LORD ABBETT

# Eight Indications of a Muni Market Metamorphosis

*While recent developments have highlighted the relative value and historical stability of municipal securities, there have been changes that also underscore the challenges that individual investors might face from navigating the market on their own.*

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Many investors feel that their options are limited in today's uncertain market environment. If investors emphasize capital preservation, they raise the risk of negative real returns, considering that interest rates—and, therefore, the potential yields on traditional safe-haven investments—might be below the rate of inflation. Yet, if investors emphasize capital appreciation, they have to increase their exposure to potentially volatile "risk-on" asset classes amid lingering concerns about global economic growth.

Municipal securities, however, could address some of investors' concerns by potentially delivering tax-equivalent yields[1] that are above the yields on corporate bonds of similar maturities and credit quality. And for the risk averse, municipal bonds have experienced less historical volatility than even Treasury securities.[2] Still, the tax-exempt bond market has not been immune from the broader uncertainty in the capital markets. And eight indications of a metamorphosis in the municipal bond market underscore the importance of rigorous security selection, continuous portfolio monitoring, and broad access to liquidity—tasks that can be daunting for individual investors in a $3.7 trillion market with more than 50,000 issuers.

## 1) RELATIVE VALUE IN A LOW-RATE WORLD

The continuation of the secular trend of low interest rates reflects investors' ongoing demand for safety given the continuing signs of moderate global economic growth and the ongoing uncertainty in Europe. Current monetary policy, such as the Federal Reserve's various programs to purchase long-term Treasury and agency securities, has also significantly contributed to the low-rate environment.

Although the municipal and Treasury markets generally move in similar directions concurrently, munis have recently lagged behind, and their yields are currently near or above those on Treasury securities at every maturity. Prior to 2008, this had been an unusual occurrence, because the yield difference had reflected that the income from municipal securities is generally exempt from federal income taxes, whereas the income from Treasury securities is not. *[It should be noted, however, that the income from municipal bonds may be subject to the alternative minimum tax. Federal, state, and local taxes may apply.]*

Another consideration in the relative value equation for municipal bonds is the steepness of the yield curve that has been anchored by a fed funds rate that is expected to remain at "exceptionally low levels" until at least mid-2015, according to the Fed. As a result, the yield difference between two-year muni bonds and 30-year muni bonds with 'AAA' credit ratings was 303 basis points (bps) at the end of August 2012, or 43 bps higher than the average difference during the prior seven years.[3]

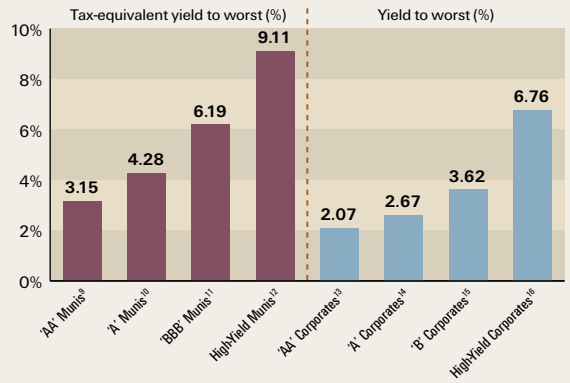
The yield curve's steepness gives municipal bond investors some choice. The front end of the curve provides lower yields as well as shorter durations for investors who are concerned about interest-rate volatility. Conversely, the back end of the yield curve provides the potential for higher yields along with greater interest-rate risk.

When the tax treatment of municipal securities is considered, their tax-equivalent yields have recently been above the yields on corporate bonds with similar credit ratings. And this difference becomes greater as one assumes more credit risk.

For investors in the 35% tax bracket, the tax-equivalent yield on a municipal bond index comprising bonds with 'AA' credit ratings was 108 bps higher than the yield on an index of similarly rated corporate bonds. (See Chart 1.) Meanwhile, as

**Chart 1. Munis' Tax-Equivalent Yields May Be Higher Than Their Corporate Counterparts**

*Data are as of August 31, 2012*




Source: All indexes are represented by BofA Merrill Lynch indexes, except for the high-yield municipal bond index, which is represented by the corresponding Barclays index.

Yield to worst is the lowest potential yield on a bond without a default. See footnotes for index definitions.

**Past performance is no guarantee of future results.**

Tax-equivalent yields for the municipal indexes are based on investors in the 35% tax bracket. Tax-equivalent yield calculation does not factor in the effect of the alternative minimum tax or taxes in an investor's individual state and will vary based on an investor's tax bracket.

Income from municipal bonds may be subject to the alternative minimum tax. Federal, state, and local taxes may apply. Indexes are unmanaged, do not reflect the reduction of fees or expenses, and are not available for direct investment.

one moves to 'BBB' credit ratings, the tax-equivalent yield on a municipal bond index was 257 bps higher than the yield on the comparable corporate bond index. The municipal indexes cited have longer average maturities[4] than their corporate counterparts, but even when that yield differential is factored in, which would be about 70 bps for the 'BBB' indexes, for example, munis' tax-equivalent yields may still provide relative value opportunities compared with corporate bonds.

### 2) Flexibility at work

Relatively high yields can indicate the presence of additional credit risk. But that relationship may not hold when it comes to the tax-equivalent yields on municipal bonds, especially considering that defaults of municipal bonds with investment-grade credit ratings have been exceedingly rare. For example, the average 10-year cumulative default rate for investment-grade municipal bonds was 0.08% from 1970–2011, compared with a rate of 2.61% for investment-grade corporate bonds over the same time period, according to Moody's Investors Service.[5]

Although municipalities have a long-term track record of stability, the current economic environment has affected many municipal budgets. And in order to preserve their credit quality, most cities and states have taken significant steps involving increased revenues, reduced expenditures, and adjusted retirement plans.

State revenues are generally dependent on income, sales, and/or corporate taxes. Therefore, when these measures declined during the prior recession, state revenues fell sharply as well. Yet, as the economy recovered and states implemented additional ways to raise revenue, state tax receipts rebounded with 10 consecutive quarters of increases that culminated with a 3.0% increase in the second quarter of 2012.[6]

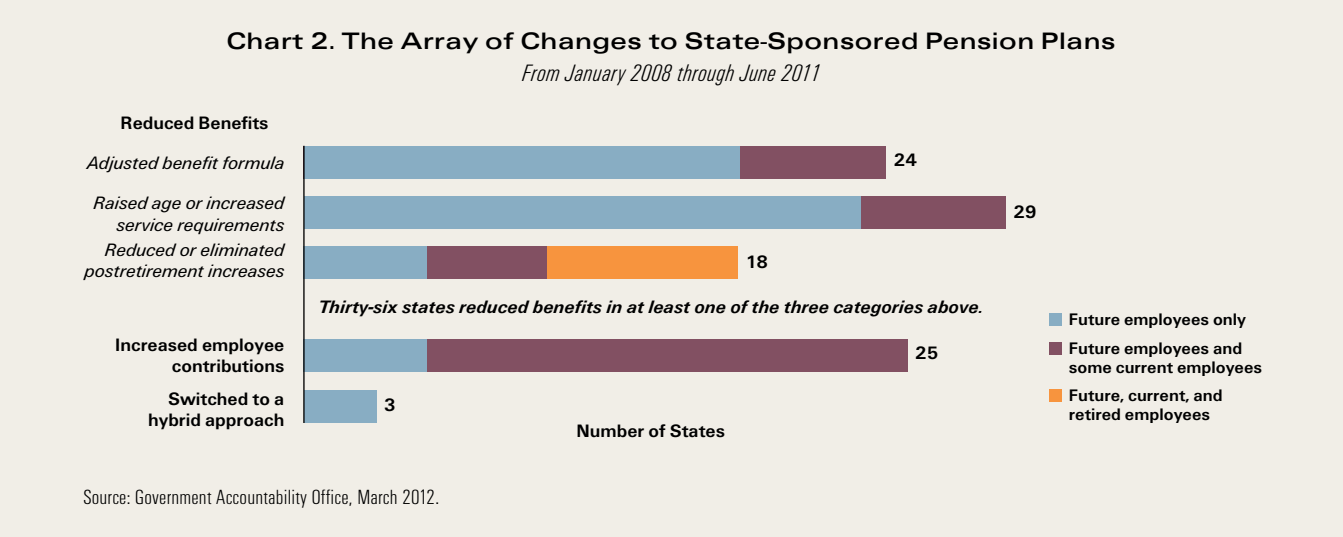
Revenues at the local level are more dependent on property taxes, which generally lag the movement in the broader economy, but these are also showing signs of stabilizing. After a decline of 1.8% in the first quarter of 2012, second-quarter property tax revenue increased 6.2% from a year earlier.[7] And if the property market has reached, or is approaching, a price bottom, the stabilization in local revenues should continue.

Meanwhile, municipalities have continued to make difficult decisions in terms of curtailed expenditures. Since the end of the prior recession in June 2009, state governments have reduced their payrolls by 151,000 and local governments have reduced their payrolls by 519,000 during a period of more than three years.[8] Although these job reductions do not support broader economic growth, they do reflect municipalities' ability to reduce expenditures in order to close deficits in their operating budgets, which includes debt service.

One public finance topic that continues to generate headlines is the widespread underfunding of retiree pension and healthcare plans—a gap that reportedly reached $1.38 trillion in 2010, according to a June 2012 report from the Pew Center on the States. While the underfunding figures are presented as a widespread problem, most states have adequate funding levels, and those states with underfunded plans still have many years to deal with these deficits.

The acknowledgment that municipalities have many years to deal with their pensions could be unsettling if they continued to delay addressing the situation. However, between January 2008 through June 2011, 35 states implemented a variety of measures to reduce benefits in state-sponsored pension plans, mostly to future employees. (See Chart 2.) In addition to the effect that these changes can have on improving plans' funding levels, when interest rates eventually rise and the economy strengthens, the funds' investment returns should improve and increase their funding levels.

Finally, discussions about quantifying pension shortfalls usually incorporate healthcare costs, but healthcare benefits are generally not legally binding, which means that municipalities can make changes that affect current employees. In addition, healthcare benefits are not necessarily lifelong commitments, as retirees may use healthcare benefits as more of a bridge from the time they retire to when they may be eligible for Medicare. Therefore, some of the potential medical costs that are included in many calculations of future liabilities might not actually need to be paid in the future.




### 3) The specter of Chapter 9

Despite the flexibility of most cities and states, the fiscal issues in certain municipalities have developed into current, acute situations. Indeed, news that a few cities have recently filed for bankruptcy has received widespread media attention, even though many of these cities and towns have relatively little outstanding debt. And the financial distress faced by these municipalities can be traced back to specific events, idiosyncratic structural issues, or a combination of both.

In Mammoth Lakes, California, for instance, the town filed for Chapter 9 bankruptcy after it lost a legal judgment that is far greater than its operating budget. And as a ski town, Mammoth Lakes had little prospect to pay the judgment through gradual economic growth, considering its reliance on the hospitality industry's inconsistent revenues. The town subsequently said it reached a settlement on the judgment as part of a mediation process.

In the case of Stockton, California, the city's budget has been almost entirely consumed by public safety contracts that accumulated during a housing-led population boom. Once the housing bubble collapsed, Stockton's unemployment rate rose to 17.5% by mid-July 2012, and the city could no longer afford its employee contracts.[17]

Municipal bankruptcies should remain exceedingly rare, but it is possible that other highly distressed cities might pursue Chapter 9 as a way to reorganize. The pockets of distress in the municipal bond market, and the task of identifying them before they become severe, highlight a prominent challenge that individuals might face when attempting to invest in the municipal bond market on their own. Active, institutional strategies, however, have more expertise in gathering and conducting in-depth credit research that can determine the level of strain faced by a municipality, while also monitoring existing investments for developing signs of distress.

### 4) Bond insurers' conspicuous disappearance

In addition to the current economic conditions, the need for credit analysis has increased due to the conspicuous disappearance of the major bond insurers that previously insured most newly issued municipal bonds.

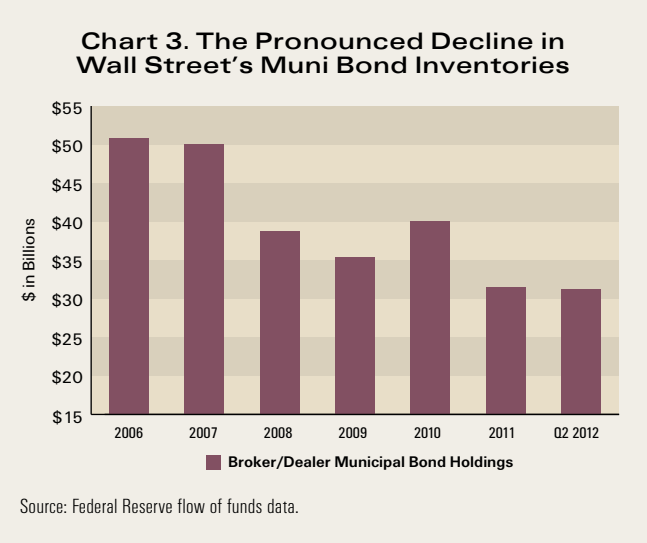
The reduced value of this insurance, which essentially enhanced the liquidity of municipal borrowers by providing a higher credit rating, stemmed from the insurers' overexposure in the residential securitization markets, rather than anything related to the municipal bond market. Once bond insurers' credit ratings were significantly downgraded, this also reduced the number of 'AAA' bonds within the Barclays Municipal Bond Index from 70% in December 2007 to 13% as of August 2012.[18]

While in-depth credit research has always focused on the underlying metrics of municipal borrowers, the reduction in bond insurance removes potential support that individual investors may have relied on as part of their investment decision. With less insurance, these investors may face the daunting task of analyzing the credit quality of a large number of highly diverse borrowers.

### 5) The constraints of going solo

There are other recent developments that might also affect an individual investor's experience within the municipal bond market, especially as they tend to access the market via a single securities dealer. From 2006 through the second quarter of 2012, securities dealers reduced their holdings of municipal securities in their inventories by about 40% as they continued to conserve capital and adjust to a changing regulatory environment. (See Chart 3.)

As a result of this reduced inventory, individual investors' access to the market and their ability to liquidate positions when




needed might be limited by what a single dealer is holding, is bringing to market as a new issue, or is willing to hold. This limited access also could incur additional trading costs because an individual's particular dealer might not have the best bid in the market, or any bid for that matter, at a given point in time.

On the other hand, institutional investors can have access to more than 100 securities dealers. This can provide access to the full spectrum of the market rather than just the securities from a single firm. This access not only enhances the security selection process but also it can improve the cost of trading and the ability to liquidate positions when needed.

### 6) more diverse participants with varying intents

Until the last decade or so, the municipal bond market was dominated by individual investors, mutual funds, and insurance companies. Yet taxable bond investors, such as hedge funds and other active trading accounts, have recently become acquainted with municipal issuers and have, consequently, increased their participation in the market.

Part of this involvement started with the introduction of Build America Bonds, which are taxable bonds that were issued by municipalities under a program that expired at the end of 2010 and garnered interest from these nontraditional buyers. These participants, having become familiar with municipal borrowers, continue to quickly enter the market at points when tax-exempt yields look attractive compared with those on taxable bonds.

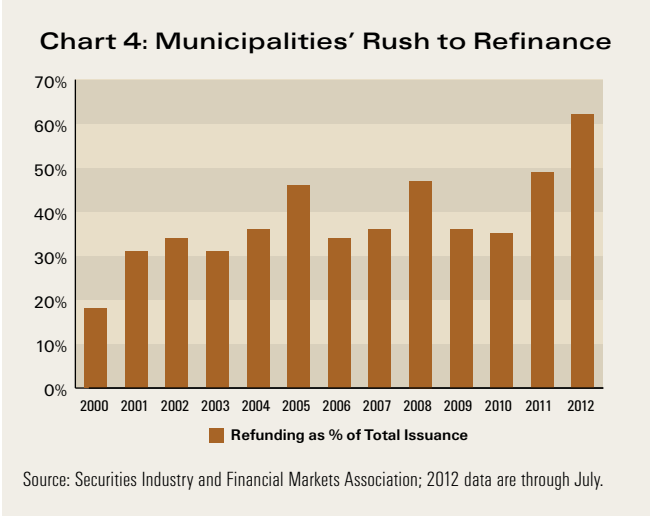
The short-term focus and relatively quick moves of these crossover buyers can intensify periods of volatility and lead to varying degrees of liquidity within the market. This development has meant that traditional investors also need to be more cognizant of these short-term market swings in order to take advantage of attractive opportunities or to navigate through pockets of volatility when they arise.

### 7) rising refinancing risk

Broad access to the market is made even more important in the current environment of low interest rates, as municipalities are increasingly refinancing existing debt in order to lower their interest costs. With the trend continuing over the past few years, it has reached the point where about 62% of the municipal bond issuance in 2012 has consisted of refinancing transactions. (See Chart 4.) During the first half of 2012, the total amount of outstanding municipal bonds actually decreased due to the amount of bonds being redeemed.

For individual investors, the refinancing trend may lead to the redemption of securities that they are currently holding. After all, more than 80% of all municipal bonds issued from 1996 through 2011 have consisted of callable securities that can be redeemed at the discretion of the borrowing municipality.[19]

If a bond issue is called from a portfolio, it can leave an individual investor with the challenging task of reinvesting the proceeds in an environment of historically low interest rates. In addition to managing call protection in a portfolio, an institutional investor could manage its reinvestment risk more effectively considering its broad access to the market and thorough research capabilities.




### 8) a future in flux

The municipal bond market has a long history of providing relatively low-cost financing for municipalities and tax-exempt income for borrowers, but these foundations of the asset class have occasionally been questioned.

Recently, two proposals to limit the level of tax-exempt income at 28% for couples earning more than $250,000 have emerged in legislation that ultimately gained little traction. These discussions have emerged in past years, but they are

becoming more frequent lately, as there has been more of a focus on specific areas of the tax code. Therefore, proposals to cap the amount of tax-exempt income deserve further monitoring, as the topic appears to have captured the attention of certain policymakers.

Another uncertainty for investors is the future direction of tax rates. The topic of taxes is fraught with political overtones, and it will certainly receive plenty of attention in the months and years ahead. Although income tax rates have not changed in the past few years, there are new taxes scheduled to take effect outside of those in the current income tax structure. For example, the implementation of the Patient Protection and Affordable Care Act carries a 3.8% surtax on net investment income for couples earning $250,000 or more, which begins on January 1, 2013, in its current state. Income from municipal bonds would also be exempt from this pending levy.

While it is unclear what the outcome will be for tax rates, it is clear that many investors will face substantial tax liabilities in the years to come, and one thing likely to remain in place in the future is the ability for municipal bonds to provide tax-exempt income and relative stability for tax-sensitive investors. ■

[1] Taxable-equivalent yield is the pretax yield that a taxable bond needs to possess for its yield to be equal to that of a tax-free municipal bond. It does not reflect state and local income taxes or the alternative minimum tax, if any, and will vary based on each investor's tax bracket. Data cited on tax-equivalent yields are from BofA Merrill Lynch and are as of July 31, 2012.

[2] Data are based on annualized standard deviation of 10-year returns ended June 30, 2012, and are from Barclays Municipal Credit Research, July 3, 2012.

[3] Yield curve data are from Bloomberg.

[4] Average maturity refers to the average maturity of the securities composing the respective indexes.

[5] U.S. Municipal Bond Defaults and Recoveries, 1997—2011, Moody's Investors Service, March 7, 2012.

[6] The Nelson Rockefeller Institute of Government, Data Alert, September 19, 2012.

[7] U.S. Census Bureau, Quarterly Summary of State and Local Government Tax Revenue, September 25, 2012.

[8] Employment data are from the U.S. Bureau of Labor Statistics, as of July 2012.

[9] The BofA Merrill Lynch AA Municipal Securities Index is a subset of the BofA Merrill Lynch U.S. Municipal Securities Index, which tracks the performance of U.S. dollar-denominated, investment-grade, tax-exempt debt publicly issued by U.S. states and territories, and their political subdivisions, in the U.S. domestic market.

[10] The BofA Merrill Lynch Single-A Municipal Securities Index is a subset of the BofA Merrill Lynch U.S. Municipal Securities Index.

[11] The BofA Merrill Lynch BBB Municipal Securities Index is a subset of the BofA Merrill Lynch U.S. Municipal Securities Index.

[12] The Barclays Capital High Yield Municipal Bond Index is an unmanaged index made up of bonds that are noninvestment grade, unrated, or rated below Ba1 by Moody's Investors Service, with a remaining maturity of at least one year.

[13] The BofA Merrill Lynch AA U.S. Corporate Index is a subset of the BofA Merrill Lynch U.S. Corporate Index, which tracks the performance of U.S. dollar-denominated, investment-grade corporate debt publicly issued in the U.S. domestic market.

[14] The BofA Merrill Lynch Single-A U.S. Corporate Index is a subset of the BofA Merrill Lynch U.S. Corporate Index.

[15] The BofA Merrill Lynch BBB U.S. Corporate Index is a subset of the BofA Merrill Lynch U.S. Corporate Index.

[16] The BofA Merrill Lynch High Yield Master II Index tracks the performance of below-investment-grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market (includes Yankee bonds).

[17] J.P. Morgan U.S. Fixed Income Strategy, July 13, 2012.

[18] Barclays Municipal Credit Research. The Barclays Municipal Bond Index is a broad measure of the municipal bond market with maturities of at least one year. To be included in this index, bonds must have a minimum credit rating of at least Baa and an outstanding par value of at least $3 million and be issued as part of a transaction of at least $50 million. The index includes both zero coupon bonds and bonds subject to the alternative minimum tax.

[19] Issuance data are from Securities Industry and Financial Markets Association.

Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

**A Note about Risk:** The value of investments in debt securities will fluctuate in response to market movements. When interest rates rise, the prices of debt securities are likely to decline, and when interest rates fall, the prices of debt securities tend to rise. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price. Investments in high-yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Lower-rated investments may be subject to greater price volatility than higher-rated investments. A portion of the income derived from a municipal bond may be subject to the alternative minimum tax. Any capital gains realized may be subject to taxation. Federal, state, and local taxes may apply. There is a risk that a bond issued as tax-exempt may be reclassified by the IRS as taxable, creating taxable rather than tax-exempt income. Bonds may also be subject to other types of risk, such as call, credit, liquidity, interest-rate, and general market risks. No investing strategy can overcome all market volatility or guarantee future results.

Taxable-equivalent yield is the pretax yield that a taxable bond needs to possess for its yield to be equal to that of a tax-free municipal bond. It does not reflect state and local income taxes or the alternative minimum tax, if any, and will vary based on each investor's tax bracket.

Treasuries are debt securities issued by the U.S. government and secured by its full faith and credit. Income from Treasury securities is exempt from state and local taxes.

The credit quality of the securities in a portfolio are assigned by a national recognized statistical rating organization (NRSRO) such as Standard & Poor's, Moody's, or Fitch, as an indication of an issuer's creditworthiness. Ratings range from AAA (highest) to D (lowest). Bonds rated BBB or above are considered investment grade. Credit ratings BB and below are lower-rated securities (junk bonds). High-yielding, noninvestment-grade bonds (junk bonds) involve higher risks than investment-grade bonds. Adverse conditions may affect the issuer's ability to pay interest and principal on these securities. The credit quality distribution breakdown is not an S&P credit rating or an opinion of S&P as to the creditworthiness of the portfolio.

A yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates.

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