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RESEARCH COMMENTARY
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# MUNICIPAL MARKET UPDATE: 2012 OUTLOOK

One year ago, prices in the municipal market were in sharp decline as predictions of a large increase in defaults precipitated an exodus out of tax-free mutual funds, while supply surged as a result of the sunset of the Build America Bonds program. Performance for the year 2011, however, turned out to be quite different than expected. As we advised, the massive defaults failed to materialize and issuance fell over 30% year over year. Further, these positive trends seem set to continue into the new year.

**Strong Finish to 2011**

Municipal yields have fallen sharply in December with price returns of over one percent for maturities of seven years or longer. For the full year, broad based indices such as the Barclays Capital Municipal Bond Index will show annual total returns in excess of 10 percent. While issuance has picked up in the last quarter, refundings are accounting for almost 50 percent of volume and the majority of these are current refundings, which merely substitute new bonds for older callable ones, not really resulting in increased supply. As investors look forward to coupon and principal payments in January, there has been a move by dealers to position scarce paper ahead of demand.

**Economic Outlook Remains Positive for Bonds**

Part of the positive performance of municipals this year is attributable to the flight to quality rally in US Treasuries caused by the continued sovereign debt crisis in Europe and its negative effect on the world's economy. (And, while during the US financial crisis of 2008 municipals' correlation to Treasuries was sometimes negative, over the last year this has climbed back to over 80%.). After months of summits and serial "stabilization" plans, no resolution is in sight, and we expect a continued drag on world economic growth as a result. At home political gridlock into the presidential election should prevent the implementation of any strong fiscal stimulus, and accommodative policy has been almost guaranteed by the Federal Reserve Open Market Committee into 2013.

**Credit Trends**

Tax receipts at the state level have been increasing all year, and while local credits' fundamentals are weaker because of their exposure to the real estate market through ad valorem property taxes, both levels of government have shown a willingness to cut expenses, raise taxes and fees, and close budget gaps without reliance on one-shot solutions.

While there have been a few high-profile municipal bankruptcy filings this this year (Harrisburg, PA; Jefferson County, AL), they were long-troubled credits and came as no surprise. The market shrugged these off as distinct outliers and not the beginning of a trend. In fact, for most of this year, defaults have trailed 2010 ($2.5 billion YTD vs. $3.10 billion). While this will technically be reversed by the bankruptcy of American Airlines, which backs approximately $3.3 billion in special airport facility debt, this is really a corporate credit default.

## Supply and Demand Outlook

Issuance year to date is running about $285 billion as compared to 2010's $433 billion. Consensus street estimates for next year range between $300 and $350 billion, including a large portion of current refundings, as mentioned above, which merely replace short call bonds with new issues. In addition banks have become more active direct lenders to municipalities given their relatively superior credit profiles and their absolute yield premiums to Treasuries. Given our economic outlook and the austerity programs visible at the governmental level, we would tend toward the lower number.

On the demand side, we have seen a decisive turnaround in mutual fund flows in the last several weeks as market volatility has increased and retail investors have reduced equity exposures. In addition, while federal income taxes look to be on hold until after the election, high tax states have shown a willingness to raise marginal income tax rates, especially on high income individuals, making in-state bonds more attractive. Finally, while absolute yields are low, on a relative basis municipals remain at historic highs to Treasuries with, for example, 30-year AAA GO's yielding 125% of the long bond. This provides a defensive cushion for this sector in any Treasury sell-off.

## Conclusion

We continue to believe that the municipal sector provides the best risk adjusted after-tax returns for individuals in the upper brackets, and even in some cases for crossover buyers. The trends that contributed to this year's stellar performance: weak economic growth, low supply, increasing demand, high relative value, and defensive technical factors, should continue in 2012. Our strategy, therefore, continues to emphasize high credit quality, call protection, maturity and duration extension, and out-weighting of essential service revenue and dedicated tax issues.