the benchmarks. In conclusion, while we are concerned with the global economy and are watching the municipal market closely, we would anticipate that the diversified nature of a manager's holdings would temper the difficult economic environment that individual municipalities face.

Historically speaking, with a low default rate for high-quality issuers and a high recovery rate, municipal bond investments continue to provide safety of principal on top of attractive after-tax yields. While it is difficult to predict the breadth and depth of the current economic cycle and its ultimate effect on the municipal bond market, an investment in a diversified, high quality municipal bonds portfolio should provide investors with continued tax-exempt income and adequate downside protection.

### Past Performance Does Not Guarantee Future Results

*Data sources for peer group comparisons, returns, and standard statistical data are provided by the sources referenced and are based on data obtained from recognized statistical services or other sources, believed to be reliable. However, some or all information has not been verified prior to the analysis, and we do not make any representations as to its accuracy or completeness. Any analysis non-factual in nature constitutes only current opinions, which are subject to change. There may be instances when consultant opinions regarding the attached fundamental or quantitative analysis may not agree.*

*The analysis was prepared solely to help with your financial planning. Accordingly, it may be incomplete or contain other departures from generally accepted accounting principles and should not be used to obtain credit or for any purposes other than your financial planning. We have not performed an audit, review, or compilation engagement in accordance with standards established by the American Institute of Certified Public Accountants.*

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