

MUNI UPDATE: RELATIVE VALUE

JANNEY FIXED INCOME STRATEGY

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After nearly six weeks of widening underperformance, the municipal markets are showing signs of support. Given strong fundamental credit quality and the improving technical picture, we view high quality names as tremendously attractive in this environment.

INTRODUCTION

Over the past six weeks, the municipal markets have experienced the most severe price shocks in decades, driving yields in the sector up to levels not seen since mid-2000 and ratios as a percent of Treasuries literally unprecedented. These declines have certainly contributed to concerns of current bondholders, but they've also created what's arguably the greatest opportunity for new investment that the last 15 months of the credit and liquidity crunch have brought. There's no way around it: high quality municipal paper, especially the longer-duration areas of the curve, are exceedingly cheap. And while a return to the sub-100% ratio days of 2007 aren't in the cards for the immediate future, there is finally a technical basis to expect stabilization in the sector. That stabilization offers a good opportunity to reiterate the themes of the Sept 29 Muni Update and, moreover, to encourage investors that were previously "layering in" to fully deploy cash into the tax-exempt markets.

Between August 31 and October 22, ratios of muni to Treasury yields exploded across the board. For the AAA rated 30 year benchmark, that explosion took tax-exempt yields up from 4.74% all the way to 5.89%, even as Treasuries declined in yield from 4.42% to 4.15%. That translates into an increase in ratios from 107.1% to 139.7%, the highest level in the history of our databases. While the current liquidity-sensitive environment is certainly outside the range of historical events, the widening in ratios to these levels when fundamental credit quality among municipal issuers remains strong, has nonetheless pushed the municipal sector to offer the most relative value of any major fixed income sector in our coverage area.

Despite expectations of falling revenues and elevated long-term spending needs, the evidence for our assessment of fundamental underlying strength is extremely strong. According to Moody's, the default experience among single A rated municipal issuers is a very slight 0.0084%, approximately 1/80th of the default experience among triple A rated corporates. In addition, recovery rates on defaulted municipal debt tends to be significantly higher than on corporate debt, as the muni bankruptcy process is oriented towards restructuring debt and returning towards solvency rather than selling assets and reducing debt. The impact of this much-reduced loss given default is significant; according to a landmark study completed by George Hempel, as much as 15% of municipal bonds fell into default during the Great Depression, but accounting for "credit cures" in which an issuer later became current on payments, and restructurings, recoveries on defaulted bonds averaged 80 - 90 cents on the dollar. Using the lower end of this

AAA GO Yield Ratios to Treasuries



Source: Janney FI Strategy; Bloomberg

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> Municipal yield ratios to Treasuries, judging by an easing supply overhang, growing demand, and better technicals appear to have reached their peak, though an instant rebound to pre-September levels seems unlikely.

band and the 15% default estimate, muni investors even during the Great Depression would have realized total credit losses of just 3% on their holdings. While some have likened the current situation to the Depression, the reality is that fundamental economic indicators, such as unemployment and GDP growth, aren't remotely close to Depression levels, even taking into account further weakening from current numbers. Fiscal and monetary policy, meanwhile, has developed much more sophisticated means to deal with and prevent the worst of the problems that plagued the economy and financial system in the 1930s. According to S&P, the median municipality with a single A credit rating has just \$1,222 in debt per capita, which, even at a punitive 6% annual debt service expense equates to just \$73 of expenses per person. While municipal revenues, both as the result of dropping income property taxes, are likely to fall into fiscal 2009 and perhaps even 2010, the magnitude of the drops is highly unlikely to push more than a handful of issuers into distressed positions, as, on average, raising \$73 worth of tax revenues per person will allow a municipality to fund its debt.

It's easy to argue that credit quality among municipal issuers, especially state and local GOs, is fundamentally sound, but there's also evidence beginning to build that the short term supply and demand picture is stabilizing. On the supply side, the distressed selling responsible for the largest portion of the muni downturn appears to have tailed off, perhaps simply because the majority of highly leveraged muni buyers have already liquidated some or all of their holdings. The lack of selling, which has sustained for several trading days now, suggests much of the supply overhang facing the markets seems to have passed through the pipeline. At the same time, a number of new issue deals that were delayed over the past six weeks still need to come to market before year end (30 Day Visible Supply of \$19.1 billion is just below the 2008 high), so the supply picture is somewhat less than perfect. This last concern should prevent ratios from falling as fast as they've risen, but the reduction in distressed selling is the real impetus behind supply improvement. In addition, the demand side of the equation is beginning to pick up as retail investors flood back into the muni markets. After waiting on the sidelines for several weeks, retail buying has generated significant price moves in the last several trading days, with individual investors snapping up as much as 75% of recent \$200 - \$300 million new issue deals. At the end of the day, retail investors are a major force in the municipal markets, as they account for the majority of U.S. income taxes and therefore have the greatest need for tax-exempt income. With yields hovering in the 5.5% - 6.0% on the long end, and lots of cash on the sidelines amid market volatility, it stands to reason that individual investors are in a strong position to provide support for the sector.

Another, arguably more subtle, factor also aiding the supply and demand picture in pushing muni ratios lower is the short term markets. The SIFMA Municipal Swap Index, an index of yields on variable rate demand bonds (VRDBs), retreated to 3.45% for the week of Oct 15 from as high as 5.74% at the beginning of the month. The reductions suggest that there's been buying activity on the short end of the yield curve, which reduces the attractiveness of alternatives to longer duration munis, thereby encouraging buying further out. In addition, the retreat of the SIFMA Index, which is the basis for most municipal interest rate swaps reduces the selling pressure on the long end driven by losses in the municipal derivatives markets.

RELATIVE VALUE

While the markets have shifted since our Sep 29 Muni Update, our fundamental view on what sectors are set to outperform remains essentially the same.

- + Long-dated GOs with high single-A to low AA ratings are an alternate, low-credit risk higher-yielding way to take advantage of sector wide pressures. The historical default rate of A2/A rated "plain vanilla" municipal bond issuers, according to Moody's, is approximately 0.0084%, a miniscule number (and, incidentally, about 1/80th the default rate of Aaa/AAA rated corporate bonds). While these issues have cheapened out significantly, they're also the credits that stand the most to gain from the ratings agencies implementing a global scale. According to Moody's and Fitch, GOs that have AA- and A+ credit ratings on the muni scale will, most likely, be upgraded to between Aa1/AA+ to Aaa/AAA on the corporate scale. As we've argued in the past, there's limited basis for believing that bonds will trade better once they're converted to the global scale and upgraded, but there's no apparent pricing downside either, and a Aaa/AAA bond, even on the global scale, might be more marketable in the coming months and years, once the memory of the scale conversion is in the past.
- + Pre-refunded municipal bonds, as we witnessed in the February-March ratio blowout, are among the strongest performers following a sector wide liquidity crunch. The analysis with pre-res in this environment is rather straightforward: Considering the majority of pre-refunded and escrowed to maturity bonds are backed by the cashflow on a portfolio

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> Because of the across-the-board nature of the muni sell off, high quality paper offers the best value in today's markets.

of Treasuries, it's hard to argue that the yield differential is driven by credit quality, making the dislocation all the more unusual. One downside, however, of buying pre-re's is that their price appreciation is limited by their relatively short maturity dates. For that reason, we believe longer-term pre-re's, which tend to be in the 2015 - 2016 range at best, have the best appreciation potential as the market begins to moderate. Block size New York MTA bonds escrowed to maturity in 2015 traded at a 3.89% yield on Oct 22, which was 117% of the comparable Treasury yield at the time. Assuming a 35% tax bracket, this 3.89% translates into a 5.98% TEY for a 7 year muni with very strong credit quality. For investors without cash on hand, the out-of Treasuries into pre-re's trade is one of the most attractive ways to take advantage of wider ratios to Treasuries.

- Revenue bonds rated Baa2/BBB or below, while they've seen rather sharp price declines, are likely to be plagued by a continued risk-aversion in the municipal markets. Moreover, with quality trading at such a discount in today's markets, there's little reason to dip deeper into the credit spectrum—such a trade is more of a bet than a relative value play. Buyers of low investment grade and high yield debt are quickly fading after severe underperformance of the sector (-15.15% total return year to date versus Lehman Muni Index -7.47%) has resulted in flows out of high yield mutual funds and weaker retail sponsorship. Those two buying engines are unlikely to provide additional support in this particularly credit-sensitive environment. Finally, the smaller size of most lower-rated issues can make it challenging to find liquidity if necessary, a point not lost on investors having trouble finding a bid for current holdings.
- Toll road and airport revenue bonds, as we discussed in our FI Weekly on August 25, are likely to be challenged by the ongoing high oil price environment. Despite recent retreats in oil from \$145 highs to the \$70 region, "energy psychology" is shifting in such a way that toll road utilization is headed on a downward trend. In addition, elevated infrastructure needs on many aging roadways and the high degree of operational leverage mean small declines in traffic can result in much larger declines on net revenues. In the airport sector, airline capacity rationalization and reduced passenger flows are driving revenues sharply downward. While the biggest risks remain at regional facilities, even larger population center airports are likely to experience pressure on credit ratios with only limited means of reducing costs. Again, with the high quality markets so cheap, there's limited advantage in dipping into riskier sectors at present.

CONCLUSIONS

The relative value offered by the muni sector is a far cry from what we indicated in the Sept 29 Muni Update. Since then, prices have declined further, and the selling pressures have diminished substantially. As such, we're not in the position of saying, "well if you liked them at par, you'll love them at 95," but rather of saying that strong evidence of stabilization has returned to the municipal markets, and while prices are unlikely to immediately reach pre-September levels, we're on track for at the least an end to the bleeding, and more likely, a solid rebound. While the short term potential for a price rebound is strong, looking at the intermediate to longer term picture, it appears that the sub-90% heydays of the municipal markets are unlikely to re-emerge in the coming months and years. The municipal sector, regardless of fundamental credit quality, was supported throughout much of the past several years by cheap liquidity and aggressive buying from highly levered accounts. Now that the cost of borrowing is likely to remain elevated above 2003 - 2007 levels for years at a minimum, there's simply less money chasing the returns of the municipal bond sector. In addition, the bad experience of the last two months for many of these leveraged investors makes it unlikely that we'll see a return of the type of aggressive institutional buying necessary to support sub-90% municipal ratios.

Select Historical Average Municipal Ratios (% of Treas)

	5yr Pre-re	AA- 10yr GO	AA- 30yr GO
Current	145.9%	138.9%	146.8%
1yr Ago	89.8%	89.9%	94.5%
3m Average	104.3%	107.3%	116.6%
12m Average	100.6%	101.8%	107.9%
5yr Average	83.6%	90.3%	97.5%

Source: Janney FI Strategy; Bloomberg

Market data from Bloomberg, Lehman Brothers, and JMS Fixed Income Strategy.

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