



Even as state and local governments in the U.S. grapple with serious fiscal challenges, we believe there are attractive opportunities in the municipal bond market, especially in areas such as essential service revenue bonds. While recent press reports seem to suggest that many states and local governments are on the brink of financial collapse, we think it is important to go behind the headlines to understand the sources and methods of state and local government financing as well as to distinguish among different types of government debt.

Recent press commentary has questioned the ability and willingness of state and local governments to pay debt service in this challenging economy. But we believe state and local governments are among the most creditworthy debt issuers and will remain so, even in the current difficult environment. Historically municipal bonds have retained very high credit ratings because of their low default rates, especially when compared with corporate bonds (Figure 1).

The Case for Investing in Municipal Bonds

By

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Figure 1

Municipal & Corporate Default History		
	Moody's	
	Municipals	Corporates
AAA	0.00%	0.50%
AA	0.03%	0.54%
A	0.03%	2.05%
BBB	0.16%	4.85%
Investment Grade	0.06%	2.50%

Source: Moody's Cumulative default rates within 10-years of original issue, by rating category, from 1970-2009.

Municipal Bond Cumulative Default Rates, 1970-2009		
	General Obligation	Revenue Bonds
All Moody's Rated	0.01%	0.19%
Investment Grade	0.01%	0.13%
Speculative Grade	0.01%	7.37%

Source: Moody's Investor Services

Municipal Defaults, 1970-2009 by Issuer Type	
Issuer Type	Count
Multi Family Housing	21
Health Care	21
Electric, Water or Sewer	3
Local Government (GO)	3
Higher Education	1
Recreation	1
Local Government (non-GO)	1
Total	51

Source: Moody's Investor Services

Municipalities have turned to tax and fee increases as well as spending cuts, especially in the areas of payroll and benefits, capital projects and services to address the shortfall in revenue.

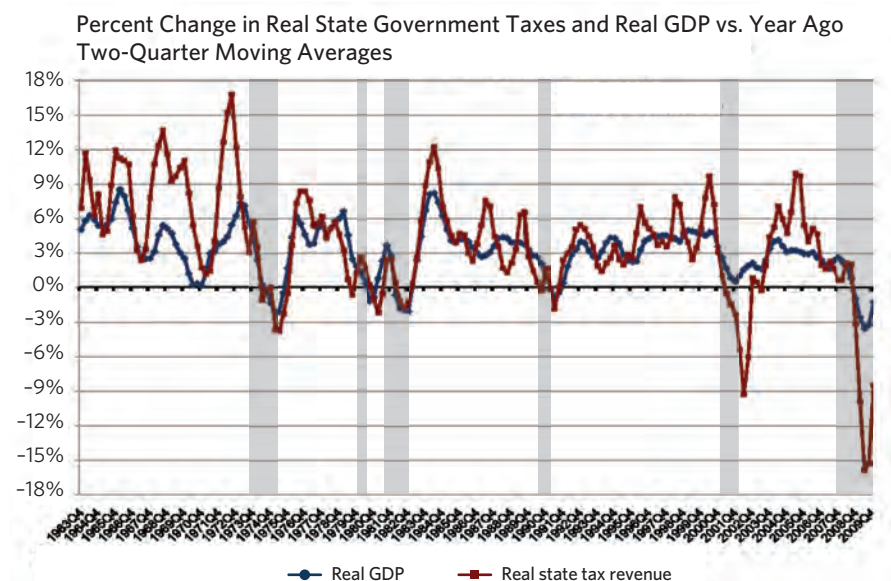
In order to render their ratings more consistent across the debt markets, in April, Moody's held a "rating recalibration" that substantially upgraded general obligation and essential service revenue bonds. Last year, Standard & Poor's upgraded six times as many municipal credits as were downgraded.

It is also important to distinguish municipal debt from other kinds of government debt such as national sovereign debt. For example, unlike the debt crisis plaguing Greece, U.S. municipal debt is self-amortizing. Municipalities' debt structure generally requires some payment of principal each year so that they do not face large balloon maturity payments that would require new debt to retire the old.

It is true that state and local governments in the U.S. have experienced sharp declines in revenue during the worst recession since World War II. Municipalities have turned to tax and fee increases as well as spending cuts, especially in the areas of payroll and benefits, capital projects and services to address the shortfall in revenue. Leverage ratios remain stable, with bond issues funding capital projects rather than closing deficits. While recovery in financial markets has helped to improve the funding status of public pension plans, municipalities must also address this liability with increased contributions and modified benefit packages. The state of Illinois, which has the weakest funding ratios of any other state, recently enacted revisions to its pension plan for new employees, raising the retirement age and capping salaries to determine future pension benefits. We believe many state and local governments will follow suit.

Both GDP and stock market performance (measured by the S&P 500 Index) demonstrate a direct, if lagging, correlation with state tax revenues and surpluses. If the nascent economic recovery continues to take hold, we believe revenues, particularly sales taxes, should rise.

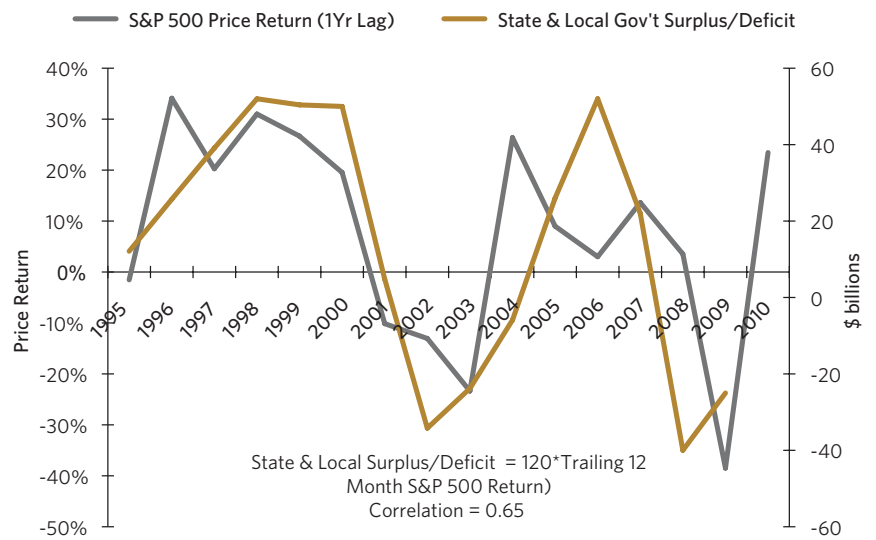
Real GDP Changes Highly Correlated to State Tax Revenue



Note: (1) Percentage changes averaged over 2 quarters; (2) No legislative adjustments; (3) Recession periods are shaded.
Source: U.S. Census Bureau (Quarterly tax collections; Bureau of Economic Analysis (real GDP).

Stock Market Performance is Highly Correlated to State & Local Government Fiscal Health

The two biggest components of state government revenue, personal income taxes and sales taxes, fell off sharply in 2009 because of the recession. In response, states have increased taxes dramatically.



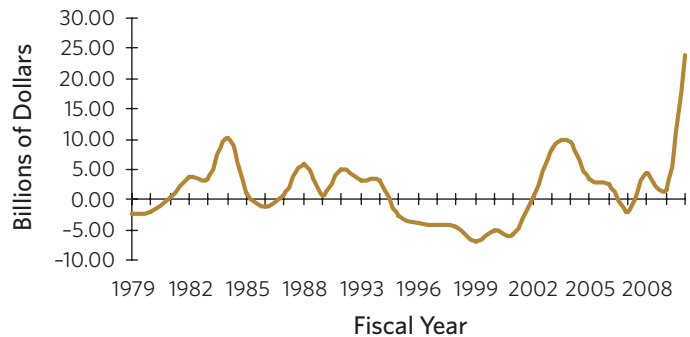
Source: Bloomberg, Bureau of Economic Statistics, Standish.

Municipal Sources of Revenue

The two biggest components of state government revenue, personal income taxes and sales taxes, fell off sharply in 2009 because of the recession. In response, states have increased taxes dramatically, as shown in Figure 2.

Figure 2

Enacted State Tax Increases

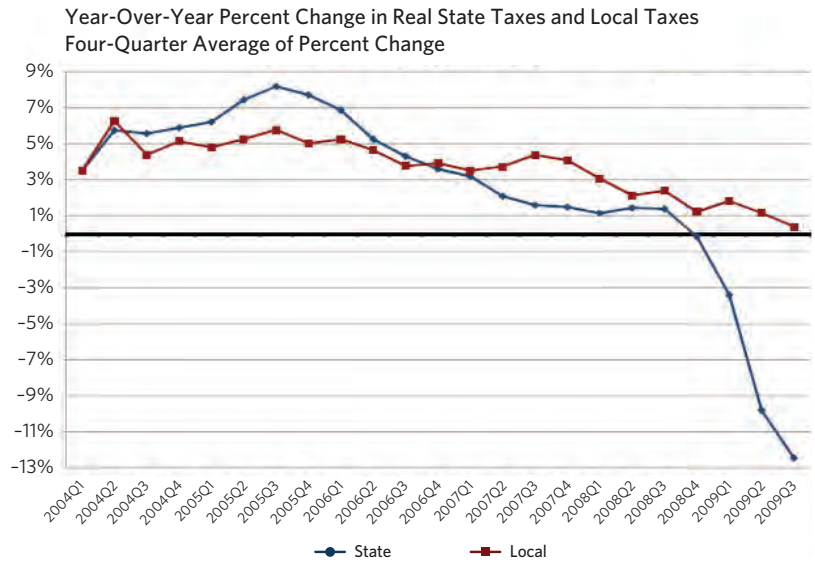


Source: Rockefeller Institute of Government; U.S. Census Bureau; and Bureau of Economic Statistics

By contrast, local governments typically rely more heavily on property tax revenues, which have remained steady. This stability is the result of the natural lags of the assessment process as well as the fact that local governments have the ability to raise tax rates to offset any decline in property taxes overall (Figure 3).

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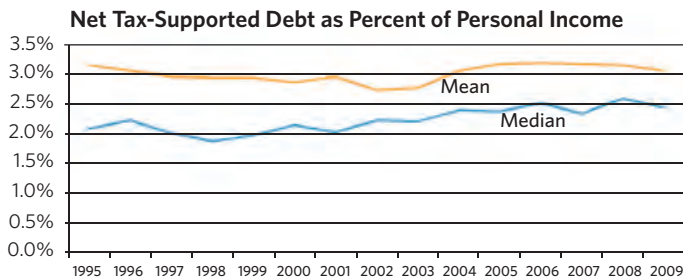
Figure 3



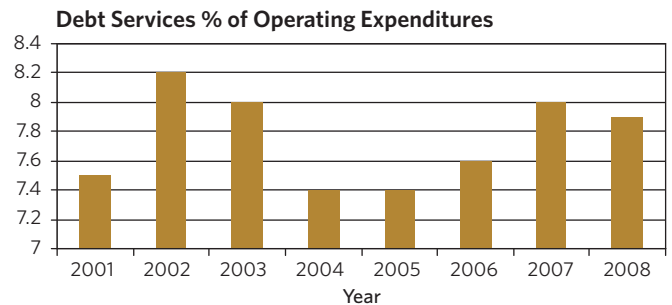
Notes: (1) 4-quarter average of percent change in real tax revenue; (2) No adjustments for legislative changes.
Source: U.S. Census Bureau (tax revenue) and Bureau of Economic Analysis (GDP price index).

Debt service, at both the state and local level, has stayed in its historical range of 6% to 8% of expenditures. Furthermore, state and local debt issuance (net of refunding) has been stable over the last six years (Figure 4).

Figure 4 - State Debt Outstanding as a % of Income Has Been Stable

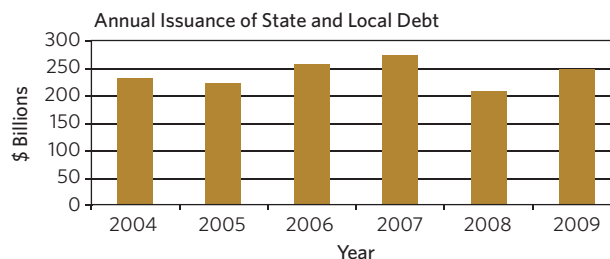


Source: Moody's Investors Service



Source: Moody's Investors Service; 1,046 Cities rated by Moody's with population over 25,000

Issuance (Excluding Refundings) Has Been Stable



Source: Thomson Financial

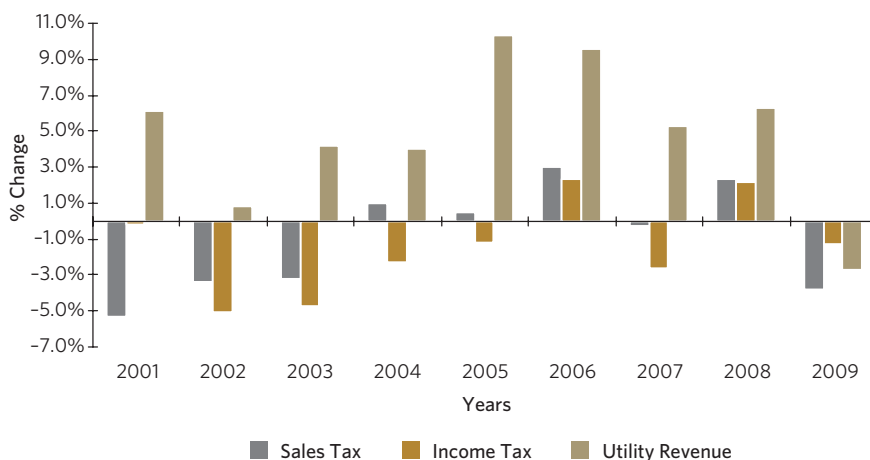
Revenue bonds are municipal bonds most commonly secured by a more narrowly defined stream of revenues such as the fees from essential services such as electric and water utilities.

Differentiating Among Municipal Bonds

In considering municipal bond investments, it is important to distinguish among the different kinds of municipal debt and their purposes. General obligation (GO) debt finances infrastructure projects, not deficits. GO bonds are the primary form of debt issuance for state and local governments and require voter, or in some cases, legislative approval. This kind of debt is issued only for the purpose disclosed on the ballot: a public building, road creation or renewal, etc., not for payroll and other operating expenses. Furthermore, the vast majority of tax-exempt bond issues are based on existing capital needs and not projections of population or economic growth.

Revenue bonds are municipal bonds most commonly secured by a more narrowly defined stream of revenues such as the fees from essential services such as electric and water utilities. In contrast to sales or income taxes, utility revenues tend to be more resilient even during economic downturns (Figure 5).

Figure 5 - Relative Stability of Utility Revenues vs. Tax Revenues



Source: National Association of State Budget Officers and The National Governors Association

The low default rates of municipals reflect their relatively strong security provisions and revenue streams. The GO pledge is a guaranty without limit, backed by full taxing power. This pledge remains in place until the debt is retired. A delayed or missed payment only prevents the government from issuing more debt or causes higher borrowing costs. GO bondholders have the right to petition a court to compel higher taxes to ensure a government pays its GO debt service. Federal bankruptcy laws prevent states from filing for bankruptcy, and many states prevent their local municipalities from filing.

We believe the high legal threshold for entering bankruptcy proceedings for local governments will continue to keep the number of filings low, as they have been in the past. Between 1980 and 2008, only 40 cities, villages and towns in the U.S. entered Chapter 9 bankruptcy out of a total of 193 filings.¹

¹ James Spiotto presentation, National Federation of Municipal Analysts Conference, October 2008.

In these difficult times, it is more important than ever for managers to work with experienced municipal research teams to thoroughly review the financial performance and position of each issuer whose bonds are under consideration for purchase for client portfolios.

For example, creditors cannot force a municipality into Chapter 9; it must be voluntary. Furthermore, the municipality must be authorized under state law to file for protection. The municipality must show that it is unable to meet its obligations and file a plan for adjusting its debts. It must obtain the agreement of creditors holding at least a majority of claims in each debt class or else a bankruptcy judge must determine that the municipality negotiated in good faith but in vain to get the majority of creditors to agree to a filing. One of the more interesting municipal bankruptcy filings recently was by the city of Vallejo, California. The judge in that case indicated labor contracts, including pension and healthcare obligations, could be rewritten in bankruptcy. This case was seen to have strengthened the bargaining power of governments in labor negotiations, an important development since payroll expenses are typically the largest local government item of expenditure.

Despite a general confidence in the soundness of state and local general obligation debt, we still believe credit analysis is of critical importance in managing municipal bond portfolios in this time of fiscal stress. Based on our analysis of municipal bond credit conditions, we are de-emphasizing general obligation bonds in view of the fiscal problems governments face and the relatively narrow yield spreads (low yields) these bonds offer. In their place, we are emphasizing high-quality revenue bonds such as water and electric utility revenue bonds. The revenues of these are relatively immune from economic decline and their expense is relative stable and legally distinct from general government operations.

We are also favoring bonds backed by legally dedicated revenues, such as personal income taxes, sales taxes or various fees, or some combination thereof. These bonds offer a high margin of safety and avoid exposure to general government fiscal stress as the revenues flow directly to bondholders. Select general obligation bonds with strong fund balances, diverse economies, moderate debt burdens, adequately funded pensions and a history of addressing budget gaps in a sound and timely manner are also worthy of consideration. Other sectors of the municipal market that show potential for high-quality credit include large hospital systems, public university revenue bonds and certain essential airports.

In these difficult times, it is more important than ever for managers to work with experienced municipal research teams to thoroughly review the financial performance and position of each issuer whose bonds are under consideration for purchase for client portfolios. While the municipal credit market is generally sound, managers need to be selective in making credit choices based on current and projected financial conditions and in consideration of relative value.

For investors concerned about rising interest rates, intermediate municipal bonds are a reasonable investment to hold.

Outlook for Municipal Bonds

We believe municipal bond returns will likely be largely derived more from yield than price appreciation this year. For investors concerned about rising interest rates, intermediate municipal bonds are a reasonable investment to hold. The municipal yield curve is historically steep, providing generous incremental yield to offset the effect of rising rates. In addition, municipals have demonstrated a muted reaction to changes in interest rates as compared to other fixed income instruments such as US Treasury bonds; tax-exempt bond "beta" hovers around 0.6%. During the last three cycles of fixed income bear markets, intermediate municipal bond income has at least offset price declines, and delivered positive total return.² Recently, the Federal Reserve raised the rate it charges on loans to commercial banks and other financial institutions. But with the federal funds rate remaining near zero for an "extended period," which could last through 2010, we expect short rates to be anchored, with longer yields confined to a fairly narrow range.

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² Based on historical performance of the Barclays Capital Municipal Bond Index. See index disclosures at back.

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The **S&P 500 Index** is an unmanaged capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The **Barclays Capital Municipal Bond Index** is a market-value-weighted index for the long-term tax-exempt bond market. To be included in the index, bonds must have a minimum credit rating of Baa. They must have an outstanding par value of at least \$7 million and be issued as part of a transaction of at least \$75 million. The bonds must be fixed rate, have a dated-date after December 31, 1990, and must be at least one year from their maturity date.

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