

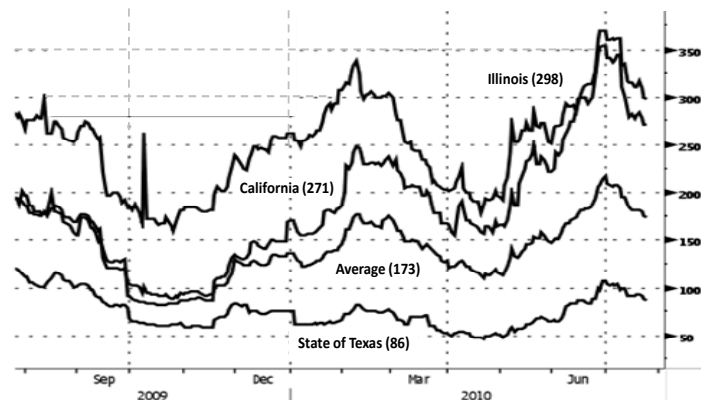
Municipal Bond Market Update

Credit concerns about large budget gaps and unfunded pension obligations at the state and local levels caused municipal bonds to lag the powerful rally in Treasuries during the second quarter. The municipal bond market is becoming increasingly more bifurcated between the “haves” and the “have nots.” Municipalities that have managed their finances well have the flexibility to refinance existing debt and/or fund their budget gaps at historically low interest rates. In contrast, those municipalities with stressed finances are finding it increasingly difficult and expensive to issue new debt. In the more extreme cases, some municipalities are teetering on the verge of filing Chapter 9 bankruptcy as they have been effectively shut out of the financial markets. While states themselves cannot file for bankruptcy, many permit their municipalities to do so. Historically, however, defaults on general obligation (G.O.) bonds have been rare.

Risk Premiums – Declining But Still Elevated

Credit default swap spreads (CDS) on municipal debt backed up significantly during the second quarter, as did those of all credit-sensitive sectors of the market. Increased concerns about a double-dip recession caused a general “flight to quality,” which benefitted US Treasuries at the expense of almost all “riskier” assets. More recently, however, declining municipal CDS spreads are signaling that risk aversion has subsided somewhat. Some of the more troubled states, such as California and Illinois, have seen their CDS spreads drop sharply, although they remain at elevated levels compared to the average and those of “safer” states such as Texas. We believe that investors in the municipal market should concentrate on high quality general obligation issues and essential purpose revenue bonds to mitigate volatility.

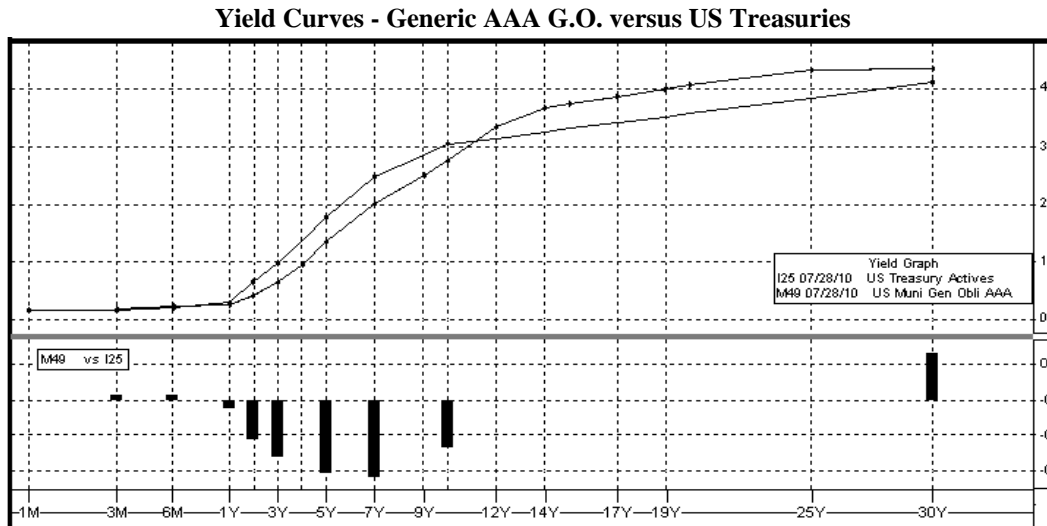
Five-Year Municipal Credit Default Swaps



Source: Bloomberg

Yield Curve – Remains Steep

The municipal yield curve remains very steep, with the yield difference between 2- and 30-year bonds currently around 355 basis points (“bps” = 1/100th of 1%), slightly higher than the start of the year when it stood at 351 bps. However, the yield curve between 2- and 10 years (215 bps) has flattened about 24 bps. On a relative value basis, the 2-10 year part of the municipal curve is less attractive than the 10-30 year part of the curve; yielding about 68% to 85% of Treasuries versus 85% to 100%. The chart below highlights this general relationship – showing generic AAA G.O. yields versus Treasuries. In general, shorter term municipal bonds yield less than Treasuries (as expected) while longer maturity municipal bonds yield as much or more than Treasuries. Municipal bonds generally yield significantly less than comparable Treasuries because of their significant tax advantages. While the long end of the municipal curve remains the “cheapest,” we would be cautious about extending maturities with yields at historically low levels. Even a modest 1% back-up in interest rates could cause a double-digit price decline in the market value of a longer maturity bond.



Source: Bloomberg

Summary

- Declining tax receipts are putting further pressure on municipalities due to high unemployment and declining home prices. Therefore, we favor higher quality municipalities that have a more steady tax base and lower unemployment.
- The long end of the municipal yield curve remains the most attractive, in our view. However, interest rates are at historically low levels and a relatively small 1% increase in yields could lead to double-digit declines in the market prices of longer maturity bonds. Unless the investor is willing and able to take on long duration risk, we believe that it is better to concentrate purchases in the 5-7 year part of the curve. We believe that investors will have a better opportunity to lock-in higher yields going forward. We believe that investors can buy cushion paper (premium bonds) to help combat rising interest rates incorporated with bond ladders in order to not miss investment opportunities down the road.
- Since absolute yields are at historically low levels, many investors may avoid investing in municipals. However, when compared to fully taxable investments, we think they still make sense for investors in higher tax brackets.

Tim Anderson, Chief Fixed Income Officer • 804-549-4806 • tanderson@riverfrontig.com
Kevin Nicholson, Senior Fixed Income Portfolio Manager • 804-836-1501 • knicholson@riverfrontig.com
RiverFront Investment Group, 9011 Arboretum Parkway, Suite 110, Richmond, VA 23236
www.riverfrontig.com

Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances.