

**MUNICIPAL BOND MARKET UPDATE – FEBRUARY 2011**

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***I have seen conflicting reports about the municipal bond market in the media recently. Some commentators have said that municipal bond issuers are having financial difficulties and that there may be significant defaults. Others say these opinions are overstated and that it's a good time to buy municipals. What are the facts? Just how safe are municipal bonds?***

Municipal bonds, like corporate bonds, represent a broad risk spectrum. To help investors assess credit risk, bonds are typically assigned credit quality ratings. Generally, high-quality bonds receive AAA or AA ratings, midgrade bonds receive A or BBB ratings and the remaining bonds receive BB or lower (below investment grade) or are not rated.

However, municipal bonds as a whole have experienced very few defaults in the post-Depression era. From 1970 through 2009, the average cumulative default rate for all Moody's-rated municipal debt was less than one-tenth of 1%. In 2010, defaults represented \$2.5 billion of the nearly \$3 trillion municipal bond market – also one-tenth of 1% of the market, even with increased economic pressures on municipalities. In addition, most of the defaults were non-rated or rated below investment grade bonds. In other words, the default rate on municipal bonds continues to be very low.

***So municipal bonds have had a good track record, but what do you see looking ahead?***

The longevity and severity of the recession have negatively impacted revenue streams – income, sales and property taxes – for municipalities, generally across the board. These are the primary sources of payment for portions of the municipal bond market. With many state and local municipal bond issuers facing substantial budget gaps, their financial strain is pronounced.

One visible industry pundit recently predicted that over the next 12 months 50 to 100 municipal issuers will default, affecting \$100 billion or more in bonds. On the surface these are very alarming numbers, but they must be put in context. There are approximately 60,000 issuers of municipal bonds, so 100 issuers represent approximately two-tenths of 1% of issuers. With \$3 trillion of municipal bonds outstanding, \$100 billion in defaults represents 3% of the market.

We recognize that in the current economic environment, many municipalities face difficult challenges. Tax increases, spending cuts or some combination of both will be required to balance budgets. We expect that most municipalities ultimately will succeed in addressing these fiscal difficulties, but a minority will not. Those that do not will be viewed negatively by the rating agencies. Therefore, we expect an increase in the level of bond issuer ratings downgrades.

It is also likely that we will see an increase in the number of municipal issuers that fail to make interest payments in a timely manner. However, this increase starts from a very low historical base of payment problems. In a recent report, credit ratings agency Moody's Investor Services noted that they anticipate a few more defaults in 2011 (and no state-level defaults), but that the overall municipal default rate will remain low – well below the usual rate of defaults in the corporate bond market. We agree and expect the vast majority of municipal bond issuers to continue making their bond interest payments on time.

***I have heard that many bond issuers' pension programs are underfunded. What is the impact to bond issuers from underfunded pension obligations?***

Underfunded pension obligations represent a significant challenge to municipal bond issuers in balancing their budgets. Pensions are incremental obligations, beyond normal operating expenses, that issuers must ultimately fund. If an issuer is 100% funded it means they have already set aside enough today to make payments on expected future pension obligations as they become due. If an issuer is underfunded, they will likely need to make additional dollar value contributions, reduce or delay benefits, or require increased contributions from employees – all changes that may be difficult to achieve.

Pension obligation funding levels vary dramatically by issuer. At the state level, 11 issuers are currently funded at 90% or more, while 10 are funded at 70% or less. According to a recent Northwestern University Study, states in aggregate will need to contribute an additional \$75 billion per year for the next 10 years, assuming 8% asset returns, to avoid a significant chance of having to draw on resources from outside their pension funds to meet benefits already promised.

However, while underfunded pensions represent significant budgeting challenges – and may affect states' credit quality and ratings – most analysts believe it is highly unlikely that we will see state-level bond defaults.

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### ***Several of my bonds are insured bonds. What should I know related to these bonds?***

Insured bonds have two layers of credit strength when they are issued: the strength of the municipality itself (without the benefit of insurance) and the strength of the bond insurer.

Unfortunately – with the exception of the subsidiaries of Assured Guaranty Ltd., including Assured Guaranty Municipal Corp. (AGMC), formerly Financial Security Assurance (FSA), and Berkshire Hathaway – the credit quality ratings of most bond insurers have declined significantly or have been withdrawn as a result of the insurers' involvement in subprime residential mortgage loans. This means that bonds that had been rated and valued based largely on their insurance are now valued mostly on the underlying issuer's financial strength apart from bond insurance – moving the credit quality ratings from AAA insured or something less, depending on the underlying rating of each issuer. Most of these bonds now have an underlying rating of A, though a few are AA or BBB, and small portions are non-rated or rated below investment grade.

### ***Prices for most municipal bonds have fallen substantially over the past couple of months. What triggered the price declines?***

Four major factors caused prices to fall:

- Credit concerns regarding municipal issuers (described above).
- The tax compromise bill in December that prevented marginal income tax rates from increasing. The bond market had anticipated taxes would increase, which would have made tax-free interest on municipal bonds more attractive to prospective buyers, increasing demand and prices. The bill changed those demand expectations.
- Non-renewal of the Build America Bond program and reduction of the Bank Qualified Bond program. These changes will cause municipal bond issuance volume to increase by over \$100 billion per year, an increase of more than one-third. Given the expectation of higher issuances – or greater supply – prices adjusted downward.
- Rising interest rates. Since November 15, longer-maturity bond yields have risen substantially. For example, the benchmark 10-year U.S. Treasury bond yield rose from 2.9 % to 3.3%. As interest rates rise bond prices decline.

### ***Do you expect the municipal bond price declines to continue?***

Price declines are likely to continue if interest rates rise or credit concerns grow. Recently, however, we have seen substantial buying by certain institutional investors, who tend to focus on high-grade bonds (rated AA or better). This activity has brought price stability to the highest quality portion of the municipal bond market, which we expect to continue as long as municipal bond yields are similar to like-quality and like-maturity taxable bonds.

### ***What should I do related to my municipal investments?***

While there are plenty of municipal issuers that are doing fine economically and will continue to satisfy their debt obligations, the message of the more pessimistic voices should not be ignored. The environment has become more challenging and a growing number of municipalities are likely to experience problems, some of them perhaps severe.

With your financial advisor's assistance, we recommend carefully reviewing your municipal bond portfolio. Depending on your individual situation and investment holdings, it may be appropriate to make some adjustments.

### ***What else should I know?***

We expect the media coverage regarding the municipal market to continue over the next year, and perhaps longer. Raymond James will continue to provide periodic updates as needed to put some of what is broadcast by the media outlets into context. Our goal is to help you – along with your financial advisor – make well-informed, thoughtful and sound decisions regarding your investments.

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