

Municipal Market Notes



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Municipal Concerns: What Lies Ahead?

In the first two months of the year, the tax-exempt municipal market continued to demonstrate good performance, and strong demand, in spite of low absolute yields. Several factors are at play:

- Tax-exempt money market fund outflows are seeking higher yield in slightly longer-term municipal bond funds.
- Tax-exempt supply has been relatively light, partly being replaced by Build America Bonds, which are taxable munis.
- The prospect of higher marginal tax rates, dividend and capital gains taxes is attracting more investor interest in tax-exempt munis.



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Behind the positive market tone, there are significant concerns that budgetary pressures at the state and local levels will be an increasing risk to bond holders. These pressures may remain with us for some time, resulting in credit rating downgrades and a certain amount of defaults.

Other concerns lie in the area of future pension obligations and other post employment benefits promised to public servants by state and local governments. To the extent that many of these obligations may be unaffordable, governments may need to rein in these long-term costs and obligations.

Both these concerns have the ability to cause municipal yields to rise and credit spreads to widen. However, the idea of a collapse with massive delinquencies in debt service seems remote, given the low default rate among municipal bond issuers. Payment histories are good, even in tough times. Those municipal issuers that maintain credit strength, good management and fiscal flexibility will likely still be able to access the capital markets. Likewise, their outstanding paper should trade well. An important question is whether one can view this positively, as a wake up call and not as unavoidable doom and gloom, for those municipalities that are a bit behind on facing their fiscal issues. We view some issuers as better able to handle these concerns than others.

Individual investors are holding large amounts of low yielding cash on the sidelines, which in our view represents overhanging demand for municipal bonds. It seems likely to us that these investors are wary of municipal credit health and will only invest when they view risk exposures as more benign.

Going forward, we will maintain our higher quality focus. Essential service revenue bonds and GOs from stronger states are our preferences. We also prefer the steeper part of the municipal yield curve, i.e., seven- to ten-year points, where possible. ■

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