Municipal Bonds

January Municipal Update

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- The municipal bond market continues to experience selling pressure. Adverse headlines have played a role. We discuss both matters in the market commentary and headline risk sections of this report.
- State budget season has kicked off with many governors having recently delivered their State of the State Addresses and state legislatures convening for the FY12 season. We discuss the latest developments in California, Illinois, Texas and New Jersey.
- At the local government level, we turn to Nassau County, New York and the possibility of it falling under the oversight of the Nassau County Interim Finance Authority (again).
- Lastly, we offer some commentary on the challenges being experienced by the American Folk Art Museum in New York City and recent developments for MBIA and its public finance subsidiary, National Public Finance Guarantee.

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The U.S. Municipal Bond Market: In the Spotlight

For many years, municipal bonds were considered the sleepy backwater of fixed income. Much has changed. The financial crisis of 2007-08 triggered greater interest in the financial performance of state and local governments. The subsequent introduction of Build America Bonds (BABs) captured the attention of global investors by introducing a new type of taxable fixed income investment. Media coverage of the municipal bond market has increased dramatically and, with it, the risk that blaring newspaper headlines will overwhelm more prosaic facts and figures.

This report has been prepared by UBS Financial Services Inc. (UBS FS). Please see important disclaimers and disclosures that begin on page 29.

Since our last monthly update, the U.S. Congress decided to allow the BABs program to expire. The extension of the Bush-era tax cuts reduced the utility value of municipal bonds as a tax shelter, at least for the time being. Individual investor withdrawals from municipal bond funds, often redirected into the equity markets, triggered further liquidation of assets. According to Lipper FMI, municipal bond funds reported net cash outflows for ten consecutive weeks as of the week ending 19 January 2011. With roughly USD 25bn withdrawn from the funds over this period, there was insufficient investor support for long-term bonds with yields below 5% and pressure on muni bond prices increased. Declining muni bond values have also resulted in a sell-off in muni closed end funds. For a list of funds covered by WMR, please see the Closed End Fund universe report.

Since mid-December through Thursday, January 20, yields climbed 28bps, 28bps and 29bps at the 5-, 10- and 30-year maturity points sending yields to 1.90%, 3.42% and 4.95%, respectively, using the AAA Municipal Market Data curve as a benchmark. During this time, yields on long-dated munis have been volatile and at points rose to levels last attained in the first quarter of 2009, right before the launch of the taxable Build America Bonds program. BABs siphoned a significant amount of market share from the traditional tax-exempt market from April 2009 through December 2010 and lent significant price support to the long end of the curve. (See Fig.1.)

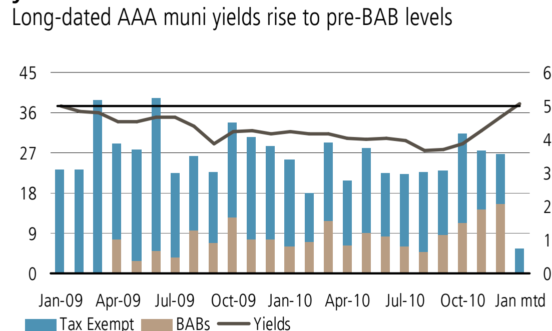
At the same time, munis significantly underperformed Treasuries, with ratios rising above 100% along most of the yield curve. Weak absolute and relative performance is particularly troubling given the low volume of new issuance so far in 2011. For example, monthly tax-exempt issuance is running at about 45% below the volume posted at this time last year, according to data compiled by *The Bond Buyer*.

During the most recent sell-off, yields on pre-refunded municipal securities (munis backed by Treasury securities) surged to almost match levels on Treasuries with comparable maturities. This scenario suggests that factors other than weak credit fundamentals are at work. (See Fig. 2). Before 2008, "pre-re" yields in the 5 year maturity spot averaged about 80% of Treasury yields. Today, the ratio is close to 100%. While still well shy of the 150% - 200% ratios seen during the financial crisis, pre-re yields are still quite attractive from a longer-term historical perspective.

As we expected and forecast in prior reports, the volatility of the long-end of the municipal curve has increased. The slope of the curve has continued to rise, with the difference

Fig. 1: New issue supply and 30-year AAA muni yields

Long-dated AAA muni yields rise to pre-BAB levels



Note: Over the timeframe shown, a small portion of taxable muni issuance was in non-BAB form.

Source: Thomson Reuters, MMD interactive, UBS WMR as of 14 January 2011

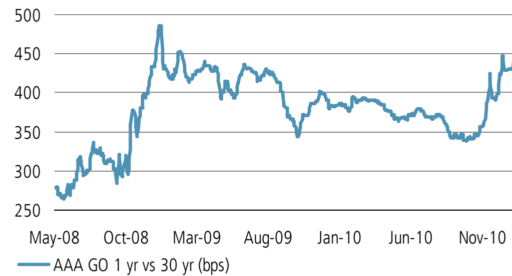
Fig. 2: Pre-refunded muni vs. Treasury ratio (%)

2 January 2007 – 18 January 2011

Source: MMD interactive, UBS WMR

in yield between one-year and 30-year AAA munis standing at 458bps as of 20 January, up 17bps from 441bps since January 3 and just 28bps away from the steepest slope reached during the height of the financial crisis at the end of 2008. (See Fig. 3). We attribute the steepening of the curve to the liquidation of assets by long-term mutual funds. Upon the expiration of the BABs program, only two natural buyers of long-term municipal bonds were left standing: mutual funds and insurance companies. When one of those two buyers becomes a forced net seller of assets, yields can rise abruptly. The mutual funds have been forced sellers as individual investors redeemed their shares, often redirecting the proceeds into the equity markets.

Fig. 3: AAA 1 yr vs. 30 yr slope analysis (bps)
1 May 2008 – 18 January 2011



Source: MMD interactive, UBS WMR

Opportunities now Present

The municipal bond market showed some signs of stabilizing earlier this week as the yield on the AAA 30-year high grade scale breached the psychologically important 5% level. On a yield ratio basis, AAA muni-to-Treasury relationships reached levels sufficiently high to begin attracting buyers back in to the market. With ratios hitting as high as 104% and 113% at the 10-year and 30-year spots on a pre-tax basis, municipals are exhibiting good relative value to other asset classes in certain maturity brackets (See Table 1). As we go to press, Thomson Reuters reports selective buying of longer-term high grade bonds by non-traditional investors enticed by the higher rates of investment on offer.

Table 1: US Fixed Income Yields (%)

Maturity	Tsy	IG Corp A	HY Corp BB	Muni AAA	Muni TEY 35%
5 year	2.06	3.27	5.22	1.89	2.93
10 year	3.46	5.00	6.84	3.42	5.53
30 year	4.62	6.12	7.83	4.95	7.88

Note: Municipal AAA curve reflects the taxable equivalent yield (TEY) based on the 35% federal tax bracket.
Source: Bloomberg, Municipal Market Data, UBS WMR as of 20 January 2011.

We think yields can still move marginally higher from current levels as supply increases and state and local governments return to the market after a very slow January. We are not inclined to call a bottom just yet because of the uncertainty regarding how well the tax-exempt market will absorb the higher volume of tax-exempt supply forecast for February and March. The 30-day Visible Supply currently stands at USD 9.4bn, up from USD 7.4bn at year end according to data compiled by *The Bond Buyer*. That compares to an average of roughly USD 11bn over the past five years. The acid test will come in February/March as the pace of new bond sales increases. If the market readily absorbs the new supply without materially increasing the 30-year M/T ratio beyond 115%, we expect to see diminished volatility and a great deal less market anxiety.

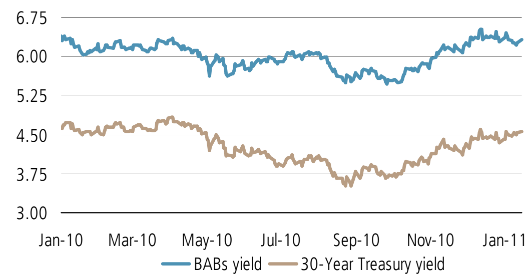
For opportunistic investors with a well developed tolerance for volatility, there are certainly good income opportunities in the current market with many high-grade long-dated municipal securities yielding 5.00% and higher. Yields in excess of 5% typically trigger a re-evaluation of risk by tax-exempt investors and a higher appetite to absorb the inevitable interest rate fluctuations in the market. As long

as one acknowledges the market volatility and potential for rates to back up a little further on heavier volume, the current yields are quite attractive from a historical perspective.

As a more general rule, and particularly for investors sensitive to valuation changes in their portfolios, we prefer the front part of the curve over longer-dated securities and have reined in our favored maturity area to the 5- to 10-year range (previously 7- to 12 years). (See WMR's US Fixed Income Strategist, 12 January 2011). Prospects for higher volatility on the long end of the curve, and rising interest rates are among the main reasons for the shift. Equally important, we see limited value in the earliest tax exempt maturities ranging from 1 to 4 years and think better opportunities may be found in the taxable fixed income markets for this segment of the yield curve.

BABs spreads improve post program expiration
In our December Market Update report, published 16 December 2010, we considered the potential impact of the expiration of the Build America Bonds program. We hypothesized that outstanding taxable BABs would likely remain an alternative to corporate securities, even in an environment without newly issued BABs. This scarcity value argument was supported during the first few weeks of the new year, as evidenced by the tightening spread between BABs and 30 year Treasury yields. Since the expiration of the program, credit spreads have contracted by roughly 20 bps as shown in Fig. 4.)

Fig. 4: Average Yield of BABs Index vs. 30 yr Tsy (bps)
4 January 2010 – 18 January 2011



Source: Bloomberg, UBS WMR

Headline Risk and Reality

We cannot refrain from taking this opportunity to comment on the sometimes well intentioned but often misguided media coverage of the challenges facing the municipal bond market.

The New York Times published an article as we went to press this morning regarding discussions among certain members of Congress to amend the Bankruptcy Code to permit states to seek bankruptcy protection. Unlike local governments, the federal bankruptcy code does not permit state governments to file for bankruptcy protection. The article described the financial stress on state budgets and the burden imposed by unfunded pension liabilities. The newspaper reported that no legislation has been introduced in either chamber of Congress, nor has a sponsor of such a bill been identified.

We are cognizant of the uncertainty that this article has

introduced and the anxiety it may create among investors. The UBS US Public Policy Office has provided us with an assessment of the likelihood of passage and the outlook for related legislation. Please see the accompanying text box.

The recent recession has placed a significant amount of strain on state and local governments throughout the country. General fund revenues have often been reduced, sometimes severely so, while unfunded pension liabilities and deferred infrastructure investment must be addressed promptly. And yet, debt service usually does not represent a significant burden on most general purpose governments and essential utility systems. Annual revenue, by and large, is sufficient to pay principal and interest on the amortizing debt without the liquidity crises that can accompany a debt structure reliant on bullet maturities. As the economy recovers, we expect the recent scrutiny of the municipal market to have one lasting positive effect: a political consensus will emerge to address those two most important and pressing issues of the day - pensions and infrastructure. Michigan, Alaska, and Utah already have adopted defined contribution plans for their pensions on a prospective basis. We expect other states to follow in due course.

Contrary to what you may read in the business press or popular media, the municipal market is not likely to be the "next sub-prime" crisis. Unlike collateralized debt obligations of asset backed securities, whose credit quality was dependent upon the cash flow generated by poorly constructed mortgages offered to unqualified buyers, state and local governments have a broad array of resources available to repay their obligations. By design, structured finance transactions were passively reliant on the cash flow models created at the time these instruments were marketed. Conventional municipal bonds, on the other hand, are issued by public agencies that normally are capable of raising the revenue necessary to meet debt service obligations.

Is it possible that a high profile municipal bond issuer will default on its obligations? Yes, it is. Is it likely to become a systemic problem throughout the country? No, it is not. The vast majority of defaults in the municipal bond market in the 2009-2010 timeframe occurred among borrowers who were unrated when the bonds were originally issued. These were not bonds issued by well known public agencies serving a substantial population and providing an essential or exclusive service. More often than not, they were bonds for speculative projects reliant on economic growth that failed to materialize.

For months, we have emphasized that defaults within

Beltway Perspective

Legislation to permit states to file for bankruptcy, as municipalities can, has been a topic of discussion in Washington, particularly among Republicans, for the past few months. The debate has recently drawn increased media attention. The interest in avoiding a federal bailout of debt-laden states is very real in Congress and legislation to allow state bankruptcy is just one option under consideration. Separate legislation requiring state and municipal pension obligations to be accurately disclosed to the federal government is also being considered. Under this potential legislation, a failure to accurately account for pension costs could result in a loss of federal tax exempt status of that state or municipality's bonds. One or both of these efforts could potentially gain traction in the Republican-controlled House of Representatives. Passage in the Democratic-controlled Senate would be a much tougher hurdle to clear, particularly as union opposition to the measure would be significant. The UBS U.S. Office of Public Policy does not believe that a state bankruptcy bill is likely to become law, nor do we think that state or local bonds will lose their current federal tax exemptions.

The UBS US Office of Public Policy provided insight on the political situation in Washington, D.C. for this report.

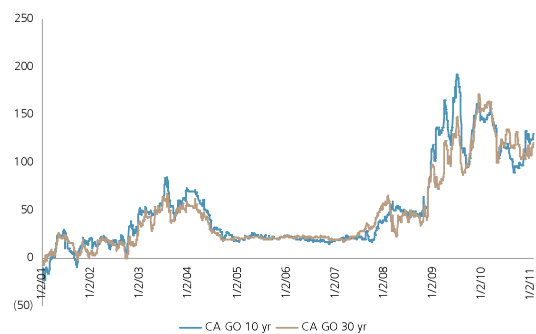
certain higher-risk sectors of the market would likely increase. The not-for-profit health care sector, particularly smaller hospitals in rural communities, will likely be under considerable strain in the next few years. Continuing care retirement communities (CCRCs) are likely to be particularly challenged. Bonds secured by taxes and fees associated with new real estate development have defaulted with higher frequency and will continue to do so. Project finance deals, often reliant on economic expansion to justify the "build it and they will come" feasibility studies, are equally at risk of default.

In this era of relative illiquidity in the municipal market, investors are well-advised to remain focused on fundamental credit analysis. By choosing highly-regarded borrowers and those who provide essential public services, investors can better insulate themselves from the infrequent muni defaults that will nevertheless occur.

Golden State Budget Battles Begin

After warning audiences in advance to "please sit down when you read the budget", Governor Brown delivered his proposals to the California Legislature on January 10. As advertised, the proposed budget offers readers an unforgiving, but realistic, assessment of the severity of the state's structural deficit. The legislature's perennial preference for short-term solutions based on faulty economic assumptions and ill-conceived legal theories is cited as a contributing factor in the magnitude of the current deficit. As the budget proposal makes all too clear, the state has few options left; the necessity for fundamental reform in the delivery of public services is essential.

Fig. 5: 10y and 30y CA GO vs. general market
Spread (in basis points), January 2001-January 2011



Source: Thomson Reuters, MMD interactive, UBS WMR as of 20 January 2011.

While the uncompromising tone of the document may surprise some, we believe the Governor's approach provides bond investors with some reason for optimism. The budget proposal relies upon significant expenditure reductions and the temporary extension of tax increases otherwise scheduled to expire later this year. The willingness of the legislature to place the tax extension on the June special election ballot is not assured due to opposition within the Republican caucus but the expenditure reductions seem a fait accompli at this point.

Those expenditure reductions would be directed primarily towards higher education, social services, and MediCal. Primary and secondary education are held relatively harmless provided voters approve the five-year extension of the 1% sales and use tax and the 0.5% vehicle license fee (VLF). All government budgets, at least to some degree, are

political documents and this proposal is no exception. By holding K-12 education harmless but dependent upon an extension of the sales tax and VLF, the Governor places the influential education lobby in the position of being obliged to support the extension of taxes. If the tax extension is not placed on the ballot, or otherwise not approved by voters, primary and secondary education will be first on the list for further expenditure reductions and payment deferrals.

In an unexpected move, the Governor also has proposed the dissolution of community redevelopment agencies (RDAs). The state's 425 redevelopment agencies would be dissolved and successor agencies created to collect tax increment revenue. The revenue would be used first to retire contractual obligations, including bonded indebtedness. Residual funds then would be redirected to local taxing authorities in proportion to their current share of the existing property tax. This is a bold strategy and one fraught with political difficulty. Regardless of the outcome, tax allocation bondholders should be held harmless; the Governor's proposal makes clear that investors have first claim on pledged revenue in accordance with the relevant trust indentures.

Investors interested in political developments in Sacramento should watch the debate surrounding the placement of the tax extension question on the June special election ballot. The Republican caucus responded relatively favorably to Governor Brown's budget but thus far has declined to support the extension of temporary taxes as a necessary part of the overall plan. Republican support for the special election is critical because tax increases require a two-thirds vote of the legislature.

That said, a debate has already emerged within the capitol as to whether the ballot question can be placed before voters without first receiving approval by a two-thirds majority of legislators. Advocates of a simple majority vote contend that the legislature is empowered to ask voters to approve an extension of taxes that already exist via statutory initiative. We are not in a position to offer an opinion on the legal arguments surrounding this question; we do expect that any such attempt to place a question on the ballot without a legislative super-majority will trigger litigation.

One more note on the Governor's proposed budget seems appropriate at this point. While the budget proposal is far and away the most realistic assessment of the structural deficit in many years, it does not address public pension reform. The absence of any discussion may well have been a concession to practical politics and the need for support among labor groups for the extension of temporary taxes. To the extent that Republican support is necessary for a ballot question in June, and the caucus is willing to let

voters decide, the price for their acquiescence may well be a first attempt at long overdue reforms of public pension benefits for state employees. We'll be following developments and will report back periodically.

Illinois Hikes Taxes

Confronted with an estimated FY12 deficit in the USD 13-15 bn range, the Illinois General Assembly passed a series of tax increases in a lame-duck session of the legislature on 11 January, prior to the new legislature being sworn in the next day. Governor Quinn signed the measure into law on 13 January. The tax package includes an increase in both the personal and corporate income tax rates (see Table 2).

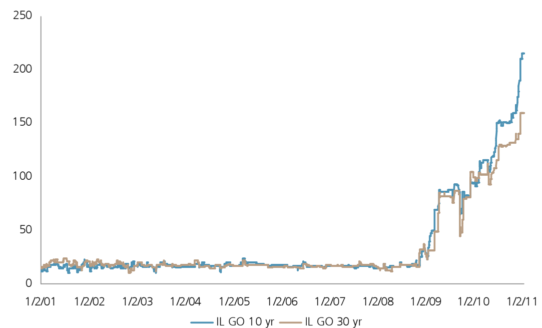
Table 2: Illinois Tax Increases
Corporate and Personal Income Tax (PIT) increases effective 2011

PIT		Corporate	
2010 rate	**3.00%**	2010 rate	**4.80%**
2011-2015	**5.00%**	2011-2015	**7.00%**
2015-2024	**3.75%**	2015-2024	**5.25%**
2025+	**3.25%**	2025+	**4.80%**

Source: Illinois Office of the Governor

To put the size of the current year's estimated budget gap into context, the state's general fund operating budget is roughly USD 33 bn annually. Various reports indicate that the FY12 deficit includes the state's backlog of more than USD 6 bn in unpaid bills to vendors and local governments, and almost USD 4 bn in missed payments to underfunded state pension plans. There may be some overlap in these figures, however, as the Comptroller's January 2011 quarterly report indicates that the USD 6.382 bn backlog in unpaid bills at the end of December includes USD 1.805 bn in unpaid pension obligations. According to the Comptroller's office, state appropriations for pensions retain continuing appropriation rights, meaning that the retirement systems can submit vouchers for payments of their certified contribution amounts regardless of whether or not the appropriations were contained in the enacted budget.

Fig. 6: 10y and 30y IL GO vs. general market
Spread (in basis points), January 2001-January 2011



Source: Thomson Reuters, MMD interactive, UBS WMR as of 20 January 2011.

The tax increases are expected to bring in roughly USD 7 bn of additional revenue. The state also announced that it will satisfy its missed payment to the pension plan by issuing approximately USD 4 bn in taxable GO bonds to fund the required deposit. The Comptroller's report indicated that the USD 1.805 bn in unpaid pension obligations would be paid with proceeds of this bond issue instead of through the use of general revenues. Collectively, the pension bond issue and tax increases provide roughly USD 11 bn of budget solutions.

While the package of tax increases is a positive indication that the state government has become more serious about its persistent operating deficit, we believe that areas of budget risk remain and note that the state still has a long way to go before the budget can be considered structurally balanced. The governor is expected to present his FY12 budget proposal in February, which should provide further

guidance on how he plans to resolve any deficiency. Investors and credit analysts will be watching closely.

Areas of Budgetary Uncertainty

Tax increases involve some risk that actual collections differ from estimates. The state anticipates collecting approximately USD 6 bn from the personal income tax (PIT) increase and roughly USD 1 bn from the increase in the corporate income tax. Tax increases can also have the unintended effects of reducing consumption and limiting job growth, which could ultimately prolong the state's recovery from the recession. Illinois historically has had a below average state and local tax burden, ranking 30th highest in the nation in overall tax burden per capita by the Tax Foundation in its most recent study covering the period through 2008.

It is not clear at this time how Illinois businesses will react to the increase. The higher tax rate could motivate state businesses to relocate. The governors of Indiana, Wisconsin and even New Jersey have criticized the tax hikes and invited Illinois businesses to re-domesticate.

While the prior 4.8% corporate income tax rate was lower than many other states, it is worth noting that corporations in the state are also subject to a 2.5% replacement tax which was not adjusted despite the rate increase. A recent report by the Tax Foundation indicates that when factoring in the replacement tax, Illinois has the third highest overall corporate tax rate among the 50 states, behind only Pennsylvania and Minnesota, from 21st previously.[1] Additionally, Chicago has a highly unionized workforce, which elevates the cost of doing business in that city. (For further commentary on Chicago, please see our December Market Update report, published 16 December 2010).

The tax increase legislation ties higher tax rates to state spending in the next four budget years. If the State Auditor General finds that lawmakers and the governor exceed specific spending levels, the higher income tax rates would revert to original levels. The spending limit, however, has been criticized for lacking teeth. A recent analysis presented by the Civic Federation of Chicago indicates that if spending reached the maximum amount authorized by the act and base revenues did not increase, the state would face an operating shortfall of USD 6.5 bn by FY15 and a cumulative deficit in excess of USD 16 bn over this period. In order to avert this outcome, base revenues would need to grow on average by 5.3% per year over the FY12-15 period, according to the Civic Federation.

On the pension borrowing plan, while it provides a near-term solution for the state's missed payment, it does not

result in any structural improvement to the state's woefully underfunded pension plans. The plans are among the weakest nationally, and the low 50% funded level is likely overstated given that it is based on an 8.5% discount rate across the largest state plans, elevated relative to actual investment earning expectations.

The pension obligation bonds (POBs) are expected to price in mid-February, according to the Governor's Office of Management and Budget, and will have an 8-year final maturity with principal payments of USD 100 mn due in 2014, USD 300 mn in 2015, USD 600 mn in 2016, and USD 900 mn due annually from 2017 through 2019. The back-loaded amortization structure is designed to allow the state to repay the roughly USD 3.5 bn in POBs sold in FY10 to fund that year's payment, before beginning to make larger principal payments on the FY11 borrowing. The FY10 bonds mature over 2011 to 2015.

In our view, issuing long-term debt to fund a current year pension payment is a misguided practice and one that is not sustainable over the long-term. Pension obligation bond borrowing has added significantly to the state's overall debt burden, with the state's two pension bond sales in FY03 and FY10 responsible for nearly 50% of all state GO debt outstanding, excluding the proposed borrowing for this purpose.

Rising Liabilities Bear Monitoring

A larger plan to borrow for operating purposes was not approved in the lame duck session, but borrowing has been used frequently by the state. Illinois sold approximately USD 1.5 bn in tobacco settlement revenue bonds in November 2010 and used the proceeds to address its backlog of unpaid bills left over from FY10. Amortization of the 2010 pension bond issue has already commenced and the state is responsible for the repayment of a July 2010 short-term borrowing sized at USD 1.3 bn during the last quarter of FY11.

While the USD 1.3 short-term borrowing is lower than the prior year's USD 2.25 bn, the debt service due on the FY10 pension bond partially offsets the savings. Meanwhile, the state's underlying problem of deficit spending is unresolved and has contributed to sizeable ongoing negative year-end fund balances under generally accepted accounting principles.

We do not expect the state to regain fiscal stability without demonstrating a greater willingness to enact initiatives that better align spending with future revenues. In order for the state's credit profile to fundamentally improve, we believe it will need to enact structural reforms to improve the

funded level of its pension plans. Given that the tax increases implemented this month are temporary in nature, longer-term solutions will need to be identified in order to stabilize the funded level of the pension plans and arrive at a manageable level of annual pension-related expenditures for the state going forward.

Pressure at the Local Level Persists

Without clarity on how the state intends to address its backlog of unpaid bills (much of which is owed to local governments) and given our expectation for an ongoing constrained environment for state funding to local governments, we continue to express a cautious outlook for local governments in the state. We expect pressure to be highest on those local governments that are most reliant on state support. Vulnerability to state aid payment delays has contributed to the erosion of credit ratings or rating outlooks for a variety of Illinois issuers over the past few fiscal years. As much attention as the media has devoted to the state's fiscal circumstances, we feel that pressure is even more intense at the local level given the ability of states to downstream fiscal woes to local entities. In these instances, an understanding of the local government's financial flexibility independent of the state is an extremely important investment consideration.

While the tax increase package does not provide municipalities with any share of the increase in revenues, it does seek to maintain state shared revenues at current levels by giving municipalities a lower distribution percentage of a higher tax rate. However, if state tax rates fall due to spending in excess of the cap, there is no mechanism to restore local distributions. The Illinois Municipal League has raised concerns regarding the definition of "state spending", which appears broad enough that it may include shared revenue to municipalities. Provisions enabling the governor to reduce the amount of money appropriated by statutory mandates could also be broad enough to include state shared revenues.

Credit Ratings on Review

Following the tax increase and related legislation, S&P and Fitch published reports indicating that they would review the state's credit rating. S&P assigns an A+ rating to the state's GO debt, with the rating on CreditWatch with negative implications. Fitch's rating is A, on negative outlook. As of press time of this report, Moody's had not responded with a new publication, but media reports indicate that it too will be reviewing the legislation. Moody's assigns an A1 rating, on negative outlook, to the state's GO debt. The tax increase is likely to be viewed as a positive step for bondholder security. We will have to wait

and see if it is enough to warrant an outlook revision back to the "stable" category.

The state's short term debt ratings of MIG 2 by Moody's and SP-1 by S&P are a notch below the highest and most common municipal note ratings, reflecting the state's relatively weaker liquidity position, among other considerations. The notes are secured by the state's full faith and credit GO pledge. Like many states, Illinois regularly relies upon short term borrowings to address temporary differences between revenue and spending patterns. It has engaged in such borrowings annually since FY03 (see Table 3 for a history of the state's short-term cash flow borrowing since July 2002). In each year, the note was repaid in the same year of issuance, with the exception of the May 2009 note issuance which was rolled into FY10 with the August 2009 borrowing.

Table 3: Illinois Note Issuances
2002-2010

Date Issued	USD (mn)	Date Issued	USD (mn)
July 2002	**1,000**	September 2007	**1,200**
May 2003	**1,500**	April 2008	**1,200**
June 2004	**850**	December 2008	**1,400**
March 2005	**765**	May 2009	**1,000**
November 2005	**1,000**	August 2009	**1,250**
February 2007	**900**	July 2010	**1,300**

Source: Moody's Investors Service.

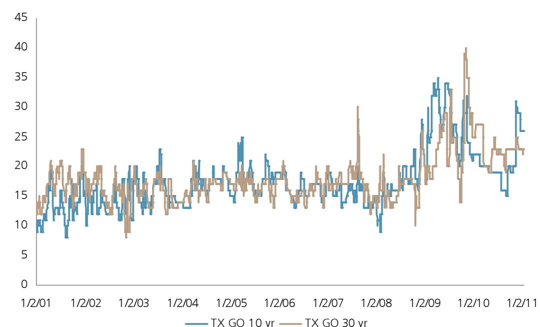
Payments to Bondholders Remain Secure

We continue to expect the state to honor its commitments to bondholders despite the severe fiscal circumstances. We discussed the specific protections afforded to investors of state GO debt that support this view in our municipal report published on 2 August 2010, "Credit Thoughts Amidst Shaken Confidence". Illinois law requires that monthly revenues be allocated first for GO debt service requirements, for example. Further, the state Treasurer and Comptroller are required to make all necessary transfers for the payment of debt service from any and all revenues and funds of the state. We encourage readers to review our August report for further information.

Texas Legislature Reconvenes

Texas Comptroller Susan Combs presented her revenue estimate for the remainder of FY11 and the upcoming 2012-13 biennium on 10 January. The Comptroller is required to provide this data in advance of the biennial legislative session, which begins this week and lasts 140 days. The Texas House of Representatives released its two year budget plan on 18 January and the Senate is expected to present its own spending plan next week.

Fig. 7: 10y and 30y TX GO vs. general market
Spread (in basis points), January 2001-January 2011



Source: Thomson Reuters, MMD interactive, UBS WMR as of 20 January 2011.

The Comptroller's report triggered a flurry of news stories indicating that the state faces a deficit of up to USD 27 bn over the next two years in comparison to an available revenue base of roughly USD 72 bn. The size of the deficit and resulting fiscal implications for the state ran counter to what many investors perceived as Texas' relatively strong financial and economic performance. While we will reserve our comments on the budget proposal for a future issue of

this report to allow for more time to review the details, we will take this opportunity to briefly comment on the size of the deficit at hand and the state's ability to address the gap.

The Comptroller indicates that the state can expect to have USD 72.2 bn available for general purpose spending in 2012-13. The number is derived from anticipated revenue collections of USD 77.3 bn offset by a 2010-11 ending general fund deficit of USD 4.3 bn (due to tax revenues falling below expectations) and an additional USD 866 mn reservation for deposits into the state's economic stabilization (or "rainy day") fund. The 2010-11 general fund budget was predicated on roughly USD 87 bn in general revenue, in contrast.

The estimated USD 27 bn deficit includes the loss of roughly USD 7 bn in federal stimulus funds. Some observers have suggested that USD 12 bn would be needed to maintain current spending levels and to accommodate school enrollment growth, and health care services for a growing population. Others estimate the deficit to be in the USD 15 bn range, including only the expired ARRA funds and lower state revenues.

There is clearly a wide range of opinion among economists and public policy experts when settling on the size of the state's budget gap. When looking at the larger figure, USD 27 bn is roughly 37.5% of projected general revenues for the 2012-13 biennium. However, the gap is equal to 21% based on the lower USD 15 bn estimate. For point of reference, the Center on Budget and Policy Priorities (CBPP) estimates that states faced an aggregate USD 191 bn in shortfalls in FY10, equal to 29% of budgets on average, and an aggregate USD 130 bn in FY11, equal to an average 20%.[2] CBPP estimates an aggregate USD 140 bn in gaps for FY12. Based on these results, Texas' experience is not dissimilar to other states when measured on the basis of the lower of the two deficit estimates.

As recently as the end of October, S&P published a report titled "Lone Star State Recovery: Why We Think Texas Will Emerge from the Recession Faster and Stronger than Most States". S&P assigns a AA+ credit rating to the state's GO debt, with a stable rating outlook. The S&P report contemplated an estimated USD 18 bn budget gap for the biennium, in line with the USD 15 bn projection. While the gap is sizeable, S&P believes that the state will tackle it "from a position of strength" given a large rainy day fund and its avoidance of the painful cuts and tax increases the majority of states have had to implement already. Recent Moody's and Fitch reports have affirmed the state's AAA GO bond rating and stable outlook also anticipated a

structural gap for the biennium of up to USD 18 bn.

Among the states, Texas has one of the lowest debt burdens and its pension fund is relatively well-funded at 84% funded (FY09). The state's GO bonds are payable from a constitutional appropriation out of the first monies coming into the state treasury not otherwise appropriated, an amount equal to USD 34.7 billion at the end of FY09. In comparison, the state has roughly USD 13.2 bn of GO bonds outstanding, of which USD 9.9 bn is self-supporting.

Texas has a strong track record of maintaining a rainy day fund since the fund was created in 1988. While many other states have depleted this resource over the past few challenging fiscal years, Texas has not. The Comptroller indicates that the rainy day fund is expected to total USD 9.4 bn for the 2012-13 period, including USD 1.2 bn in transfers over 2011-13, equal to over 12% of anticipated revenue collections. Oil and natural gas tax revenues earned during the mid and late 2000s were retained, helping to bolster overall available resources. While it takes a supermajority vote of the legislature to draw money from the reserve account, it is notable that available funds would be expected to more than offset lower state revenues, thereby very readily narrowing the gap.

Thus far, state Republicans are firmly against tapping the rainy day fund to balance the budget. The budget proposal unveiled by the House did not raise taxes or draw on the rainy day fund. Balance instead was achieved by reducing spending across all state funds by nearly 17%, including a 30% cut in Medicaid; not funding enrollment increases for schools or giving school districts the required level of state funds to offset reduced property taxes; and eliminating over 9,000 government jobs, among other adjustments. Budget deliberations will now ensue.

The House plan would require the legislature to re-write school funding formulas. The state cut school property taxes by one-third in 2006 and expanded the business tax to make up the difference. Unfortunately, the expanded business tax has failed to provide the same amount of revenue that the property tax did, contributing to a burgeoning structural gap.

Given that Texas does not levy an income tax, its primary source of tax revenue is the sales tax (64%) followed by an array of other taxes and fees. An income tax remains politically unpopular in the state despite the additional revenue it would raise; the legislature is highly unlikely to contemplate its implementation. State and local sales taxes have been trending upwards in recent months, with December marking the ninth consecutive month of year

over year improvement, according to the Comptroller. December collections of USD 1.81 bn were up from USD 1.65 bn in December 2009.

Texas' employment has outperformed the nation and its unemployment rate is also below the national average. Property values did not deteriorate as much in Texas as in other parts of the country. With only about 20% of the state's workforce unionized, the cost of doing business is also more favorable than in other states. The low level of unionized employees is similarly supportive for pension funding. However, Texas finds itself in a unique position of having a growing population with relatively high poverty levels and needs for public services. In order to accommodate population growth, Texas has to grow jobs more rapidly than other states, offsetting what on the surface appears to be a relatively stronger employment picture. On balance, however, Texas entered the national recession after many other states and its recovery is generally expected to outpace the nation as a whole.

The last time Texas faced a budget gap of significant magnitude was in 2003, when the deficit reached USD 10 bn. The budget was balanced primarily through spending cuts and increases in fees in that instance. Governor Perry has said those measures can be used again in the 2011 session. We will continue to monitor developments. Should budgetary negotiations unravel and structural solutions appear far off, we believe that a modest level of downward rating pressure is possible. Despite the prospects for increased media attention during the legislative session in Austin, we believe Texas GO bonds are very secure and bondholders should not be concerned by recent negative headlines.

New Jersey Confronts its own Budgetary Challenges

New Jersey has shown improvement in balancing its available resources with expenditure needs by cutting the overall size of its budget. Challenges remain – specifically those related to sizeable long-term liabilities associated with debt, pensions and other post-employment benefits (or 'OPEB'). The state's efforts to restore structural balance and address these long-term liabilities were hamstrung by the economic recession. These concerns are taking on more focus as the state gears up for the FY12 budget.

The state's debt position increased dramatically over the FY01 to FY05 period on borrowing for the state's court-ordered school construction program along with debt

issued for operating purposes in FYs 03-05. The latter practice has since been prohibited. Since that time, net tax supported debt has actually been flat at USD 32 bn, with the majority of the state's debt (approximately 90%) subject to appropriation. Debt service, including appropriation debt, is equal to 8% of spending. This level is more or less in line with other states, with the median for all states estimated at 5-7%.[3]

While the state's debt burden appears to have levelled off, pension and OPEB liabilities have grown. The annual required contribution (or 'ARC') for the pension is equal to 11% of state spending, while the pay-as-you-go amount for OPEBs is an additional 5%. The ARC for OPEB, if funded, would equal an even higher 15% of spending. This sizeable amount is the third highest among states, in part because New Jersey is responsible for funding the full contribution for teachers, whereas most states require some form of employee contribution.

New Jersey's funding level across its pension plans is estimated at 62% as of 30 June 2010, with a funding gap of roughly USD 54 bn. As recently as FY02, the pension was fully funded. The Governor has noted publicly that, without reform, the unfunded liability will grow from USD 54 bn to USD 183 bn in thirty years, with the ARC increasing to USD 13 bn over the same period, more than the state currently spends on its entire system of public education. A 9% benefit increase was granted in 2001 which Governor Christie is now seeking to rescind.

Other factors leading to the funding level decline are adverse market conditions and underfunding of actuarially required contributions. The state has not paid the full ARC since 2003. It was implementing a phased approach, whereby it paid approximately 20%, 30%, 40%, 57.5% and 50% of the ARC in each of FYs 04-09, respectively. It then skipped payments entirely in FY10 and FY11 after paying only 4.8% in FY09. The deferral of FY10 and FY11 will further weaken funded ratios, although this will be mitigated in part by investment earnings if current levels remain supportive – the pension posted 14% growth through February 2010.

Unlike debt service payments which are fixed, state pension contributions can be manipulated. State law currently requires 1/7th funding of the ARC beginning in FY12, ratcheting up until the ARC is fully funded by FY18. Under this approach, FY12 represents the first fiscal year since 2008 where a contribution will be made. The plan targets 91% funding by 2041 with funded ratios expected to decline further before improving. A host of pension reforms are on the table to improve overall funding but

these require legislative approval. Any reforms, if approved, are likely to be subject to legal challenges by employee unions. Along with the phased-in funding requirements, potential solutions include raising the retirement age, curbing cost of living adjustments (COLAs) and requiring employees to contribute more to their pension plans. The state also intends to reduce its assumed rate of return on investments (currently 8.25%) to better reflect the current interest-rate environment.

The Governor delivered his state of the state address on January 11. He focused on balancing the FY12 budget, putting the state's unemployment insurance fund on a long-term sustainable path, achieving education and pension reform, and stemming property tax growth. The Governor is expected to deliver a more specific budget address in February. Governor Christie thus far has captured a great deal of attention nationally for his broad efforts to rein in state spending. Like most states, New Jersey's revenue outlook is improving. The state collected 3.8% more in revenue in the first 5 months of FY11 than projected; income taxes are almost 13% above estimates. This is partially attributed to high-income filers rushing to pay taxes prior to Bush tax cuts being potentially phased out.

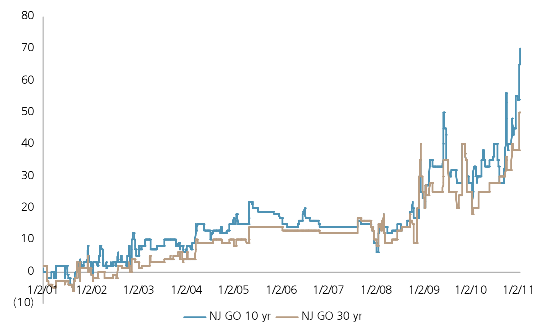
For FY12, the state is expected to face a USD 10.5 bn deficit, equal to roughly one-third of its budget, by some accounts, but this amount includes full funding of the pension ARC (USD 3.5 bn) and the state school aid formula (USD 2.3 bn), neither of which were fully funded in FY11. The actual gap is more likely to be in the USD 4 bn range assuming the actuarially required pension payment is phased in over seven years, beginning in FY12, and local aid to governments is reduced. Last year, the state cut USD 1.7 bn in school district, USD 334 mn in municipal and USD 178 mn in higher education aid to help close a FY11 gap equal to a staggering 37% of spending. In the state of the state address, the Governor indicated that the budget he will present next month will balance the FY12 gap with no new taxes.

Recent state budgets appear to have been particularly difficult for local governments. In FY11, state aid to municipalities was reduced by 23% on top of cuts implemented in prior fiscal years. A 2% cap on growth in property taxes also was enacted over the past year (a reduction from 4% previously). New Jersey property taxes are the highest in the nation, on average, having increased 70% over the past ten years partially due to the rising costs of pension and other post-employment benefits at the local level.

New Jersey municipalities led the nation in downgrades for 2010. At least 24 municipalities were downgraded by Moody's for the year, almost twice as much as the next highest state, New York, according to a Bloomberg News tally. The 2% property tax cap is believed to have played a factor in this trend. New Jersey has 566 towns and cities, 604 school districts and 21 counties – more local governments per square mile than any other state in the Union. The rating downgrades included Trenton, New Brunswick, Newark and Atlantic City, with this group being the largest in terms of debt outstanding. Outside of these issuers, the remaining municipalities affected by downgrades, each had under USD 100 mn in debt outstanding.

The New Jersey Economic Development Authority was in the market last week with a refunding issuance for its school facilities construction bonds. The bond issue was intended to eliminate much of its VRDB, swap and LOC renewal risk. The bonds are secured by the state's obligation to appropriate for the payment of debt service. Due to unfavorable market conditions, the deal was re-priced at higher yields and the state decided to downsize the offering. Bonds maturing in 2016 with a 5% coupon were priced at a yield of 3.26% while the 2025 maturity with a 5.25% coupon had a yield of 5.52%. By comparison, when the Economic Development Authority issued school facilities construction bonds in April 2010, the 2014 maturity with a 4% coupon had a yield of 2.77% and the 2031 maturity with a 5% coupon had a yield of 4.61%.

Fig. 8: 10y and 30y NJ GO vs. general market
Spread (in basis points), January 2001-January 2011



Source: Thomson Reuters, MMD interactive, UBS WMR as of 20 January 2011.

Nassau County Déjà Vu

Moody's Investors Service recently announced that it had downgraded Nassau County, NY's outstanding long-term and short-term debt ratings to A1 and MIG 2, respectively. These actions coincided with news that the Nassau County Interim Finance Authority (NIFA or "the Authority") might re-establish direct financial oversight of the county government. NIFA is a New York State public benefit corporation with the power to monitor county finances. Upon the declaration of a "control period", the Authority may exercise more direct oversight of county government. The prospect of more direct oversight by NIFA is a double-edged sword. While the Authority is likely to enforce greater budgetary discipline upon the County, the necessity for such intervention has naturally raised concerns among bond investors. There is growing concern about the ability and willingness of elected officials to restore some structural balance to the County's financial operations.

The principal cause of concern is the adoption of a budget for calendar year 2011. Lower property tax rates were instituted in 2010 after the election of a new County Executive who ran on a dual platform of lower taxation and the maintenance of services through expense efficiencies. While property tax rates have been reduced (a 4% increase for 2011 was rescinded), the County has been much less successful identifying and achieving expense savings. The budget adopted for 2011 relied upon greater financial assistance from the State of New York and more relief from mandatory expenditures imposed through statute. The reliance on external aid, in particular, has raised concern about the County's ability to tackle structural imbalances on its own.

An Historical Perspective

Nassau County has long been one of the wealthiest counties in the United States, ranking eleventh in average median income over the 2006 to 2008 period according to the U.S. Bureau of the Census. The County's location directly proximate to New York City's eastern border make it an attractive place to live for individuals with higher incomes eager to escape the income tax imposed by New York City. After World War II, middle-income families settled there in search of good schools and manageable commutes. The Long Island railroad facilitated development in the first half of the 20th Century and the development of an extensive highway system connecting the County with the New York City economy added further impetus to unprecedented residential development after World War II. Today the County still enjoys substantial resources with per capita income at 160% of the national average and housing values at 260% of the national average.

For 30 years, steady population growth and an expanding tax base provided sufficient funds to build schools, parks, and other public amenities. During the 1970s, the County was considered to be one of America's best local government credits, in stark contrast to its two neighbors – Suffolk County and New York City.

Over the ensuing three decades, different trends emerged. The role of politics and patronage in the operation and management of County government elicited widespread criticism and concern. Higher property tax rates began to be seen as more of a burden. The cost of local government, and the comparatively higher wage rates granted to public sector workers, was viewed as more onerous. Subsequent economic recessions and the virtual disappearance of the aviation industry weakened the job market.

Dissatisfaction among county residents manifested itself in several ways. The County's system of property valuation was subjected to more challenges and a higher a volume of assessment appeals were recorded. The County's myriad local governments, ranging from villages to towns to special districts to the County government itself – all relied upon a property tax base that was no longer expanding exponentially. The costs of tax certiorari claims, or legal proceedings whereby a property owner can challenge the assessed valuation of land and improvements through formal appeals to administrative agencies and the courts, were financed through the County, which guaranteed the repayments on behalf of weaker local governments. In doing so, the County leveraged its greater access to credit (relative to that of its local governments) to support weaker political subdivisions. By the mid-1990's, these issues culminated in a more contentious political environment in the County and resistance to higher property taxes.

The Nassau County Interim Finance Authority

By 1999, the County found itself in a liquidity crunch and was unable to muster the political will to enact a balanced budget. Its bond ratings had dropped to Baa3 and BBB by Moody's and S&P, respectively, which threatened the County's ability to access the bond markets at manageable rates. Even with bond insurance, bonds were selling at a yield to maturity of 6.50% in 18 years. In response, the State of New York created NIFA to ensure the adoption of a balanced budget and the effective use of USD 100mn of State funding to improve liquidity and maintain debt service payments. The Authority was empowered to review and approve budgets and labor contracts, authorize bond issues and approve all major financial commitments. NIFA was able to issue bonds backed by sales tax revenues collected in the County and influenced the conversion of the County-owned medical center to ownership by an independently financed public benefit corporation.

The County used the resulting opportunities to reassess property values and reform the property tax process to reduce valuation appeals. This enabled it to concurrently finance expenses resulting from tax certiorari claims and eliminate additional borrowing; the amount of debt outstanding related to this expense actually was reduced in FY 2006. The economic recession dealt a significant blow to these positive developments in 2008. Commercial property owners began to appeal assessments more aggressively. The County registered 1.6% annual declines in real estate values in each of the last two years.

The property tax reforms undertaken in the early 2000's had increased the importance of sales tax revenue to the County revenue base. Sales taxes are traditionally a leading

indicator of economic trends and, as the recession deepened, revenue suffered. The County recorded consecutive deficits and a steady pattern of reserve drawdowns had emerged. Reductions in tax revenue were exacerbated when the new County Executive decided to forego implementation of a 4% increase in property taxes. Finally, the failure to achieve the full measure of anticipated savings from the County workforce reduction has had a negative impact.

Future Outlook

The budget adopted by the County for 2011 maintains the same taxation policies but also relies on an estimated USD 60mn of projected savings from labor concessions, USD 20mn in aid from Albany (which is facing its own budget difficulties), and USD 100mn in new borrowing to finance operating expenses. The budget also anticipates the successful completion of sale/leaseback transactions and asset sales that are subject to a high level of uncertainty. An expected increase in the sales tax rate was not approved by the State legislature; the tax would have generated an estimated USD 60mn in new revenues for the County. These factors have created an estimated USD 350mn structural budget deficit, according to NIFA.

It also appears now that additional short-term borrowing is necessary to provide sufficient liquidity throughout 2011. The use of long-term financing to pay for operating expenditures has been a traditional and reliable "red flag" in the world of municipal credit. The use of new borrowings in the face of an already significant short term debt burden – USD 210mn – continues and increases a reliance on nonrecurring revenues to balance the County's budget. Prior budget gaps were addressed through the use of non- general fund balances, bond proceeds, federal funding, and one-time payments from the State. The result is a greater reliance on short-term funding risks in an increasingly uncertain short-term financing and interest rate environment.

The County also faces risk related to NIFA's own variable rate financing and interest rate swap obligations. It is estimated that variable rate debt totals USD 840-850mn across both NIFA and the County. This would equal 24% of the County's outstanding debt. The majority of the credit facilities supporting this debt expire in the next two years which creates significant rollover risk for the County and likely increases in the costs associated with this debt.

While the County was successful in obtaining insurance for its bond offering this week from Assured Guaranty, the County cannot rely on continued support from a less diverse universe of credit providers to support a large scale

conversion of short-term County indebtedness to long-term bonds. Over this same period, the County will have to increase the amount of revenues set aside for NIFA debt while likely receiving lower State aid. This will add further pressure to cash flows and cash balances throughout 2011. These factors all contributed to the lowering of the ratings on the outstanding and to-be-issued short-term debt to MIG 2 by Moody's. S&P thus far has maintained its SP-1+ rating on the County's short-term debt.

The County is now counting on a repeal of the law that mandates County financing of ongoing tax certiorari claims beginning in 2013. This would lower expenses for the County both currently and in terms of reduced borrowing needs. Of course, the towns, schools, and special districts that rely upon the County to underwrite these assessment reductions are likely to oppose such a plan and may initiate litigation to prevent its implementation.

In response to the failure by the County Executive and the Legislature to develop a credible response to the structural deficit, NIFA proposed the imposition of a new "control" period. The Authority thus far has delayed the imposition of such an action to allow the County to re-examine its proposed budget and financial plan. The mere threat of a control period could motivate County stakeholders to move forward with meaningful reform but we remain doubtful; we believe that NIFA will once again assume direct responsibility.

Recent developments have increased our concern regarding the credit quality and rating outlook for Nassau County obligations. We expect more adverse media attention and greater skepticism over the County's willingness to adopt painful budget solutions. Thus far, the new administration in Mineola has not demonstrated enough willingness to reduce expenditures to align the county government with the grim reality that future population and employment growth is unlikely to resemble historical patterns.

Nassau County has not exercised the financial discipline necessary to reduce spending in line with economic realities. That said, the County's bonds are sufficiently secure; default is unlikely with the Authority actively engaged in financial oversight. But investors in County bonds must be willing to accept adverse media attention regarding a structural deficit highly sensitive to economic recession, and a corresponding increase in credit spreads. The distinction between the relative performance due to credit concerns and the probability of default is important and one that is often missed by critics of state and local government. We believe the principal risk to Nassau County bondholders is not default but rather liquidity in

the face of adverse news related to persistent budget difficulties and political dysfunction.

Folk Art Museum Taps Bond Insurance Policy

The American Folk Art Museum issued USD 31.865 mn of debt through the New York City Trust for Cultural Resources in October 2000 to finance a portion of the costs incurred for the construction and equipping of its new museum facility located at 45 West 53rd Street in New York City. The 30,000-square foot, eight-level building includes four floors of gallery space and additional supplemental facilities for use by the museum. The American Folk Art Museum, founded in 1961, considers itself to be the leading museum of folk art scholarship in the nation.

Since 1 July 2009, the museum has not made the required debt service payments on its bonds. The bonds are secured by a mortgage on the property, a pledge of the gross revenues of the museum and a debt service reserve fund. The museum used the debt service reserve fund to cover the January and July 2010 interest payments and the July 2010 principal payment on the bonds. Following the draw on the reserve fund in July, insufficient balances remained to make any further payments.

The bond is insured by ACA Financial Guaranty. As required under its bond insurance policy, ACA advanced the funds necessary to make the payment due to bondholders in January 2011 and successfully executed a forbearance agreement with the museum in August. The forbearance agreement expires on 30 June 2011 (unless extended or sooner terminated), and provides that ACA will not declare certain defaults, or exercise certain of its rights and remedies such as accelerating the bonds or foreclosing on the mortgage, as long as the museum is in compliance with the terms and conditions of the agreement. The museum reported that it was in compliance with these terms as of 20 August 2010.

As an outcome of the crisis affecting bond insurers, ACA is in "run-off' and has had its credit ratings withdrawn. When it was an active bond insurer, ACA's public finance business model was focused on insuring high-yield municipal bonds. While the museum is not rated by any of the major rating agencies, a comparison of its key credit metrics based on its most recent available audited financial results to rating agency medians for non-profit 501(c)3 institutions would classify it in the non-investment grade category, in our view.

As previously mentioned, the security pledge on the bonds includes a mortgage on the building which is located in an attractive area of midtown Manhattan, across the street from the Museum of Modern Art. While the mortgage pledge is a key part of the collateral, its utility to bondholders could be limited given that ACA, as bond insurer, has the right to control proceedings without bondholder consent following an event of default. If ACA decided to foreclose on the building, it is not clear how the proceeds of the sale would be directed to bondholders, or if they would be directed to bondholders at all. As long as ACA honors its requirement to pay principal and interest to bondholders in line with the stated maturity schedule on the bonds, it is meeting its obligation to bondholders in full.

The museum's financial condition began to severely deteriorate in the fiscal year ending 30 June 2008 as the effects of the national recession set in. Total revenues were down 45% for the year, driven by large declines in contributions, membership, magazine sales, auxiliary activities (consisting primarily of goods sold at its two gift shops), and the absence of any income from investments. The only bright spot in results was a significant increase in revenues from special events and benefits, but this increase was insufficient to offset losses in other areas. Although admissions did not decline too severely (-5%) despite the slowdown in the overall economy; they represent only about 6% of total revenues and therefore are immaterial to the health of this credit. The museum failed to cut spending from FY07 levels to compensate for the decline in revenues, resulting in a large deficit of nearly USD 5 mn for the period. Net assets declined to USD 10.8 mn in FY08 from USD 15.6 mn the prior year. Subsequent to the end of the fiscal year, the fair value of the museum's investments and reserve funds were reported to have declined by a further 20%.

Audited financial results for FY09 show continued deterioration over the weak results for 2008. The museum's net assets declined to USD 3.1 mn as revenues continued to deteriorate and were not offset with commensurate reductions in spending. The museum reported a USD 6.3 mn operating loss for the period, an increase from the USD 2.7 mn loss the prior year. Audited results also show a significant unrestricted net asset deficit of roughly USD 1.6 mn, a reflection of the large operating losses. The previously noted draws on the debt service reserve fund, along with investment losses, reduced available balances, while new sources of liquid assets failed to materialize. The audit indicates an outstanding debt of USD 29.945 mn at fiscal year-end. The museum was not in

compliance with certain covenants in connection with the bond issue in both FY08 and FY09.

The most recent update on the museum's financial condition that we were able to obtain is provided in Note 15 of the FY09 audit. This notation gives some indication of results for FY10, citing that the museum recorded a USD 3.6 mn operating loss for the period ending 30 June 2010 and that the unrestricted net deficit grew to USD 5.2 mn over this time. Both figures are based on unaudited results. The museum also indicates that it has taken steps to reduce its expenses and increase revenues in its budget for FY11 to achieve breakeven operations.

Absent management's ability to turn around museum operating performance and rebuild its balance sheet through donations or other more traditional approaches, a key item that could improve the museum's ability to independently support its debt service payments is the sale of its air rights and grant of an easement for light and air to a developer. The museum received bond insurer consent to execute a purchase and sale agreement for this purpose with a developer in October 2008. No further updates on the transaction have been forthcoming and, as noted in the museum's audited results for FY09, the sale is subject to a variety of closing conditions and there is no assurance that it will materialize.

The air rights negotiation is related to a proposal by a developer (Hines) to build a skyscraper next to the museum at 53 West 53rd Street. The project is envisioned as being architecturally significant and potentially as tall as the Empire State Building. The new building would house an expansion of the Museum of Modern Art, a hotel, and apartments. The project has faced considerable local opposition; the, city council approved the building in October of 2009 contingent on the height being reduced by 200 feet to 1,050 feet total. The status of the project is unclear at this time and we are in no position to offer an opinion as to its likelihood of occurring.

On 14 January 2011, MSRB trade data showed a trade on the Folk Art bonds at a price of roughly 53 cents.

Bond Insurance Update - Mixed Messages

The bond insurance industry was the subject of widespread media attention once again in January. In a series of contradictory events, MBIA and National Public Finance Guarantee were both downgraded by a major rating agency and shortly thereafter given a new lease on life by a

favorable court decision. First, Standard & Poor's downgraded the financial strength rating of MBIA and National Public Finance Guarantee Corp to "B" and "BBB", respectively. The revision to MBIA's rating was attributed to stress-case loss projections for its structured finance portfolio. The downgrade to National was a knock-on effect of the downgrade to MBIA; S&P expressed concern about the possibility that National's otherwise ample resources could be used to bolster MBIA's depleted capital position.

Three weeks later, the Appellate Division of the New York State Supreme Court reversed an earlier decision by a lower court and granted MBIA's motion to dismiss a lawsuit brought by a group of banks challenging the creation of National as a separate and distinct insurance company. The appellate court overturned a lower court's ruling that favored the plaintiffs when it initially denied MBIA's own motion to dismiss the case. The appellate court ruled that a separate and parallel action by the plaintiffs, called an Article 78 proceeding, was the appropriate avenue for challenging a regulatory action by the New York State Department of Insurance.

The appellate court's ruling was good news for MBIA and its public finance subsidiary, National Public Finance Guarantee. However, plaintiffs are likely to appeal the appellate court's ruling further and seek a hearing from the Court of Appeals in Albany in a "best two-out-of-three" contest. If the ruling stands, further legal challenges will move to an Article 78 proceeding in which the plaintiffs must prove that the New York State Insurance Department acted arbitrarily and capriciously in its decision to permit MBIA to establish National as an independent subsidiary.

We do not expect an early resolution to this dispute. And until it's resolved, National's financial strength ratings from S&P and Moody's are unlikely to improve. In the event National is successful, the company must still obtain significant upgrades from the ratings agencies, convince the market of its operational and financial independence, and potentially raise capital from third party investors. Clearly, there is still a long road ahead.

Current state ratings and outlook[4]

State	Moody's Rating	Outlook	Last Rating/ OL change[3]	S&P Rating	Outlook	Last Rating/ OL change[3]	Fitch Rating	Outlook	Last Rating/ OL change[3]
Alabama	Aa1	Stable	4/16/2010	AA	Stable	8/3/2007	AA+	Stable	4/5/2010
Alaska	Aaa	Stable	11/22/2010	AA+	Stable	3/27/208	AA+	Stable	4/5/2010
Arizona	Aa3[2]	Stable	7/15/2010	A+[2]	Negative	12/23/2009			
Arkansas	Aa1	Stable	4/16/2010	AA	Stable	1/10/2003			
California	A1	stable	4/16/2010	A-	Negative	1/14/2010	A-	Stable	4/5/2010
Colorado				AA[2]	Stable	7/10/2007			
Connecticut	Aa2	stable	4/16/2010	AA	Stable	9/26/2003	AA	Stable	6/3/2010
Delaware	Aaa	Stable		AAA	Stable	2/22/2000	AAA	Stable	4/13/2006
Dist. of Columbia	Aa2	Stable	4/16/2010	A+	Stable	6/6/2007	AA-	Stable	4/5/2010
Florida	Aa1	Stable	4/16/2010	AAA	Negative	1/14/2009	AAA	Negative	4/5/2010
Georgia	Aaa	Stable		AAA	Stable	7/29/1997	AAA	Stable	4/13/2006
Hawaii	Aa1	Negative	4/16/2010	AA	Stable	1/29/2007	AA+	Negative	4/5/2010
Idaho	Aa1[2]	Stable	4/16/2010	AA[2]	Stable	7/20/2009	AA-[1]	Stable	2/13/2007
Illinois	A1	Negative	9/23/2010	A+	Negative	12/10/2009	A	Negative	6/11/2010
Indiana	Aaa[2]	Stable	4/16/2010	AAA[2]	Stable	7/18/2008	AA+[1]	Stable	4/5/2010
Iowa	Aaa[2]	Stable	4/16/2010	AAA[2]	Stable	9/11/2008	AAA	Stable	4/5/2010
Kansas	Aa1[2]	Stable	4/16/2010	AA+[2]	Stable	5/20/2005			
Kentucky	Aa1[2]	Negative	4/16/2010	AA-[2]	Stable	6/23/2009	AA[1]	Negative	4/5/2010
Louisiana	Aa2	Stable	4/16/2010	AA-	Stable	10/9/2009	AA	Stable	4/5/2010
Maine	Aa2	stable	4/16/2010	AA	Negative	3/10/2010	AA+	Stable	4/5/2010
Maryland	Aaa	Stable		AAA	Stable	5/7/1992	AAA	Stable	4/13/2006
Massachusetts	Aa1	Stable	4/16/2010	AA	Stable	3/15/2005	AA+	Stable	4/5/2010
Michigan	Aa2	Stable	4/16/2010	AA-	Stable	5/22/2007	AA-	Stable	4/5/2010
Minnesota	Aa1	Stable	4/16/2010	AAA	Stable	7/24/1997	AAA	Stable	4/5/2010
Mississippi	Aa2	Stable	4/16/2010	AA	Stable	11/30/2005	AA+	Stable	4/5/2010
Missouri	Aaa	Stable		AAA	Stable	2/16/1994	AAA	Stable	4/13/2006
Montana	Aa1	Stable	4/16/2010	AA	Stable	5/5/2008	AA+	Stable	4/5/2010
Nebraska	Aa2[1]	Stable	4/16/2010	AA+[2]	Stable	10/11/2006			
Nevada	Aa1	Negative	11/10/2010	AA+	Stable	6/23/2006	AA+	Stable	4/5/2010
New Hampshire	Aa1	Stable	4/16/2010	AA	Stable	12/4/2003	AA+	Stable	4/5/2010
New Jersey	Aa2	Negative	9/22/2010	AA	Stable	7/19/2005	AA	Stable	4/5/2010
New Mexico	Aaa	Stable	4/16/2010	AA+	Stable	2/5/1999			

New York	Aa2	Stable	4/16/2010	AA	Stable	9/14/2004	AA	Stable	4/5/2010
New York City	Aa2	Stable	4/16/2010	AA	Stable	6/5/2007	AA	Stable	4/5/2010
North Carolina	Aaa	Stable	1/12/2007	AAA	Stable	6/25/1992	AAA	Stable	4/13/2006
North Dakota	Aa1[2]	Stable	4/16/2010	AA+[2]	Stable	3/17/2009			
Ohio	Aa1	Negative	4/16/2010	AA+	Negative	9/23/2009	AA-	Stable	4/5/2010
Oklahoma	Aa2	Stable	4/16/2010	AA+	Stable	9/5/2008	AA+	Stable	4/5/2010
Oregon	Aa1	Stable	4/16/2010	AA	Stable	8/23/2007	AA+	Stable	4/5/2010
Pennsylvania	Aa1	Negative	4/16/2010	AA	Stable	11/6/1998	AA+	Stable	4/5/2010
Puerto Rico	A3	Negative	8/10/2010	BBB-	Positive	11/29/2010			
Rhode Island	Aa2	Stable	4/16/2010	AA	Negative	3/9/2009	AA	Negative	4/5/2010
South Carolina	Aaa	Stable	3/23/2007	AA+	Stable	7/11/2005	AAA	Stable	4/13/2006
South Dakota	A1[1]	Stable		AA[2]	Stable	12/21/2006	AA[1]	Stable	4/5/2010
Tennessee	Aaa	Stable	4/16/2010	AA+	Stable	10/12/2006	AAA	Stable	4/5/2010
Texas	Aaa	Stable	4/16/2010	AA+	Stable	8/10/2009	AAA	Stable	4/5/2010
Utah	Aaa	Stable		AAA	Stable	6/7/1991	AAA	Stable	4/13/2006
Vermont	Aaa	Stable	2/2/2007	AA+	Stable	9/11/2000	AAA	Stable	4/5/2010
Virginia	Aaa	Stable	5/27/2004	AAA	Stable	11/11/1992	AAA	Stable	4/13/2006
Washington	Aa1	Stable	4/16/2010	AA+	Stable	11/12/2007	AA+	Stable	4/5/2010
West Virginia	Aa1	Stable	7/9/2010	AA	Stable	8/21/2009	AA	Positive	4/5/2010
Wisconsin	Aa2	Stable	4/16/2010	AA	Stable	8/15/2008	AA	Stable	4/5/2010
Wyoming				AA+[2]	Stable	6/30/2008			

Source: Moody's, S&P and Fitch as of 15 December 2010
1 = Lease rating 2 = issuer credit rating: a rating equivalent to a General Obligation (GO) rating for states with no GO debt
3 = Last rating change or outlook revision. Does not reflect an affirmation.
4 = Moody's and Fitch recalibrated ratings on US municipal bond issues and issuers in April 2010.

End Notes

[1] Source: Hodge, Scott, A. The Tax Foundation, "Illinois Corporate Tax Hike Inches U.S. Closer to #1 Ranking Globally", Fiscal Fact No. 257, 14 January 2011.
[2] McNichol, Elizabeth; Oliff, Phil; and Johnson, Nicholas. Center on Budget and Policy Priorities, "States Continue to Feel the Recession's Impact", updated 16 December 2010.
[3] Moody's, "Special Comment: Municipal Market Investor Confidence: Linkages to Credit Quality", 6 January 2011.

Appendix

Statement of Risk

Municipal bonds: Although historical default rates are very low, all municipal bonds carry credit risk, with the degree of risk largely following the particular bond's sector. Additionally, all municipal bonds feature valuation, return, and liquidity risk. Valuation tends to follow internal and external factors, including the level of interest rates, bond ratings, supply factors, and media reporting. These can be difficult or impossible to project accurately. Also, most municipal bonds are callable and/or subject to earlier than expected redemption, which can reduce an investor's total return. Because of the large number of municipal issuers and credit structures, not all bonds can be easily or quickly sold on the open market.

Terms and Abbreviations

Term / Abbreviation	Description / Definition	Term / Abbreviation	Description / Definition
GO	General Obligation Bond	TEY	Taxable Equivalent Yield (tax free yield divided by 100 minus the marginal tax rate)
MMD	Municipal Market Data		

	Rating Agencies			Credit Ratings
	S&P	Moody's	Fitch/IBCA	Definition
Investment Grade	AAA	Aaa	AAA	Issuers have exceptionally strong credit quality. AAA is the best credit quality.
	AA+	Aa1	AA+	Issuers have very strong credit quality.
	AA	Aa2	AA	
	AA-	Aa3	AA-	
	A+	A1	A+	Issuers have high credit quality.
	A	A2	A	
	A-	A3	A-	
	BBB+	Baa1	BBB+	Issuers have adequate credit quality. This is the lowest Investment Grade category.
	BBB	Baa2	BBB	
	BBB-	Baa3	BBB-	
Non-Investment Grade	BB+	Ba1	BB+	Issuers have weak credit quality. This is the highest Speculative Grade category.
	BB	Ba2	BB	
	BB-	Ba3	BB-	
	B+	B1	B+	Issuers have very weak credit quality.
	B	B2	B	
	B-	B3	B-	
	CCC+	Caa1	CCC+	Issuers have extremely weak credit quality.
	CCC	Caa2	CCC	
	CCC-	Caa3	CCC-	
	CC	Ca	CC+	Issuers have very high risk of default.
	C		CC	
			CC-	
	D	C	DDD	Obligor failed to make payment on one or more of its financial commitments. this is the lowest quality of the Speculative Grade category.

UBS FS and/or its affiliates trade as principal in the fixed income securities discussed in this report.

Appendix

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