



January 2012

## The Municipal Market: Emerging from the Tunnel

In last year's publication of "*The Municipal Market: Oncoming Train? or a Light at the End of the Tunnel?*", we predicted that state and local governments would remain creditworthy and observed that the fundamentals of the municipal bond market were stabilizing. The market came around to agree with us, and, in a year filled with financial and political turmoil, municipal bonds delivered impressive investment results. The stability of those returns throughout the year was notable, standing in stark contrast to many other financial markets where volatility repeatedly surged and receded.

We expect many of last year's biggest challenges for investors will linger through 2012, including:

- Risks of a financial meltdown in Europe;
- Rising government deficits and debt levels throughout the developed world;
- A contentious U.S. presidential election and protracted political gridlock in Washington;
- Stagnant domestic and overseas economic growth.

Municipal bond investors should temper expectations about total returns in the coming year and prepare for increased volatility in prices, as the markets grapple with three major issues that will likely influence valuations:

- Changing patterns in the supply of and demand for tax-exempt bonds;
- A growing federal imprint on taxation and regulation of financial markets;
- Potential credit risks as fiscal and economic problems spill over from Europe and Washington

Despite this unsettled landscape, we remain constructive on municipal bond fundamentals. Many supply and demand factors look favorable, and we do not expect any major legislation or regulations this year which might shake the municipal bond market.

We continue to pursue an investment philosophy based on intensive credit research as the key tool for both avoiding pitfalls that may emerge from these issues and for identifying opportunities to add undervalued, stable credits to our clients' municipal bond portfolios.

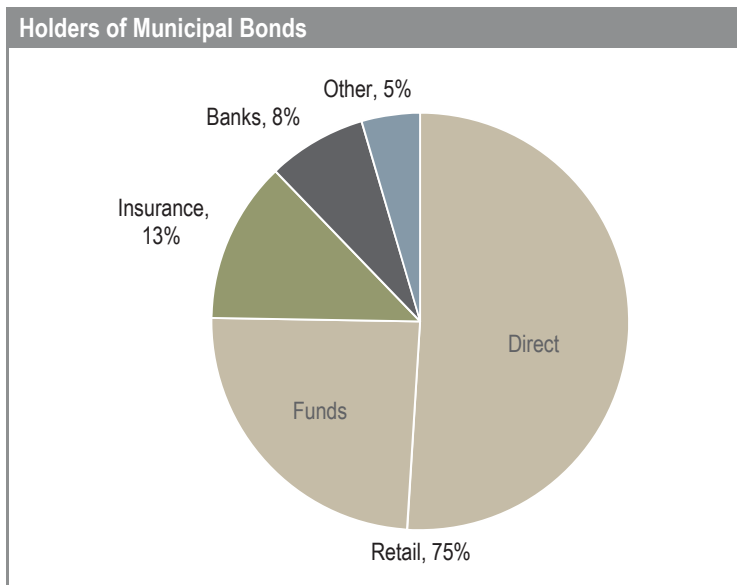
**STANDISH**

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**Tax Sensitive Fixed Income**

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## Technical Outlook: Supply and Demand



Source: Federal Reserve as of September 30, 2011  
May not total 100% due to rounding

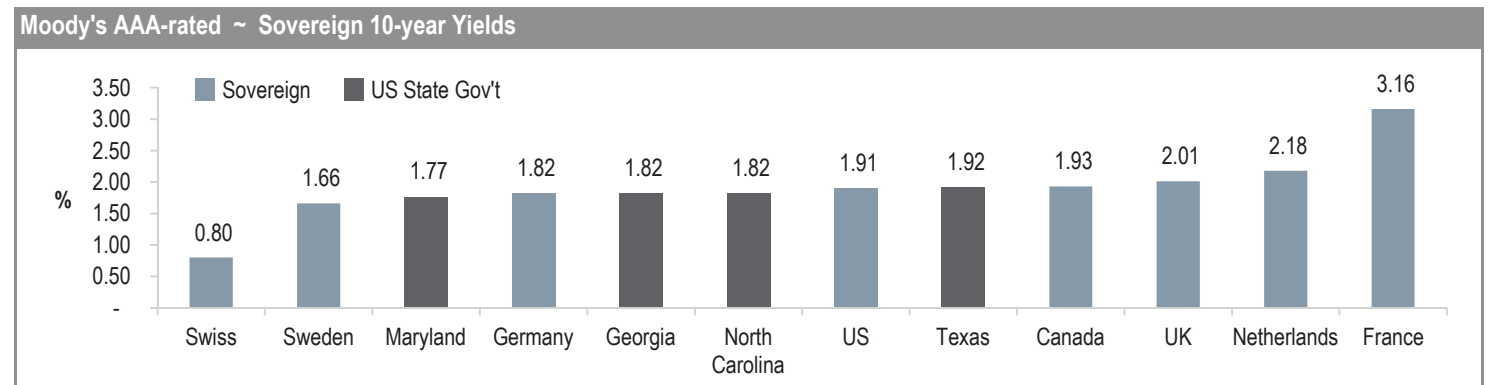
### *Are there unexpected changes in demand that could disrupt municipal market stability?*

The tax-exempt bond market has traditionally relied overwhelmingly on the individual investor for support. Recent Federal Reserve data show the \$3.7 trillion municipal bond market to be significantly larger than the previous estimate of \$2.9 trillion, and greater than expected dominance of retail investors.

Retail's dominance of municipal bond demand poses liquidity challenges. For example, Standish observed that fears over municipal bond credit quality caused retail investors to flee the market during the fourth quarter of 2010. Combined with a year-end surge in supply, municipal bond prices plummeted. These types of retail driven dislocations can recur, presenting long-term investors with opportunities to capitalize on the market's inefficiency and purchase bonds with significant excess income and the potential for price appreciation.

### *What other types of investors may consider municipal bonds?*

The municipal market offers opportunity even for investors not subject to U.S. federal taxes. Fixed income portfolios may look to municipal bonds, and in particular, U.S. state general obligations, as a comparable yielding alternative high grade sovereign credit.

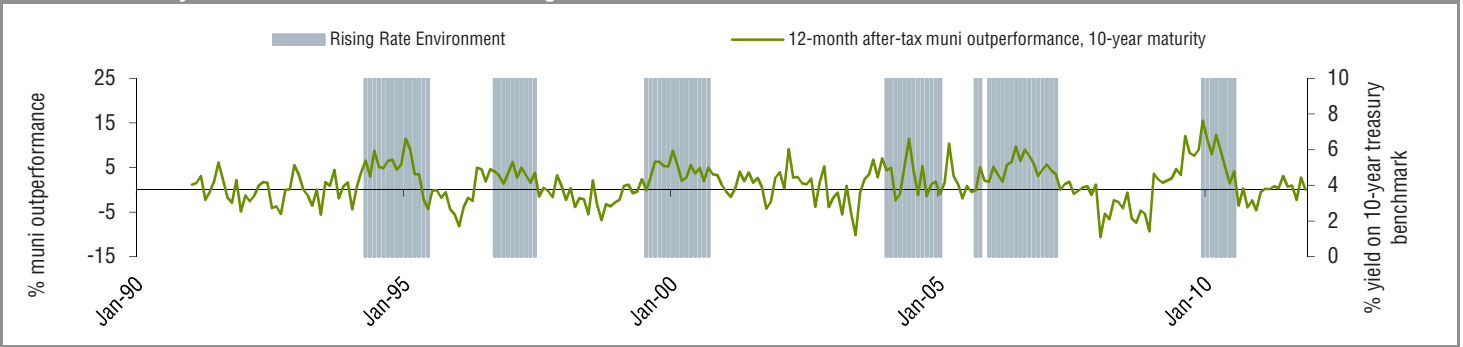


Source: Bloomberg, Thomson Reuters, Standish as of January 11, 2012. These states/sovereigns were chosen based on comparable quality.

The competitive yield that municipals offer, combined with their low volatility and lack of correlation with other asset classes, highlight the benefit of adding municipals. Modern portfolio theory argues that incorporating munis should enhance risk-adjusted returns of a total fixed income portfolio. We found that the Barclays State GO index is negatively correlated with the S&P 500, and movements in State GO bonds explain only about half the volatility of U.S. Treasury bonds or Global Sovereign credits, as measured by the Merrill Global Sovereign Market Plus Index. Especially during rising interest rate environments, the low beta of municipal bonds has demonstrated diversification characteristics to mitigate price erosion.

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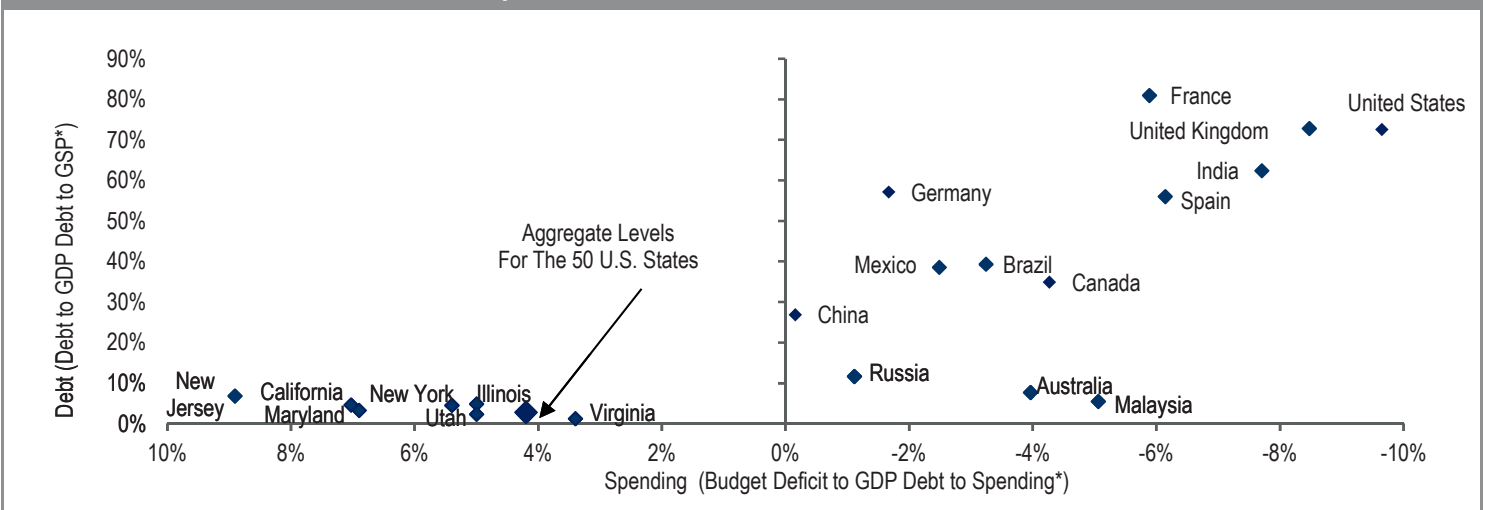
Muni vs. Treasury After-Tax Relative Return in Rising Rate Environment



Returns series shown is 12-month rolling after-tax total return difference between munis and treasuries. Interest rate environment gauged by Barclay's 10-year treasury bellwether benchmark. Muni Data based on 10-year Thomson Reuters MMD scale. 35% tax rate used. Source: Barclays, Thomson, Standish as of November 30, 2011

The political, economic and debt crisis in Europe has yet to play out, while U.S. states have already embarked successfully on austerity programs in the midst of the recent recession, leading to balanced fiscal operations. In the coming months and years, event risk is likely to be lower, and credit quality (and credit ratings) significantly more stable for U.S. state issuers than for European sovereigns. The relatively low debt burdens and high financial liquidity make state GO debt attractive for bond buyers.

U.S. Government Debt and Deficits are Relatively Low



Source: International Monetary Fund, Standard and Poor's, September 2011; \* Applies to States (GSP is Gross State Product)

U.S. state GO debt is issued chiefly for capital borrowing, and is self-amortizing, with average maturity of approximately eleven years. In contrast, debt issued by France, Germany, Greece and Spain, among others, mostly cover operating shortfalls. With average maturities of six to seven years, these sovereign credits pose greater rollover risks for investors.

State governments are making progress with pension reform in order to manage long term liabilities and financial stability. While clearly more progress is required, U.S. state public pension liabilities are more actively addressed when compared to other sovereign issuers globally.

The highest quality state general obligation bonds, as well as high grade essential purpose revenue issuers, have proven to trade relatively efficiently during periods of dislocation in the municipal market. Liquidity should only improve as new classes of institutional investors are attracted to the municipal market in search of yield, credit quality and price stability. Additionally, the US Federal Reserve Bank's Operation Twist program will remove nearly a quarter of long dated treasuries from the market, leaving municipals an even more compelling alternative for liability-driven investors seeking high-quality, long duration assets.

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## *How do you see the nation's massive infrastructure needs affecting municipal issuance in 2012?*

The nation's continuing infrastructure needs require approximately \$210 to \$280 billion of tax-exempt borrowing annually for new capital projects, averaging \$250 billion from 2002 through 2010. Financial austerity in 2011 cut that amount to \$150 billion. A wave of refinancings is projected for 2012 as issuers take advantage of current low interest rates and retire higher-coupon bonds. If refinancing supply accelerates beyond demand from reinvesting maturities and coupon income, or investor appetite is diverted to cash or stocks, rates may be pushed higher to absorb the projected new issuance. So far this year, the trend of limited bond issuance persists, driving yields even lower.

## Federal Role Looms Larger

### *How will gridlock in Washington affect the market for municipal bonds?*

In what is shaping up to be a highly-charged political year, Congress and the Administration will be wrangling over several important budget and tax reform measures. While wholesale tax reform and long-term deficit reduction seem increasingly unlikely before Election Day, the recurring need to fund government operations without tripping over the country's debt limit will likely bring to the fore two key issues which might affect municipal bondholders:

- Capping or eliminating tax preferences, including the federal tax-exemption of municipal bond interest;
- Extending the Bush-era tax cuts, or allowing them to expire.

The ultimate resolution of these issues is highly uncertain, potentially adding volatility to the muni market as the debate heats up.

### *Is the tax-exempt treatment of municipal bond interest in danger?*

Assaults on municipal bond tax-exemption have come from a number of fronts. For instance, the 2010 Bowles – Simpson deficit reduction plan proposed completely phasing out the loopholes that reduce individuals' tax liabilities, including the tax-exemption of municipal bond interest. The Bowles – Simpson plan was quickly shelved, and has not been revisited. We believe such a sweeping proposal has virtually no chance of being enacted in 2012.

A proposal from the White House, contained in the American Jobs Act, sought to limit, at a maximum tax rate of 28%, deductions taken by wealthy taxpayers. This plan was a radical departure from all previous proposals as it would partly tax interest income from all municipals without grandfathering currently outstanding bonds. The Jobs Act failed to clear its first Senate vote in 2011 and is a long shot for 2012. Even if tax-exemption were to be capped at a 28%, municipal bonds would still offer attractive yields rate when compared with the after-tax yields from comparable corporate or government securities.

We expect tax-exemption will not be completely eliminated.

- Voters like tax-exempt income. While often portrayed as a favorite investment of "The 1%," municipals are not just for the wealthy, but are held widely across the entire range of taxpayers. Indeed, the latest detailed tax data from 2009 reveal that twelve times as many Main Street taxpayers with incomes below \$100,000 received 1.5 times the amount of tax-exempt interest as those with incomes over \$1 million.
- Tax-exempt municipal bonds remain essential tools for state and local elected officials, and lobbying efforts to keep this low-cost capital financing in place are beginning to heat up.
- Responsibility for U.S. infrastructure maintenance and development has been largely relegated to the state governments, sometimes with contribution from the federal government; U.S. states require favorable financing rates to satisfy this obligation. The federal government is in no position to be taking on the additional liability for improving the nation's infrastructure, which received a grade of "D" in the latest American Society of Civil Engineers 2009 report card.

### *Can we expect higher federal taxes?*

Theoretically, an increase in the highest marginal tax rate should raise the valuations of tax-exempt municipals. The historic data, however, do not support this immediate connection.

If there is no agreement on tax reform this year, the Bush-era tax cuts will expire on December 31, 2012. In 2013, the new Medicare tax on investment income becomes effective. This 3.8% tax is levied on taxable interest (but **not tax-exempt** interest), dividends and capital gains. Higher taxes seem likely in the future, with substantial increases on tap for capital gains and dividends. Consequently, successfully managing not only federal taxes but also state and local income taxes, the federal alternative minimum tax (AMT) and capital gains taxes, will have increasing value for investors

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Top Federal Tax Rates in 2013 Under Current Law	Current Top Tax Rate	If Bush-era Rates Expire	
		Income Taxes	Income Taxes Plus Medicare Tax
	Taxable interest	35.00%	39.60%
Short-term capital gains	35.00%	39.60%	43.40%
Long-term capital gains	15.00%	20.00%	23.80%
Dividends	15.00%	39.60%	43.40%

## *New U.S. and international regulations to reign in bank risk are in the works. How will the market for municipal bonds be affected?*

The so-called Volcker Rule in the Dodd-Frank Act, which seeks to ban banks from proprietary trading, is scheduled to be implemented later in 2012. As currently proposed, bank holdings of general obligations may not be considered as proprietary trading, and banks would presumably purchase general obligations over revenue bonds. The impact of the Volcker Rule on municipal market demand would be muted, however, as banks own only 8% of all outstanding municipal securities due to existing tax laws. In a second application, the Volcker Rule could classify as speculative: customer hedges or leveraged investments in municipal bonds by bank affiliates. While leveraged holdings of municipal bonds are currently a relatively small part of the current market, in the years leading up to the financial crisis, tender option bond programs were a major source of demand for longer maturity municipals. These types of leveraged investments would be less likely to reappear if the Volcker Rule is implemented as proposed, possibly limiting the demand for longer maturity municipal bonds.

A set of global rules for international banks governing capital, liquidity and leverage are set out under the Basel III agreement. But before they become effective in 2013, the Basel III rules must be passed into law by each participating nation. While Basel III is largely consistent with Dodd-Frank, ironing out the differences before the 2013 deadline will be an enormous challenge, especially in a U.S. election year. Basel III may stimulate some bank buying of municipal bonds as it applies the same zero-risk weighting for U.S. banks to U.S. Treasury securities and to obligations of “non-central government public sector entities,” thought to include state and local municipals.

At the behest of regulators banks have restored their balance sheets and their liquid asset holdings. While the spigot of lending to businesses and consumers has not reopened, banks have increased their direct lending to state and local governments, skirting the public market and modestly reducing municipal bond supply.

## External Forces:

### *Worries over state and local fiscal conditions have abated. Yet, are there still looming global macroeconomic developments which may affect municipal bond credits?*

Data from the U.S. Department of Commerce indicate that, on average, U.S. exports to Europe comprise approximately 2% of U.S. GDP. In some states the percentages are considerably higher; these states include Utah (5.6%; gold and silver), South Carolina (4.1%; automobiles), West Virginia (3.9%; coal) and Louisiana (3.5%; petroleum)<sup>1</sup>. Rocky Mountain States such as Montana, Wyoming and Colorado have the lowest exports to Europe. Absent any other trends, states with above average dependence on exports to a weakening Europe<sup>1</sup> are more likely to have underperforming economies and greater potential for revenue shortfalls. These states could pass along their budget challenges to their local governments as a means of closing budget gaps.

A prolonged European recession could cause broader economic malaise in the U.S. and result in more widespread budget issues for state governments in the form of lower tax revenues and higher welfare costs. Ultimately local governments that rely on property taxes and state aid, especially school districts, would suffer. We believe our current overweighting of revenue bonds, especially essential purpose municipal utilities and dedicated tax bonds, is prudent to insulate client portfolios from potential credit weakness.

<sup>1</sup>Source: “U.S. States with Exposure to a European Recession”, Wells Fargo Securities November 14, 2011

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Standish views the potential fiscal challenge that could be triggered by Europe<sup>1</sup> as budget, rather than significant credit, problems that might lead to major downgrades or even defaults. State and local government debt, whether backed by a general obligation pledge or a specific revenue stream, is well secured. The vast majority of municipal issuers have low to moderate debt burdens and reasonable financial flexibility.<sup>1</sup>

## *Would further downgrades of the United States lead to downgrades of municipal bonds?*

Standish's view is that the relationship between the credit quality of municipal bonds relative to the U.S. is tenuous. State and local government credits will remain generally strong regardless of the federal government's credit ratings; any downgrades of these credits and resulting spread widening would likely present a buying opportunity. Essential purpose revenue bonds represent separate operating entities and have demonstrated stability and resilience of revenue and operations, thus making a U.S. downgrade irrelevant to these revenue sectors.

Municipal bonds whose credit quality is linked directly to that of the U.S. government share the same ratings of the U.S. (Aaa, negative outlook, AA+, negative outlook, and AAA negative outlook by Moody's, Standard and Poor's and Fitch Ratings respectively) and would be downgraded alongside the U.S. These bonds include re-rated pre-refunded bonds (both US Agency and US Treasury collateral) and housing bonds backed by the Federal National Mortgage Association (Fannie Mae), Government National Mortgage Association (Ginnie Mae) and Freddie Mac. These credits comprise 3% of the market according to Barclays Capital.

Moody's has a negative outlook on three triple-A rated states (Maryland, New Mexico, and Virginia) and 36 triple-A rated local governments primarily because Moody's believes that those state and local economies are highly dependent on the federal government for revenue generating activity. Especially since the financial crisis, Moody's threshold for downgrade is much lower for the highest rated issuers; lower rated credits can endure more economic volatility before they are downgraded, and will be reviewed if the US rating were cut. S&P criteria for state and local governments does not establish a link between municipal ratings and the federal government's rating, but the agency has also signaled a one-notch ceiling for state and local governments over the U.S. Therefore, AAA-rated state and local governments may be downgraded by S&P if the U.S. is double-A or lower.

## *What is your outlook on municipal creditworthiness, especially if the U.S. cut its aid payments to state and local municipal borrowers?*

We do not believe there would be any municipal defaults directly tied to Federal aid reductions and it is unlikely that there would be wide scale rating downgrades. Federal aid to state and local governments is not directly used for debt service. Virtually all Federal aid is used to finance federal programs implemented at the state and local level; states are under no obligation to pick up the balance of the funding requirements if federal aid is slashed.

The number of municipal defaults and par amount were lower in 2011 than in 2010. Through the first 11 months of 2011, 85 tax exempt bond issues totaling \$2.3 billion par amount defaulted, down from 115 and \$2.79 billion in the first 11 months of 2010. Defaults will likely continue to be rare and limited to unrated and sub-investment grade credits in the riskiest sectors in the municipal market, such as land-secured, retirement facilities and other project financings. There are approximately \$8.9 billion (324 bond issues) of tax exempt debt in default, compared to approximately \$3.7 trillion outstanding, a default rate of approximately 0.24%.<sup>2</sup>

## Opportunities in 2012

### *What are some of the most attractive investment opportunities you see ?*

We continue to favor credit-intensive revenue bond sectors that in the past were "wrapped" by the monoline insurers (including airports, essential service utility and healthcare bonds). We find these high-quality issuers with strong credit characteristics and revenues that are better insulated from economic slowdowns and political tampering. As retail investors lack the time, expertise or access to analyze and monitor these revenue bond credits, lack of interest has created inefficiency. Weaker demand for revenue bonds from retail buyers can result in higher yields than would be justified by the sector's strong credit fundamentals. The potential excess income over general obligations from single-A revenue bonds has increased since the

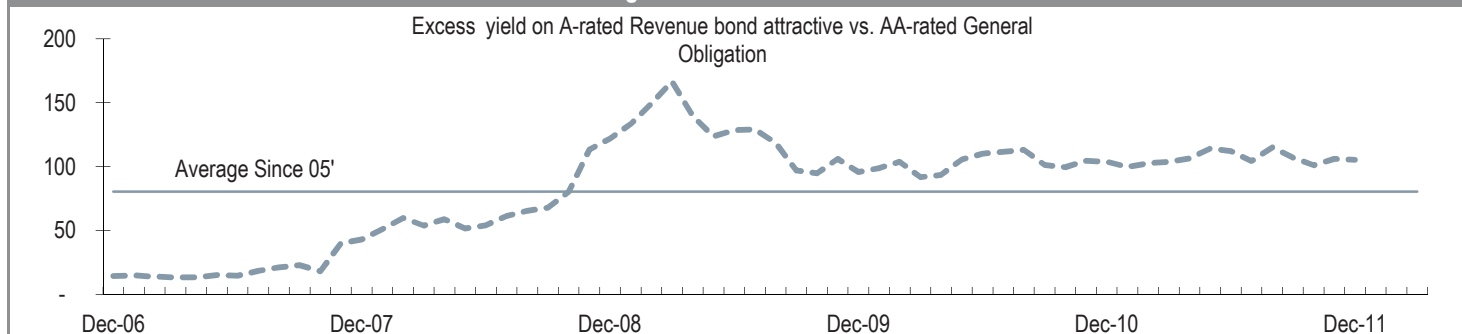
<sup>1</sup>Source: "U.S. States with Exposure to a European Recession", Wells Fargo Securities November 14, 2011

<sup>2</sup>Source: Municipal Market Advisor, November 2011. Published December 6, 2011

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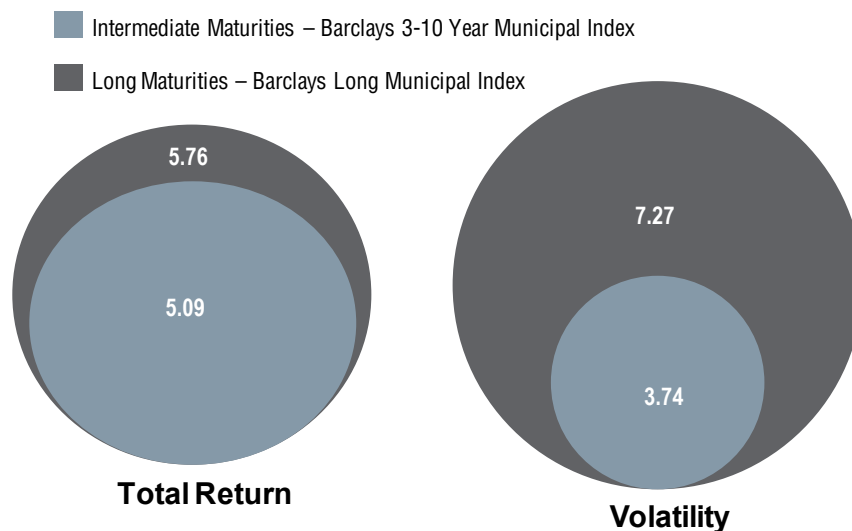
value of bond insurance melted away in the financial crisis. In our opinion, this relationship is likely to persist as there are few intermediaries to enter the market and extract the excess spread in return for providing liquidity. Indeed, this was the role played by the bond insurers before they became defunct.

## Revenue "A" Rated Bond Yields Attractive vs. General Obligation



Source: Standish, Barclays Capital as of December 31, 2011; 5-15 year Maturity

For long-term investors, we believe intermediate municipals continue to offer the best balance between total returns and volatility. As the diagram below indicates, over the ten years ended December 31, 2011, intermediate municipals (as represented by the Barclays Capital 3- to 10-Year Index) produced annualized investment returns which were 88% of the returns generated by the Barclays Capital Long Municipal with only 51% of the volatility of returns. We expect the yield curve will remain steep in 2012, with short-rates anchored by the Federal Reserve's stated commitment to maintain accommodative policy. In this environment, we expect municipal bond investors to benefit from the incremental yield of high grade intermediate bonds.



Source: J.P. Morgan, Standish as of December 31, 2011

Recent Standish analysis has indicated that if ten-year municipal yields rise over the next year by one-half a percentage point, or 50 basis points (50 bp), while two-year yields remained pinned at their current levels, the income from intermediate municipal bond indexes would be sufficient to offset the price declines caused by higher rates, and total returns would be positive.

Scenario Analysis: 10-Year Municipal Rates Rise 50bp over 12 Months				
Barclays Muni Index	1-3 Year	1-5 Year	1-7 Year	1-10 Year
Duration (years)	2.12	2.76	3.29	3.98
Yield	0.91%	1.11%	1.28%	1.65%
Scenario Price Return	-0.31%	-0.55%	-0.85%	-1.40%
Total Return	0.60%	0.55%	0.43%	0.24%

Source: Standish, Barclays Capital as of December 31, 2011

The direction of longer interest rates is more difficult to predict, and Standish Tax Sensitive portfolios are positioned to avoid

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excess interest rate risk, both in terms of duration posture and maturity extension. Portfolios have limited exposure to callable bonds, where duration increases with rising interest rates. We focus on sector and security selection to deliver excess income in the face of an uncertain economic and interest rate environment.

While it would be unlikely to repeat the total returns generated during the market rally of 2011, we expect high grade intermediate municipal bonds will continue to provide attractive after-tax income, with stable credit quality and relatively low volatility. As well, as the cycle turns, we expect municipal after tax returns to exceed those of treasuries and inflation.

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*The Barclays Municipal Index is a market capitalization weighted index of U.S. public municipal bonds that have maturities of one year or more and have an investment grade credit rating no lower than BBB/Baa3. The index tracks the performance of municipal security trades in the U.S. Bond Market*

*The Barclays Municipal 3-10 year Index is a market capitalization weighted index of U.S. public municipal bonds that have maturities of two to 12 years and have an investment grade credit rating no lower than BBB/Baa3. The index tracks the performance of municipal security trades in the U.S. Bond Market within this maturity range*

*Barclays Long Municipal Index: This index is the Long Bond (22+) component of the Municipal Bond index.*

*The GO Bond Index component of the Municipal Bond index. To be included in the index, bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be investment-grade. 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. Remarketed issues, taxable municipal bonds, bonds with floating rates, and derivatives, are excluded from the benchmark.*

*The BofA Merrill Lynch Global Broad Market Sovereign Plus Index tracks the performance of investment grade sovereign debt of large and small cap issuers publicly issued and denominated in the issuer's own domestic market and currency. In order to qualify for inclusion in the Index, a country (i) must have an investment grade foreign currency long-term sovereign debt rating (based on an average of Moody's, S&P and Fitch); (ii) must have at least \$10 billion (USD equivalent) outstanding face value of Index qualifying debt (i.e., after imposing constituent level filters on amount outstanding, remaining term to maturity, etc.); (iii) must be available to foreign investors; and (iv) must have at least one readily available, transparent price source for its securities. Euro sovereigns are treated as a group with respect to minimum size requirements, but each member country is evaluated individually with respect to all other criteria. To qualify as a Euro member, entry into the European Monetary Union must be announced on or before the country qualification date (September 30) and must take effect on or before January 1 of the upcoming year. Qualification with respect to all country criteria other than rating is determined annually based on information as of September 30th, but does not take effect until December 31st. Conversion of local currency outstanding face value into USD terms is based on the average of the previous 12 month-end exchange rates up to and including the September 30th evaluation date. Qualification with respect to country rating criteria is determined monthly based on information available as of the third business day before the last business day of the month and takes effect on each month-end rebalancing date.*