

Bond Market Perspectives



October 11, 2011

One Year Later

Anthony Valeri, CFA

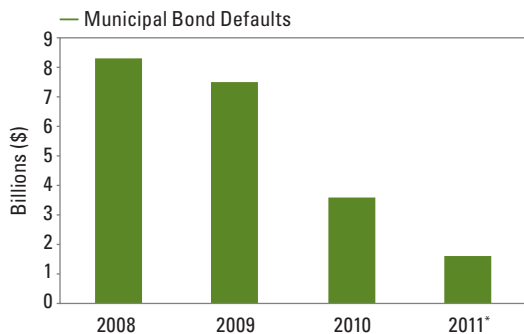
Market Strategist
LPL Financial

Highlights

Municipal bond defaults are on pace to decline for a third consecutive year and current default levels nowhere near the grim forecasts from one year ago.

We continue to find municipal bonds one of the more attractive high-quality bond options but last week's market action illustrates the occasional bumps that may lead to a lower return environment going forward.

1 Defaults Are On Pace To Decline For A Third Consecutive Year



Source: Securities Income Advisors, LPL Financial 10/10/11

*Annualized pace based on data through September 30, 2011.

It was just over one year ago that Meredith Whitney's firm released a research report on municipal credit quality. The 600 page report was initially released on September 30, 2010, but garnered much more attention following her December 2010 appearance on *60 Minutes*.

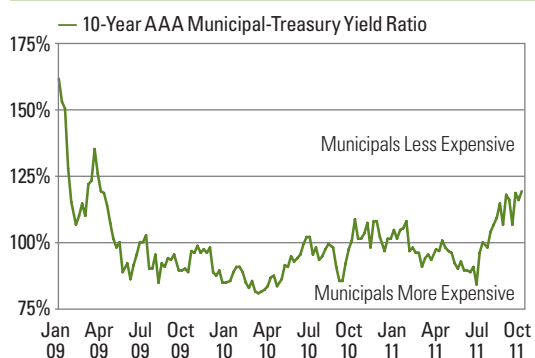
Thankfully for investors, the gloomy "\$50 to \$100 billion in defaults" forecast over "the next six to 12 months" has failed to materialize and municipal bond defaults are on pace to decline for a third consecutive year. In fact, one year later, defaults are nowhere near the apocalyptic forecast. Through the end of September, defaults totaled \$1.6 billion year-to-date according to Municipal Market Advisors (MMA), an independent research firm. Securities Income Advisors, which maintains a longer-term history of municipal defaults, estimates roughly \$1.2 billion in defaults over the same period [Chart 1]. Both firms measure defaults slightly differently but use the same source data from the Municipal Securities Rulemaking Board (MSRB).

As we have mentioned in the past, defaults have been concentrated among the most speculative of issuers and that continues to be the case today. Non-rated bonds and housing sector-related bonds continue to dominate defaults. Defaults among higher-quality general obligation (tax-backed) and essential service revenue bonds remain extremely rare. It is perhaps no surprise that Florida, where non-rated housing-related bond deals were common during the housing boom, leads all states in terms of the number of defaulted bond issuers.

Fewer defaults are a reflection of economic improvement over the past two years as states attempt to balance budgets by increasing revenues and cutting costs. The U.S. Census Bureau reported that state and local revenues increased 6.9% on average during the second quarter of 2011, the seventh consecutive quarterly increase. Higher individual income tax revenue and corporate tax revenues have been the biggest drivers of revenue gains and more than offset a modest 1.2% decline in property tax revenue. On the expense side of the ledger, states and municipalities have dramatically cut costs to ensure that debt service payments are prioritized and made to bondholders. To be sure, state and local budgets remain under pressure and will likely remain under pressure for the current fiscal year, which ends next June and likely beyond. However, the past two years highlight that the budget crises do not necessarily translate into a debt crisis.



2 Municipal Bond Valuations Still Attractive



Source: Bloomberg, LPL Financial 10/07/11

Fewer defaults and a more realistic view of credit quality have helped propel the municipal bond market up over 8% year-to-date, according to the Barclays Municipal Bond Index. Stressed budgets have also led to reduced issuance and tight supply relative to the demand for tax-exempt income. A more favorable supply-demand balance along with general high-quality bond strength has been a key driver of performance. States and localities have managed revenues carefully and are reluctant to launch new infrastructure projects that may be assisted by new bond financing. Municipal bond new issuance has accelerated over recent months but is still running 35% below the pace of 2010. In a sign of the times, the State of California waited until September to issue its first general obligation bond of 2011.

Despite the impressive performance, municipal bonds remain attractively valued relative to Treasuries [Chart 2]. Average yields on top-quality, AAA-rated municipal bonds remain higher than comparable maturity Treasuries. This has led to some of the most attractive yield ratios since early 2009 and one way to measure municipal bond valuations. The higher the ratio, or percentage, municipal yields are relative to Treasuries, the more attractive municipal bond valuations are and vice versa.

As we highlighted recently (see the September 13, 2011 *Bond Market Perspectives*, "Back to School with Municipal Bonds"), attractive valuations are tempered by lower yields and a pick-up in new issuance, which together may translate into lower returns going forward. Last week, heavy new issuance and general weakness among high-quality bonds conspired to send municipal bond prices lower. Intermediate municipal bond prices declined most and yields among some maturities increased by 0.20% compared to more modest 0.06% to 0.08% yield increases on short- and long-term issues.

Last week's performance is an example of the ebb-and-flow we expect from the municipal bond market between now and year-end. Manageable defaults and attractive valuations will work to support prices while low yields and the occasional spurt of new issuance may pressure prices lower as the market accommodates an influx of bond supply. Over time, we expect interest income will more than offset bouts of weakness but last week's market action illustrates how the occasional bump may lead to lower returns going forward. We still consider municipal bonds one of the more attractive high-quality bond options and believe there are benefits from this sector albeit at a more modest pace than witnessed over the first nine months of 2011.



IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

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.

Municipal Market Advisors is an independent strategy, research and advisory firm.

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.

Credit rating is an assessment of the credit worthiness of individuals and corporations. It is based upon the history of borrowing and repayment, as well as the availability of assets and extent of liabilities.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise, are subject to availability, and change in price.

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.

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.

Non-rated bonds have not been issued a rating by bond rating agencies such as Standard and Poors and Moodys. Bonds that have not been rated by an agency are usually considered to be junk bonds or fall below investment grade.

The Barclays Municipal Bond Index is a market capitalization-weighted index of investment-grade municipal bonds with maturities of at least one year. All indices are unmanaged and include reinvested dividends. One cannot invest directly in an index. Past performance is no guarantee of future results.

This research material has been prepared by LPL Financial.

The LPL Financial family of affiliated companies includes LPL Financial and UVEST Financial Services Group, Inc., each of which is a member of FINRA/SIPC.

To the extent you are receiving investment advice from a separately registered independent investment advisor, please note that LPL Financial is not an affiliate of and makes no representation with respect to such entity.

Not FDIC or NCUA/NCUSIF Insured | No Bank or Credit Union Guarantee | May Lose Value | Not Guaranteed by any Government Agency | Not a Bank/Credit Union Deposit