

Bond Market Perspectives

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Highlights

The municipal bond market extended an impressive performance run to five weeks but we caution investors to curb their enthusiasm.

Any near-term weakness is likely to be limited however as the June-July reinvestment period looms and provide a potentially favorable intermediate-term backdrop.

We would use weakness as a buying opportunity.

Curb Your Municipal Enthusiasm

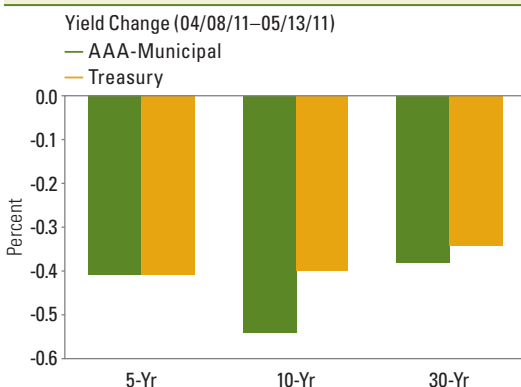
The municipal bond market extended its impressive run of performance to five weeks. Municipal bond strength persisted last week despite Treasuries finishing relatively unchanged. Municipal outperformance stretches back to early April, a period that marked the start of overall bond market strength. As a reflection of the strength, municipal bond yields have declined more than comparable Treasury yields [Chart 1]. The same factors that started the municipal bounce (see *Bond Market Perspectives – Municipal Bounce Back*, April 26, 2011) continue to drive the municipal bond market, specifically:

Domestic fiscal austerity. Lawmakers continue to debate how to address the budget deficit and deficit reduction talk has included proposals for higher tax rates and the elimination of tax loopholes. Both developments are positive for municipal bonds and boost the allure of their tax-advantaged status. Proposals to eliminate the tax exemption on municipal bonds continue to be discussed but while none have garnered significant traction, all proposals would be applied to future municipal bond issuance only. Existing municipal bonds would be grandfathered and protected from any such legislation. A plan to eliminate the tax exemption on future municipal bond issues, which we deem very unlikely, would only serve to increase the value of existing municipal bonds as it would create a scarcity premium for municipal bonds that maintain their tax exemption.

Reduced credit quality fears. A continued decline in defaults is slowly working to contradict overblown credit quality fears. Defaults declined to \$254 million during the first quarter of 2011 versus \$1.0 billion in the first quarter of 2010. Furthermore, the prospect for further credit quality improvement looks promising. State revenues increased by a preliminary 9.5% through the first two months of 2011, according to the Rockefeller Institute of Government, and follow a robust improvement during the fourth quarter of 2010. The National Conference of State Legislatures reported that 37 states have met or exceeded state revenue targets so far for the 2011 fiscal year. The state of California, for example, announced that revenues are \$2 billion ahead of forecast through the end of April. While many states will still have many tough budget cuts to make for fiscal year 2012, the improved revenues imply that expected cuts may not be as severe as initially anticipated.

Low supply environment. Although new issuance has been constrained for much of 2011, supply over the past few weeks has been particularly light. Through the end of April, new issuance in 2011 is running at roughly half

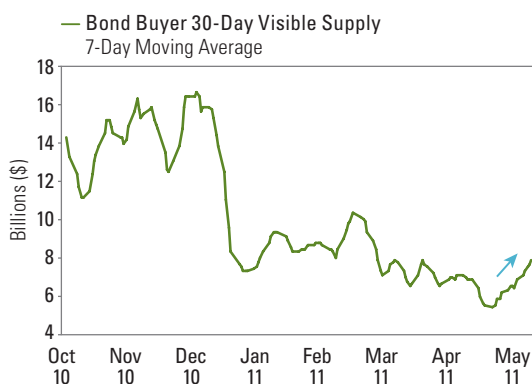
1 Greater Yield Declines Reflect Municipal Bond Strength



Source: Bloomberg, LPL Financial 05/13/11



2 New Issuance Has Begun to Increase Due to Lower Yields and a Firmer Market



Source: Bond Buyer, Bloomberg, LPL Financial 05/13/11

the 2010 pace. Forecasts for full year municipal bond issuance have been slashed to just over \$200 billion, which would be the lowest total since 2000. Buyers awaiting an increase in new issuance to create market weakness and thus a buying opportunity have thrown in the towel and begun to put money to work. We would not categorize current buying demand as robust but it has proven more than sufficient for existing level of new issuance.

General bond market strength. Bonds overall have enjoyed good performance over the past five weeks providing a favorable tailwind for municipal bonds as well. Several economic reports disappointed investors over the course of April and early May leading investors to fear that economic growth may slow. Still high energy prices and worries over the end of Federal Reserve bond purchases and its stimulative impact also fueled growth concerns. In response, the 10-year Treasury yield declined from a high of 3.60% in early April to a recent low of 3.14%.

The low supply environment and general bond market strength have been the primary drivers in our view and may be poised to lose momentum. Treasury yields are at the low end of our expected trading range and further price gains among high-quality bonds overall, which would lead to still lower yields, are likely limited. Even on a standalone basis investors may question the now lower level of municipal yields. Average 5- and 10-year AAA-rated municipal yields are only 0.3% above the record lows of early September 2010. Furthermore, lower municipal yields and a better market environment are enticing issuers to come to market. Forward supply measures [Chart 2] are rising and increased issuance would likely slow or halt the municipal advance. We believe the current pace of performance is due for a breather.

Nonetheless, we expect any near-term weakness is likely to be limited for two reasons. First, the increase in expected new issuance as shown in the nearby chart still reflects a low level of issuance when compared to longer-term averages. States continue to make progress on budgets for the new fiscal year which starts July 1 and are unlikely to issue new bonds until budgets are passed and borrowing needs are clarified. Since the majority of states are not likely to pass new budgets until June, we believe most states will avoid the typically quiet summer issuance period and a pick-up in primary market supply will likely not be a significant factor until later in the year.

A seasonally strong period for municipal bonds is just around the corner and may also limit any weakness. June and July are two of the largest months in terms of maturing bonds and create significant reinvestment needs. Municipal Market Advisors (MMA) estimates that June-July reinvestment needs will total just over \$70 billion. With new issuance averaging just \$17 billion per month so far in 2011, the increase in demand from investors having to reinvest maturing bond proceeds should not only be able to absorb existing issuance but also to provide ample room for an increase in new issuance.

We still find municipal bonds attractive but believe investors should curb their municipal enthusiasm. We believe the impressive performance run is due for



a breather. Any weakness is likely to be limited in our view, given a still low level of issuance and a pickup in demand from June and July reinvestment needs. We would be inclined to use weakness as a buying opportunity.

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Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of a fund shares is not guaranteed and will fluctuate.

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An obligation rated 'AAA' has the highest rating assigned by Standard & Poor's. The obligor's capacity to meet its financial commitment on the obligation is extremely strong.

Municipal bonds are subject to availability, price, and to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise. Interest income may be subject to the alternative minimum tax. Federally tax-free but other state and local taxes may apply.

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