

# Municipal Bond Market Weekly

**Bottom Line: Municipal bond market rallies with declines in market rates due to risk aversion**

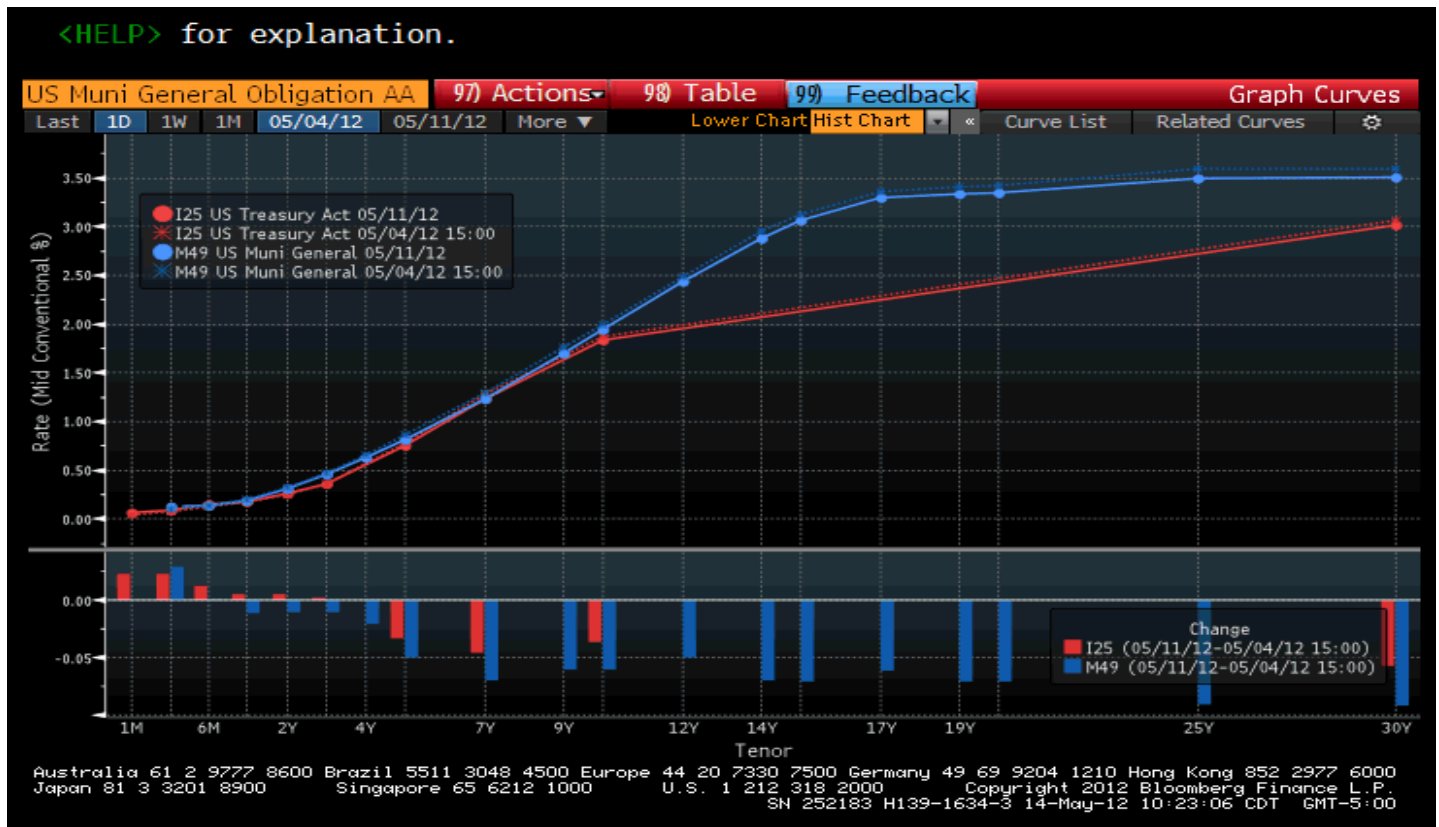
## What Happened in the Muni Bond Market Last Week?

### Municipal Bond and Treasury Yields (Figure 1) - For the week, (5/7/12 – 5/11/12)

The less risky fixed income markets rallied last week as investors became more risk averse due to a worsening European debt/political situation, mixed U.S. economic data came and concerns over the JP Morgan loss announcement. Treasuries dropped across the curve. Five-year Treasury yields declined by 3.3 basis points (bps), 10-year notes declined by 3.7 bps and 30-year bonds dropped by 5.7 bps. The 10-year Treasury yield is currently near the lows set last September and October. Bloomberg AAA-rated general obligation bond yields also declined across the curve; -5 bps on the 5-year, -6 bps on the 10-year and -9 bps on the 30-year maturity.

One can observe these changes by looking at how rates have changed along the yield curve for both the Treasury curve and for the AAA-rated G.O. Index since last week. The top panel of graph below shows four yield curves; two for the Treasury curve (in red) - one for the most current date and one from last week) and two for the AAA-rated G.O. (in blue) - current and last week. The bottom panel of the graph below shows changes in the rates along both curves for the week for both Treasuries and the AAA G.O. Index.

**Figure 1 - Yield Curve and Muni Curve Changes – Data Source: Bloomberg**



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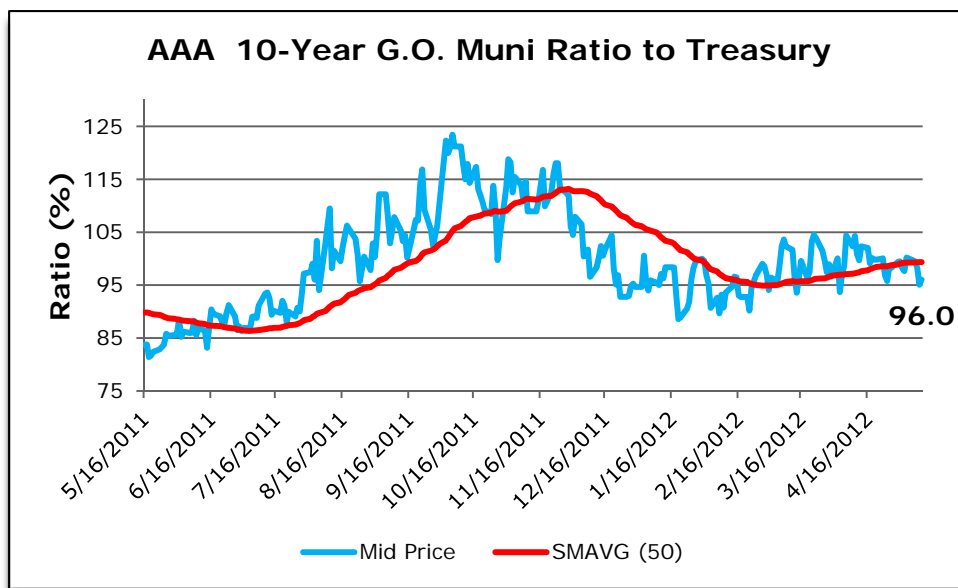
**Muni Ratio (Figure 2)**

The AAA-rated general obligation index outperformed the 10-year Treasury market last week, resulting in a drop in the ratio to 96.0 from 100.4 registered at the end of the previous week. This was the largest weekly change since early April. The average daily ratio for the year is 97.3; so, we finished slightly richer for the week. It was also the tightest weekly close since mid-February. It is also the tightest weekly close to the 50-day moving average since the same period in mid-February.

**Bond Buyer Indexes (Table 1 and Figure 3) – Week of 5/3/12 – 5/10/12**

The Bond Buyer's 20-Bond G.O. Index of 20-year general obligation bond's yields declined by 10 bps for the week to 3.71%. This is the lowest level since Feb. 23<sup>rd</sup> and is 37 bps lower than thirty days ago. The Revenue Index, which measures 30-year revenue bond yields fell 4 bps to 4.73%. This is the lowest since March 1<sup>st</sup> and is 15 bps lower than it was thirty days ago.

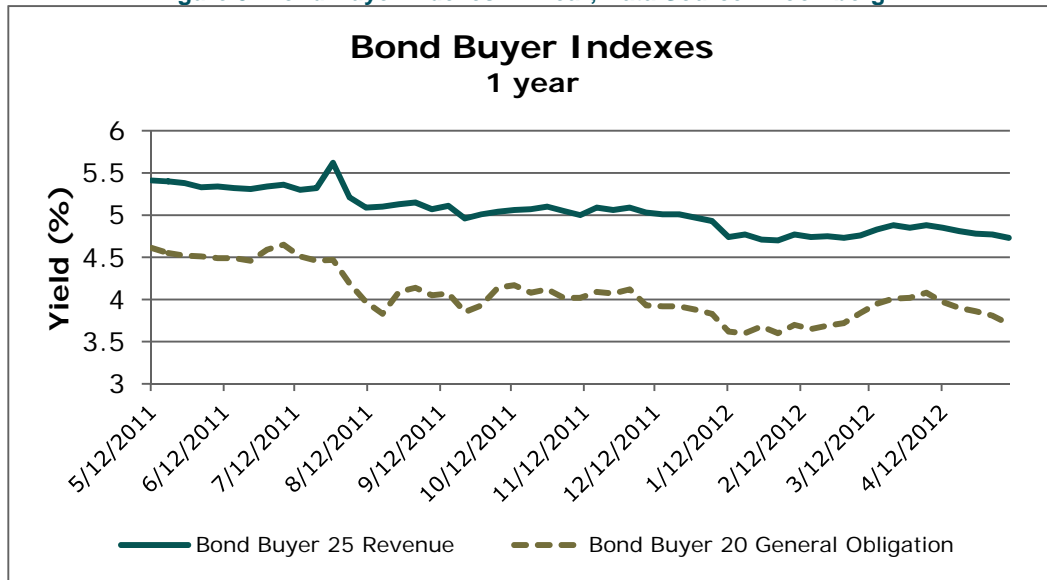
**Figure 2 - Muni Ratio – Data Source: Bloomberg**



**Table 1 - Bond Buyer Indexes – Source: Bloomberg**

<u>Index</u>	<u>Yield %</u>	<u>Yield Last Week</u>	<u>1 Week Change (bps)</u>	<u>Yield 1 Month Ago</u>	<u>1 Month Change (bps)</u>
Bond Buyer 20 Gen'l Obligation Index	3.71	3.81	-10.0	4.08	-37.0
Bond Buyer 11 Gen'l Obligation Index	3.49	3.59	-10.0	3.86	-37.0
Bond Buyer 25 Revenue Index	4.73	4.77	-4.0	4.88	-15.0

Figure 3- Bond Buyer Indexes - 1 Year; Data Source: Bloomberg



**What Are Market Participants Talking/Writing About?**

**Market Color**

*Monday (4/30/12)* – The municipal market started the morning very active as people were digesting the elections in France and Greece. After a brisk morning, the municipal market settled down according to traders. Yields inside five years were unchanged while yields outside of six years fell between 1-2 bps on the day.

*Tuesday (5/1/12)* – Munis benefitted from several factors including fears continuing from Euro-related problems and a demand/supply imbalance. Demand was very strong on Tuesday. One trader said that it was a dogfight to buy if the right bond and yield came along. Several deals were priced stronger from premarketing levels. Yields inside two years were steady while three-year paper fell 1 bps. Yields in the four- to six-year maturity range dropped 2 bps and outside seven years yields plunged 4 bps.

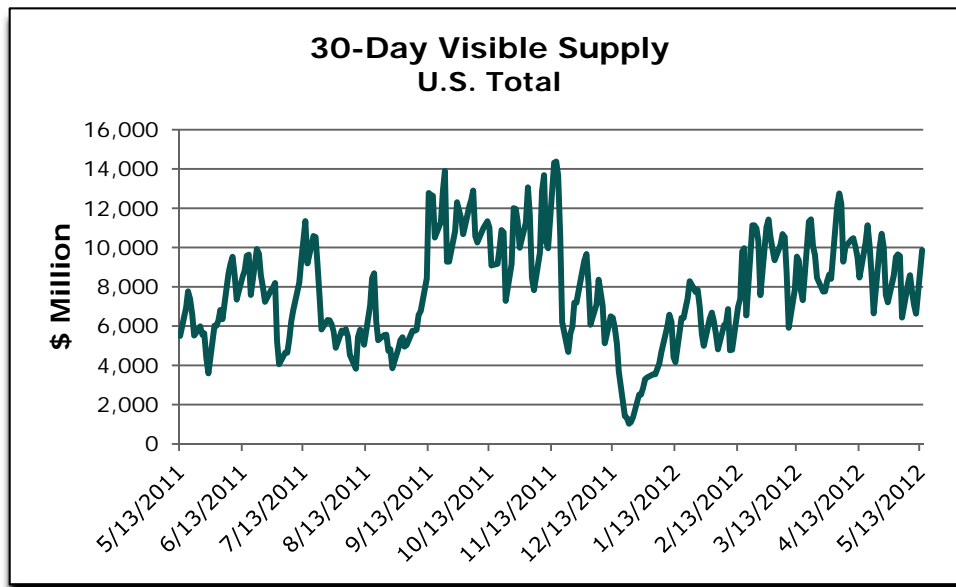
*Wednesday (5/2/12)* – Once again, tax-exempt bonds had a strong day – the seventh consecutive day of declining yields. In fact, for the third straight day, 30-year bonds set a new record. Yields inside four years fell by 1 bps and by 2 bps outside of five years.

*Thursday (5/3/12)* – Municipal bonds finally paused on Thursday following Treasury yields slightly higher. The muni yield curve steepened on Thursday with short-end yields falling and longer maturities rising. Inside of two years yields were steady while three- to four-year yields fell as much as 2 bps and outside of five years they rose by 1-2 bps.

*Friday (5/4/12)* – Despite news of JPM Morgan’s loss, munis took a rest on Friday with little change.

*Supply (Figure 4)* – Bloomberg 30-Day visible Supply increased this week to \$9.871 billion - the highest daily measure since April 25<sup>th</sup>. For the week of May 14<sup>th</sup>, the market is expecting to see approximately \$7.8 billion of new issuance.

Figure 4 - Bloomberg 30-Day Visible Supply



#### Articles of Interest

*Money Pours into Muni Mutual Funds* – Municipal bond mutual funds saw huge net inflows during the week ending May 9<sup>th</sup>. Lipper FMI reported net inflows of \$901 million, nearly doubling the amount observed the previous week. Funds have now seen positive inflows for 33 out of the past 36 weeks. High-yield muni funds also saw strong inflows of \$258 million, the 21<sup>st</sup> week out the past 22 weeks.

*Puerto Rico Commonwealth Pension Gap and Credit Metrics Weak but Bonds Have Been Loved Nonetheless*– Puerto Rico Commonwealth has a credit rating of Baa1 by Moody's (with a Negative Outlook), BBB by Standard and Poor's and BBB+ Fitch. Puerto Rico has the weakest public pension funding status of all state-level general obligors at 9% compared a U.S.-wide state funding status of 75%. Just a few more credit metrics (Moody's) to put Puerto Rico's credit quality in perspective; Puerto Rico has a debt service ratio i.e. degree of financial flexibility, that ranks worse than any state in the union (16.9% vs. the median of 4.9%), the highest net tax-supported debt per capita of \$10,474 (the U.S. state median is \$1,066 and the next highest is CT at \$5,236) and a net tax-supported debt as a % of personal income of 71% (the US. state median is 2.8% with the next highest being Hawaii at 10.1%). Due to high unemployment (15%), and chronic budget deficits and large government relative to the size of the economy and an economy that has been in recession since 2006, Puerto Rico clearly has worse credit quality than any state in the union. Nonetheless, this has not dimmed the demand for the commonwealth's bonds. Investors, hungry for yield and triple tax-exemption have bid up the island's securities. In fact, Puerto Rico municipal bonds earned 15.6% in the past year, beating all states according to Barclay's data. As of last Thursday and according to Bloomberg data, 10-year Puerto Rico debt yields 3.83% about 190 bps above AAA GOs (narrower than the 233 bps at year-end). Moody's cites Puerto Rico's strengths as strong management and dedication to fiscal reform, its political link to the U.S., its large economic size relative to many states (10<sup>th</sup> largest) and broad legal powers to raise revenues and ability to adjust spending. Given that it is a very widely-held jurisdiction it may present more systemic risk than most state jurisdictions.

*Assured Guaranty Article in WSJ/Bloomberg* – In late March, Moody's warned that it may cut Assured Guaranty's credit rating to the "A" range from the current Aa3 rating (S&P gives them an AA- rating with Stable Outlook). Given Moody's record of making a final rating decision within three months of first notice, we should know by the end of June. Assured has mounted its rebuttal through a lengthy evidence piece. A majority of bonds rated by Assured are rated A or higher. The concern is that municipalities typically buy credit enhancement from insurers rated higher than their own underlying rating – and if they were downgraded, lost business would ensue thus perpetuating a declining credit profile. The municipal bond insurance industry has essentially eviscerated since 2008 –

before 2008 approximately 50% (up to 60%) of new municipal bond issuance carried bond insurance but now only 5% does. Trading indicators (equity prices and credit spreads) paint an unfavorable outcome for Assured. However, *Credit Sights*, an independent credit analysis firm, is going to bat for Assured saying that the credit fundamentals do not warrant a downgrade especially given that Assured's credit metrics have actually improved since 2007 – they describe Assured's balance sheet as a “fortress”.

*State of Pension Funding of State and Local Pensions* – The Center for Retirement Research of Boston College has published a report on the state of the nation's state and local pension plans. The average funded status (ratio of assets to liabilities) of the pension plans in the study ended 2011 at 75%. However, the liabilities were discounted at 8%, which is not reflective of current low interest rate environment. When they normalize the liabilities across time, it shows that the current funded status is closer to 50% at the end of 2011, down significantly from 68% in 2011. The things that have benefitted pension plans are a strong recovery in the stock market since 2008, a rebound in tax revenues, higher employee contributions and reductions in benefits (through layoffs, pay freezes and suspended inflation adjustments). Given, much of the improvements in benefit costs have been one-time reductions, the liability will not be aided as much in the future through these cost controls. The Center does some forecasting of the future funded status showing that if the stock market increases at about its “historical rate” (8%), the funded status could recover to 82% overall by 2015.

### Where Are Relative Values?

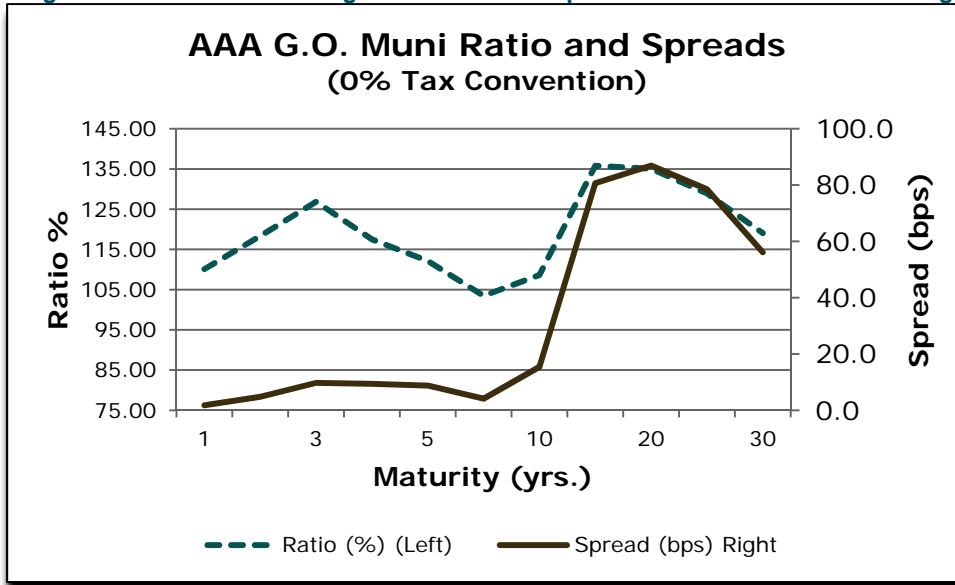
In this section you will find numerous graphs and tables showing relative value viewed in a variety of ways.

#### Relative Value by Maturity

Table 2 - AAA Muni Ratios and Spreads by Maturity - Data Source: Bloomberg

.5/14/2012	Yield-to-Maturity (%)		0% Tax Rate		35% Tax Equivalent	
Maturity (yrs.)	AAA Gen. Oblig.	Treasury	Spread (bps)	Ratio (%)	Spread (bps)	Ratio (%)
1	0.19	0.17	1.7	110.1	12.0	169.4
2	0.31	0.26	4.8	118.3	21.5	182.0
3	0.46	0.36	9.7	126.8	34.5	195.1
4	0.63	0.54	9.4	117.5	43.3	180.7
5	0.81	0.72	8.8	112.1	52.4	172.5
7	1.23	1.19	4.1	103.4	70.3	159.2
10	1.94	1.79	15.4	108.6	119.9	167.1
15	3.06	2.25	80.7	135.8	245.5	208.9
20	3.35	2.48	86.9	135.0	267.3	207.8
25	3.50	2.71	78.5	128.9	267.0	198.3
30	3.51	2.95	56.1	119.0	245.1	183.1

Figure 5 – AAA General Obligation Ratios and Spreads – Data Source: Bloomberg



**Relative Value by Rating**

Figure 6 – Muni Index Yield Curve by Credit Rating – Data Source: Bloomberg

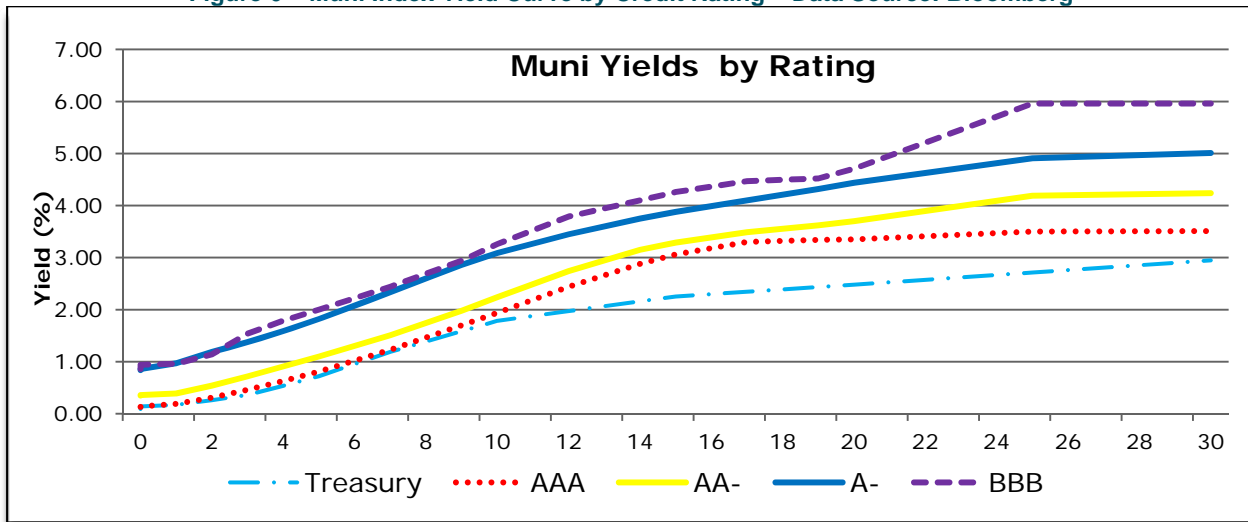


Figure 7 – Muni Index Ratios by Maturity and by Credit Rating – Data Source: Bloomberg

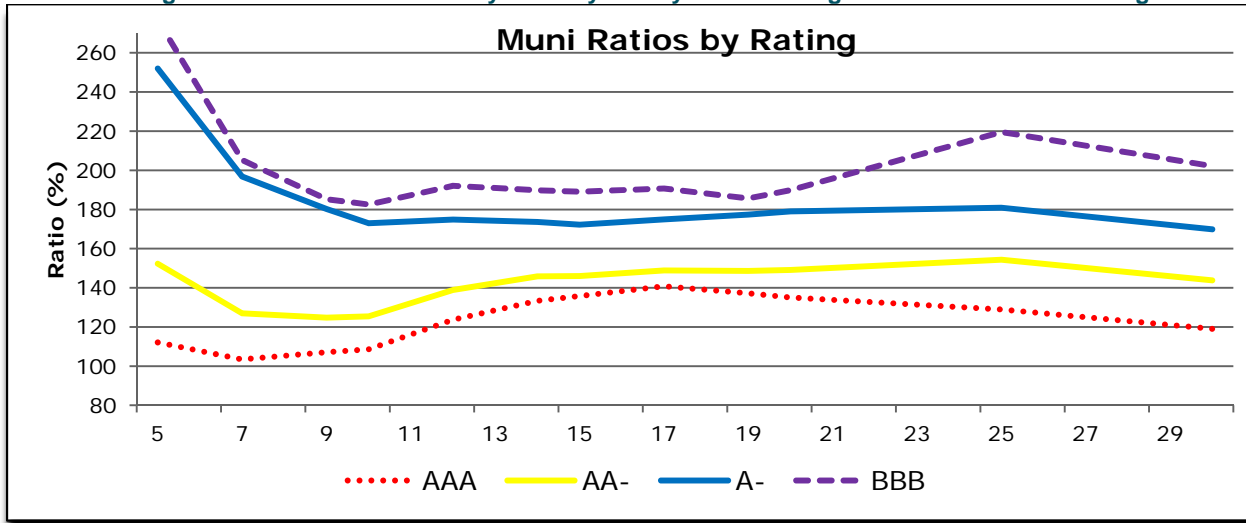
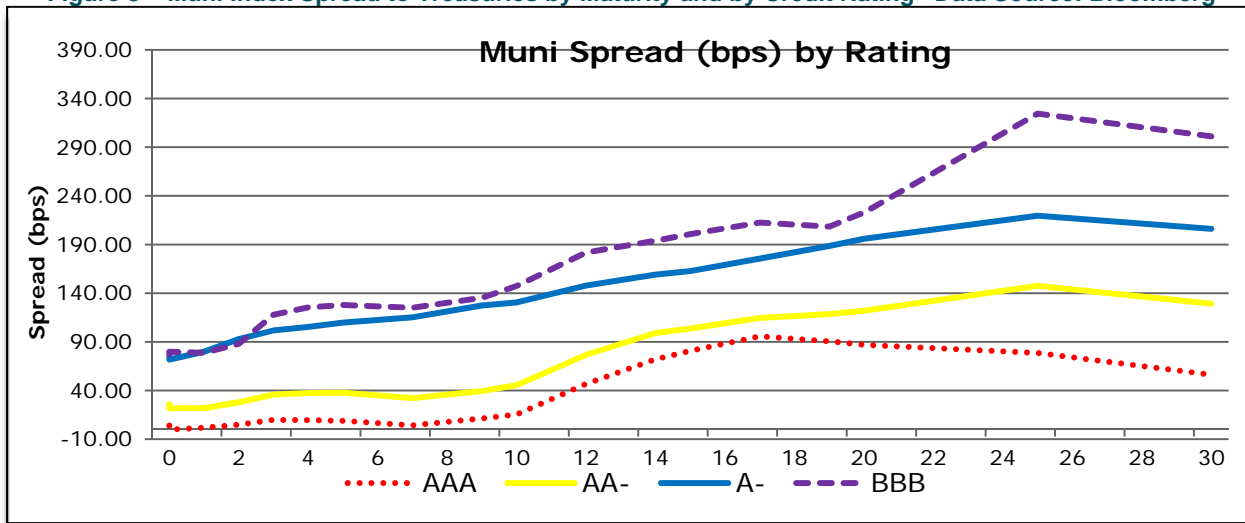


Figure 8 – Muni Index Spread to Treasuries by Maturity and by Credit Rating – Data Source: Bloomberg



**Relative Value by State General Obligation****Table 3 – State G.O. Yields, Spreads, Ratios, Changes and Credit Ratings – Data Source: Bloomberg**

5/14/2012	10-year Yield (%)	Spread (bps)	Ratio (%)	Spread to AAA	Yield 1 Week Ago	1 Week Change (bps)	Yield 1 Month Ago	1 Month Change (bps)	Moody's	S&P
<b>Treasury</b>	1.79									
<b>AAA GO</b>	1.94	15.4	108.6	0	2.000	-6.0	2.140	-20.0		
<b>CA</b>	2.80	101.4	156.8	86	2.950	-15.0	3.160	-36.0	A1	A-
<b>CT</b>	2.22	43.4	124.3	28	2.300	-8.0	2.390	-17.0	Aa3	AA
<b>FL</b>	2.51	72.4	140.5	57	2.620	-11.0	2.710	-20.0	Aa1	AAA
<b>GA</b>	2.00	21.4	112.0	6	2.050	-5.0	2.180	-18.0	Aaa	AAA
<b>IL</b>	3.66	187.4	204.9	172	3.720	-6.0	3.750	-9.0	A2	A+
<b>MD</b>	2.16	37.4	120.9	22	2.220	-6.0	2.340	-18.0	Aaa	AAA
<b>MA</b>	2.23	44.4	124.9	29	2.320	-9.0	2.330	-10.0	Aa1	AA+
<b>MI</b>	2.73	94.4	152.9	79	2.810	-8.0	2.910	-18.0	Aa2	AA-
<b>MN</b>	2.04	25.4	114.2	10	2.130	-9.0	2.250	-21.0	Aa1	AA+
<b>NJ</b>	2.40	61.4	134.4	46	2.480	-8.0	2.590	-19.0	Aa3	AA-
<b>NYC</b>	2.68	89.4	150.1	74	2.770	-9.0	2.910	-23.0		
<b>NY</b>	2.44	65.4	136.6	50	2.520	-8.0	2.540	-10.0	Aa2	AA
<b>NC</b>	1.90	11.4	106.4	-4	1.950	-5.0	2.200	-30.0	Aaa	AAA
<b>OH</b>	2.31	52.4	129.3	37	2.380	-7.0	2.490	-18.0	Aa1	AA+
<b>PA</b>	2.41	62.4	134.9	47	2.490	-8.0	2.610	-20.0	Aa1	AA
<b>PR Rev</b>	3.80	201.4	212.8	186	3.870	-7.0	3.880	-8.0		
<b>SC</b>	1.93	14.4	108.1	-1	2.020	-9.0	2.240	-31.0	Aaa	AA+
<b>TX</b>	2.42	63.4	135.5	48	2.500	-8.0	2.600	-18.0	Aaa	AA+
<b>VA</b>	1.98	19.4	110.9	4	2.060	-8.0	2.220	-24.0	Aaa	AAA
<b>WA</b>	2.18	39.4	122.1	24	2.290	-11.0	2.370	-19.0	Aa1	AA+
<b>WI</b>	2.30	51.4	128.8	36	2.370	-7.0	2.460	-16.0	Aa2	AA

For more information please contact your Financial Advisor.

## Appendix – Important Disclosures

Municipal bonds may be used to fund expenditures such as the construction of highways, bridges or schools. Municipal bonds are generally exempt from federal taxes and from most state and local taxes, especially if the investor lives in the state in which the bond is issued. For this reason, municipal bonds are popular with people in high income tax brackets.

Some of the potential risks associated with municipal bonds include call risk, reinvestment risk, default risk and inflation risk. Additionally, it is important that an investor is familiar with the inverse relationship between a bond's price and its yield. Bond prices will fall as interest rates rise and vice versa.

When considering a potential investment, investors should compare the credit qualities of available bond issues before they invest. The two most recognized rating agencies that assign credit ratings to bond issuers are Moody's Investors Service ("Moody's") and Standard & Poor's Corporation ("S&P"). Moody's lowest investment-grade rating for a bond is Baa3 and S&P's lowest investment-grade rating for a bond is BBB-.

A general obligation bond is a municipal bond backed by the credit and "taxing power" of the issuing jurisdiction, whereas a revenue bond is typically solely reliant on revenue from a given project.

The Bond Buyer 20-Bond Index consists of 20 general obligation bonds that mature in 20 years. The average rating of the 20 bonds is roughly equivalent to Moody's Investors Service's Aa2 rating and Standard & Poor's Corp.'s AA. The Bond Buyer 11-Bond Index uses a select group of 11 bonds in the 20-Bond Index. The average rating of the 11 bonds is roughly equivalent to Moody's Aa1 and S&P's AA-plus. The Bond Buyer Revenue Bond Index consists of 25 various revenue bonds that mature in 30 years. The average rating is roughly equivalent to Moody's A1 and S&P's A-plus. The indexes represent theoretical yields rather than actual price or yield quotations. Municipal bond traders are asked to estimate what a current-coupon bond for each issuer in the indexes would yield if the bond was sold at par value. The indexes are simple averages of the average estimated yields of the bonds, are unmanaged and a direct investment cannot be made in them.

This is not a complete analysis of every material fact regarding any sector, municipality or security. The opinions expressed here reflect our judgment at this date and are subject to change. The information has been obtained from sources we consider to be reliable, but we cannot guarantee the accuracy. Municipal securities investments are not appropriate for all investors, especially those taxed at lower rates. The alternative minimum tax (AMT) may be applicable, even for securities identified as tax-exempt. It is strongly recommended that an investor discuss with their financial professional all materially important information such as risks, ratings and tax implications prior to making an investment. Past performance is not a guarantee of future results.

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