

Market Analysis, Research & Education

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Asset Class Update: Municipal Bonds

Yielding More As High-Quality Credits Are Tested

KEY TAKEAWAYS

- Given the weak economy and distressed credit markets, the budgets of municipalities and other public issuers are expected to face more pressure in 2009.
- However, most issuers of investment-grade muni bonds maintain high credit-quality, supported by relatively stable revenue streams, the ability to increase revenues (for some issuers), and a very low track record of defaults.
- Despite a muni bond rally in early 2009, yields (which move inversely to prices) remain at uncharacteristically high levels relative to Treasury bonds of comparable maturities (implying low valuations).

Municipal bonds have rallied (+4.8%) so far this year, after one of the group's worst calendar-year performances ever in 2008 (-2.5%).ⁱ Muni bond yields are still above historical averages, however, suggesting that many investors remain concerned about certain unresolved technical factors and the potential stress that a slowing economy might have on municipal revenues. The key question facing investors in the near term: Whether the superior yields of high-quality muni bonds relative to those of risk-free credits, such as U.S. Treasuries, are adequate compensation for owning them in an economic climate that could make it more challenging for some muni issuers to meet their debt obligations.

Spotlight on market fundamentals

Historic credit crisis created muni market aberration in 2008

The credit-market crisis that erupted in 2008 sparked so-called technical conditions that led to the recent performance volatility of muni bonds. Many financial institutions were forced to sell muni bond holdings as part of massive deleveraging efforts (reduction of liabilities) to offset losses on structured credit assets. Several firms went bankrupt, were acquired or changed their corporate status to a depository bank. The massive unwinding of complex debt securities led to weaker liquidity in a marketplace consisting of fewer qualified buyers. In addition, many bond insurance firms (which insured about half of all muni bonds) suffered losses on their book of subprime mortgage securities. The insurers' damaged fiscal health resulted in increased selling pressure on muni bonds, as investors worried about these firms' ability to insure against potential muni bond defaults.ⁱⁱ These factors and the overall credit-market turmoil sparked a flight to Treasury bonds and other risk-free securities backed by the U.S. government, while fixed-income securities backed by other credits—even those of high quality, such as municipalities—fared poorly.

Muni budgets facing fiscal pressures

Concerns about municipal credits (an issuer's ability to meet its debt obligations) are likely to play a more prominent role in the outlook for this asset class. Negative headlines should persist in 2009, with many state and local municipal issuers facing considerable shortfalls in their fiscal budgets due to the weak economy and declining tax revenues. For example, the state of California—hit hard by falling property values and rising unemployment—had been facing a projected budget shortfall of about \$42 billion over the next 17 months—until it approved a new fiscal budget plan in mid-February that included up to \$13 billion in tax/fee increases.ⁱⁱⁱ

Assessing valuation and outlook

Muni bond yields still historically high

The ongoing challenges have pressured muni bond prices and resulted in above-average yields on muni bonds (bond yields move inversely to bond prices). Municipal bonds, which produce income that is generally exempt from federal taxes, rarely sport yields that surpass those of Treasury bonds. However, in the fourth quarter of

2008, muni bond yields of short- and long-term maturities soared, while those of Treasuries plummeted due to incredible demand for U.S. government-backed paper (see Exhibit 1, below). For example, in mid-December 2008, muni bonds of long- and short-term maturities on average were yielding about double those of Treasury bonds.^{iv} Although the average price of muni bonds rallied sharply in 2009, the yields offered by muni bonds have remained more attractive relative to those of Treasuries, even before considering their tax-advantaged status. They are significantly more attractive on an after-tax basis. Specifically, the average 30-year Treasury bond yield was 3.5% as of mid-February, while the tax-equivalent yield of a 30-year muni bond was 7.3% (see Exhibit 1, below).^v

Muni credits typically high quality

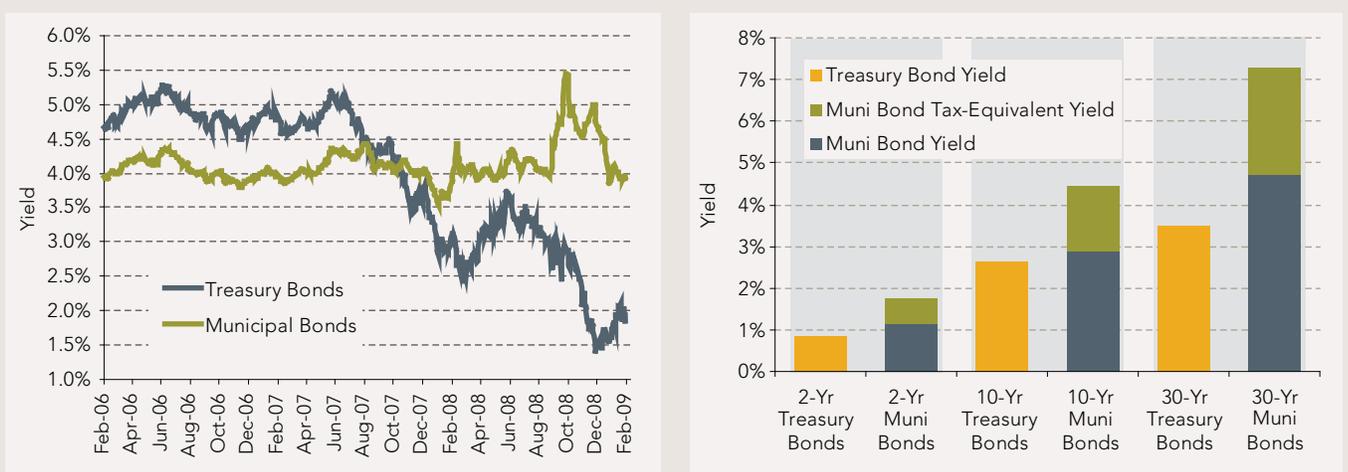
Most investment-grade muni bonds are highly-rated, even without bond insurance. Historically, investment-grade muni bonds have defaulted at a rate of barely above 0% during the past three decades.^{vi} High-grade munis rarely default, largely because the revenue streams of municipalities tend to be stickier, meaning they are far less volatile than private issuers, such as corporations.^{vii} General obligation bonds are secured with a pledge of full faith by an issuing state or local government to ensure that its revenue-producing powers, such as its ability to raise taxes, will be used to satisfy the debt. In recent months, many states have proposed tax and fee hikes to offset budget shortfalls. Thus GO issuers generally maintain high credit-quality because they have many levers to pull to boost their revenues that aren't available to private-sector issuers.

The other category of muni bonds—revenue bonds—are issued to finance public works projects, such as toll roads and housing projects, and are supported by the revenues of the project [see *Know What You Own: Muni Bonds*, on page 3.]. Many of these projects are in less economically sensitive sectors (water, sewer, hospital) and hence are more stable credits. Meanwhile, the recently-passed federal law to provide roughly \$790 billion in stimulus to the U.S. economy includes various items to provide assistance to states that should help alleviate some of the fiscal pressures. Going forward, fiscally strapped issuers will likely look for ways to meet their debt obligations, but investors should remember that municipal bond issuers as a group remain relatively high credit issuers.

Investment implications

The challenging economic backdrop is likely to put greater pressure on municipal bond issuers in the coming months. However, it's also important to bear in mind that most municipal issuers have had very high credit quality and thus a low rate of defaults throughout economic cycles over the past several decades. Yields offered by muni bonds have provided relatively attractive compensation for investors in an uncertain market climate, along with the added benefit of their tax-exempt status. What's more, it's not unrealistic to expect higher tax rates in the future, as federal and municipal governments look to address budget issues—and such action could make the tax advantage of muni bonds even more valuable. ■

EXHIBIT 1: Municipal bond yields haven't fallen as significantly as those of Treasury bonds in recent months (left)...and as a result they have been offering more attractive yields on an after-tax basis (right).



Yields represented by the following indices: Treasury Bonds - Barclays Capital® (BC) Treasury Index; Municipal Bonds - BC Municipal Index. Source: Barclays Capital, FMRCo (MARE) as of 2/18/09.
 Tax-equivalent yield calculated using top federal income tax rate (35%). Source: Municipal Market Data - Thomson Financial Services, Bloomberg, FMRCo (MARE) as of 2/17/09.

Know What You Own: Municipal Bonds

■ General Obligation (GO) Bonds

Secured with a “general obligation” pledge by an issuing state or local government to ensure that its revenue-producing powers (ability to levy taxes) will be utilized to satisfy the debt.

■ Revenue Bonds

Municipal credits not backed by a GO pledge. These credits are issued to finance public works projects, such as a new toll road, bridge, housing project or water treatment facility, and are supported by the revenues of the project. Revenue bonds also include those backed by the revenues of non-profit institutions, such as public universities and hospitals, as well as the funds collected by municipal water and sewer authorities.

■ Characteristics

- The income is exempt from federal (and often state) taxes. Thus, munis are often seen as a suitable investment for those in high federal tax brackets looking for higher after-tax income.
- Tend to be considered low-risk credits relative to private-sector debt.
- Revenues from municipal issuers tend to be less volatile than those of private-sector issuers. For example, revenue from local GO bonds typically comes from property taxes, which are tied to real estate valuations. Revenue supporting state-issued GO bonds generally comes from income taxes, sales taxes and license fees.
- Can be rated investment-grade or high yield. Most investment-grade-rated munis have ratings that are in the highest ratings categories.
- Municipal debt is generally issued under a more favorable legal framework than corporate bonds (e.g. more favorable bankruptcy code).
- Investment-grade-rated munis as a category have a very low historical rate of default.
- In the event of default, muni bond investors tend to receive a higher average rate of recovery on their investment relative to defaulted corporate bonds.
- Offer diversification benefits as a component of a fixed-income portfolio.

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Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk. Past performance is no guarantee of future results.

Although bonds generally present less short-term risk and volatility than stocks, bonds do contain interest rate risk (as interest rate rise, bond prices usually fall and vice versa) and the risk of default, or the risk that an issuer will be unable to make income or principal payments. Additionally, bonds and short-term investments entail greater inflation risk, or the risk that the return of an investment will not keep up with increases in the prices of goods and services, than stocks.

All indices are unmanaged and performance of the indices include reinvestment of dividends and interest income, unless otherwise noted, are not illustrative of any particular investment and an investment cannot be made in any index.

The municipal market is volatile and can be significantly affected by adverse tax, legislative, or political changes and the financial condition of the issuers of municipal securities. Interest rate increases can cause the price of a debt security to decrease.

Barclays Capital® (BC) U.S. Treasury Index—an index which covers public obligations of the U.S. Treasury with a remaining maturity of one year or more. The BC U.S. Municipal Bond Index covers the USD-denominated long term tax exempt bond market with four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds.

[i] Municipal bond performance represented by BC Municipal Bond Index. Source: FMRCo (MARE) as of 2/19/09.

[ii] Bond insurance provides a credit enhancement that allows issuers to obtain higher ratings and borrow at lower rates.

[iii] California budget plan. Source: Wall Street Journal, Feb 20, 2009.

[iv] Yields of 2-, 10-, and 30-year muni bonds were compared to treasury bond yields of the same maturities. Muni bond data sourced from Municipal Market Data - Thomson Financial Services. Source: Municipal Market Data-Thomson Financial Services, Bloomberg, FMRCo (MARE) as of 2/18/09.

[v] Performance and statistics represented by: Treasury bonds - BC Treasury Index; Municipal bonds - BC Municipal Bond Index. Source: FMRCo (MARE) as of 2/17/09.

[vi] Source for default rate data: Moody's Investors Service special report, June 2006. Report showed investment-grade muni bonds defaulted at a cumulative rate of 0.07% over 10-year time horizons between 1970-2005.

[vii] Default: The failure of a debtor to make timely principal and interest payments as they come due according to the provisions of a bond indenture—the contract that spells out the covenants municipalities must abide by as bond issuers. In the event of default, bondholders may make claims against the assets of the issuer to recoup their principal. Defaulted obligations that are enhanced by bond insurance generally aren't counted as defaults if they continue to be paid due to the credit enhancement.

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