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Wealth Management Research **17 August 2010**

Municipal Bonds

How low can they go?

- Munis show some resiliency despite negative credit pressures. As yields fell, total returns for the sector stood at +1.26% in July and are nearly 6.00% year-to-date, according to BofA ML Municipal indexes.
- Although we expect Treasury yields to move higher over a 12-month horizon, we now see a lower trajectory for the rate path for all maturities. We look for a more modest rise in muni rates barring any significant credit event.
- In our view, a "lower for longer" interest rate environment creates opportunities to upgrade muni sectors, take profits and reposition for potentially higher tax rates; credit selection remains a crucial factor in portfolio construction. We provide a credit update on New York State, the Commonwealth of Puerto Rico, Illinois and comment on FGIC's bankruptcy filing.

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Market Overview

Following a modest sell-off occurring in June, muni bond performance picked up along with the broader fixed income markets last month. Supported by continued thin net tax-exempt supply and low US Treasury yields, muni sector returns are off to a solid start in August posting a 1.2% total return month-to-date as shown in Figure 1.

Despite declining a bit, taxable Build America Bonds (BABs) are continuing to draw market share from the traditional tax-exempt market. Build America Bonds comprised almost 30% of the new issue market despite the program's uncertain status beyond its current expiration date set for year-end. Since our last discussion on the topic in our 10 June 2010 Municipal Report, another new bill to extend and expand the BAB program was introduced in the House. Resistance to a further extension of the Program persists in the Senate as concerns over the size of the deficit mount. Congressional voting has been postponed until September.

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Municipal Bonds

Net cash inflows to muni mutual funds, an indicator of individual investor demand, have been positive and consistent. According to Lipper FMI, municipal funds recorded net cash inflows of USD 653.2 mn from investors during the week ended July 28, the fourth consecutive week of inflows exceeding USD 600 mn. For the week ending August 4, flows softened to USD 370 mn before more than doubling this past week to nearly USD 1 bn. Technical factors are still favorable while credit fundamentals remain stressed and negative headlines persist.

On the budget front, New York State successfully reached an agreement on its FY11 budget. The conclusion of negotiations in Albany now leaves California as the lone state still unable to resolve its budgetary impasse for the most recent fiscal year. In late July, Governor Schwarzenegger issued the order for state employee furloughs in response to a projected USD 19 billion budget deficit. On Thursday, August 12, a San Francisco appellate court affirmed an earlier Superior Court order blocking the State from furloughing state workers as a budget-saving maneuver. The California Department of Administration immediately announced that the decision by the First District Court of Appeals will be appealed to the State Supreme Court. Stay tuned.

State Controller John Chiang, with whom the governor has been feuding, has said that he will start issuing IOUs later this month or in September if a new state budget is not passed. Chiang estimates that California's cash position will become dire by October if fighting continues over a new spending plan. Readers may recall that last year California began issuing IOUs to creditors in July to address a widening budget gap. Negotiations continue.

We were encouraged by Congress' decision to extend further stimulus funding to the states. The stimulus bill includes USD 16 billion for six more months of increased Medicaid payments to states. The remaining USD 10 billion is allocated for schools to rehire laid-off teachers or prevent further layoffs. Many state budgets counted on this funding to balance FY11 budgets so its passage is significant in resolving an area of uncertainty for revenue assumptions. California's state Finance Department, for example, estimates that the federal stimulus bill will send USD 1.2 billion directly to California schools and provide for another USD 1.3 billion that can be used to help plug the state's USD 19 billion budget hole. The amount is about USD 500 million less than Schwarzenegger's budget proposal assumes. In our view, spreads on California GO debt are likely to widen prior to the November elections given the budget impasse. We are less sanguine about the speed at which the political negotiations over the budget will conclude but are confident that the State will honor its full faith and credit obligations. Sellers should look to reduce exposure while spreads have moderated. New purchasers may wish to wait for a better entry point.

Since July 1, yields on high grade general obligation (GO) bonds have declined by 32bps and 40bps at the 5-year and 10-year maturity points moving rates to 1.24% and 2.39% respectively. Movement at the long-end was more muted with yields falling 18bps to 3.84% from 4.02%. At this stage, AAA yields at the front part of the curve are at their lowest point on record using data available since 1981. In addition to continued supply/demand imbalance in the muni market, the prospects of higher tax rates, slow economic growth, low inflation and Treasury yields are key factors helping push muni rates lower.

Lower for longer

In mid-July, WMR lowered our Treasury forecasts for all maturities and horizons. In particular, the 2-year and 10-year forecasts were cut by 50bps to 1.50% and 3.75% from 2.00% and 4.25% respectively. The change followed a reassessment of growth prospects in the US and modified expectations that the Federal Reserve will keep the target fed funds rate unchanged at zero to 25 bps until June 2011. UBS econo-

Figure 1: US fixed income sector returns (%)

	2009	YTD	MTD
Municipals	**14.4**	**5.9**	**1.2**
Treasuries	-3.9	8.2	1.4
TIPS	10.3	5.9	1.4
Agencies	1.1	5.4	0.6
Investment grade corporates	20.1	10.2	1.8
High yield corporates	57.9	8.3	0.0
Mortgages	5.9	5.6	0.1

Source: BofA/ML Indexes, UBS WMR as of 16 August 2010

mist Maury Harris lowered his GDP growth estimates to 3.0% from 3.5% in Q2 2010 and 2.5% from 3.0% in Q3 and Q4 on 2 July 2010. This past week, Dr. Harris cut his growth estimates further (see US Daily Economic Comment 13 August 2010). A larger-than expected US trade deficit for June suggests that official Q2 2010 GDP statistics are likely to be revised downward. We believe that they will show that the economy grew at a mere 1.2%, rather than 2.4%. We also expect Q3 GDP to grow at 1.5% rather than the 3.0% previously penciled in. This results in whole-year GDP growth of 2.6% in 2010 and 2.8% in 2011, down from 3.0% in both cases.

Putting it all together, our end-point forecast for US Treasury yields suggests that the rate rise we expect over the course of the next 12 months will be somewhat limited. (See Figure 2).

Fig 2. US interest rate forecasts (%)

	16 Aug	In 3 months	In 6 months	In 12 months
3-month LIBOR	0.36	0.50	0.50	1.00
2-year Treasury	0.50	0.75	1.00	1.50
5-year Treasury	1.43	1.75	2.25	2.75
10-year Treasury	2.63	3.00	3.25	3.75
30-year Treasury	3.75	3.75	4.00	4.50

Source: Bloomberg for recent yield levels, UBS WMR Interest rates and bond markets, 14 July 2010

Muni rate rise more modest

While the level of Treasury rates is a key factor that usually influences the direction of muni rates, other factors are equally relevant in today's market. Supply/demand dynamics, tax rates, headline risk, potential institutional selling and legislative changes are among other important market drivers to watch. On the supply front, we anticipate taxable Build America Bond (BAB) issuance to swell in the fourth quarter. If the program is extended, as many observers expect, the subsidy rate is likely to be reduced. Regardless of whether the program expires, or is extended with a lower subsidy rate, we anticipate taxable BAB yields to rise in response to greater year-end volume. Issuers are likely to seek market access ahead of the deadline, thereby providing opportunities for taxable fixed income buyers. In contrast, tax-exempt bond prices would continue to be supported by thin tax-exempt supply, particularly at the long end of the curve where the bulk of BAB issuance occurs.

Although the prospect of rising marginal tax rates has increased the appeal of tax-exempt munis all year, the outcome of what will happen with the Bush tax cuts is now less clear. We expect headline risk to persist as municipal finances will likely lag the overall economic recovery by 18 months or longer as has been the case in previous recessionary cycles. Potential institutional selling is another factor to watch yet is hard to foresee. The bulk of the market, roughly two-thirds, is held by households either directly or indirectly. Legislative changes could have varied implications.

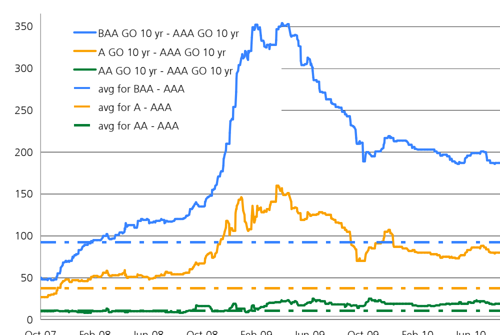
Note that Municipal-to-Treasury ratios have drifted higher in recent months and have become increasingly more volatile due to sharp movements in Treasury rates. That said, except for the shortest-dated area of the curve, there is room for spreads to compress suggesting munis may outperform Treasuries should rates eventually rise. We stick with our more defensive posture towards duration for better risk/reward potential. Unanticipated events could trigger greater price volatility on long duration assets, in our view.

Tale of two spreads

Credit quality spreads within tax-exempts have been moderating in recent months while spreads on an index of taxable Build America Bond (BABs) are steadily widening. Strong demand outstripping supply continues to help improve quality spreads in the tax-exempt market. (See Figure 3.) At the same time, spreads in the taxable BAB market have been increasing on uncertainty surrounding the program's status and investor concern over muni credit risk generally.

Fig. 3: Muni credit quality spreads (bps)

Spreads moderate despite ongoing fiscal stress.



Source: MMD Interactive, UBS WMR as of 16 August 2010

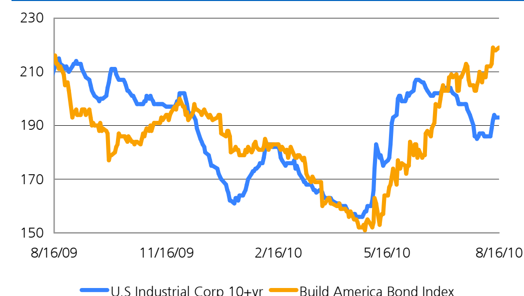
Note: Credit quality average spreads are since 1991.

For example, since July 1, quality spreads in the tax-exempt market between AAA and Baa 10-year general obligation bonds have narrowed 14bps to 187bps from 201bps. In the AAA versus A rating cate-

gories, improvements of 8bps occurred, moving spreads to 80bps from 88bps; while upper tier AA compared to AAA rated bonds had yields contract 3bps to 19bps from 22bps over the same time frame. In contrast, spreads on an index of BABs have widened 14bps to 219bps from 205bps, while an index of corporate bonds with similar duration had spreads narrow roughly 11bps from 203bps to 192bps. (See Figure 4). Going forward, we see room for quality spreads in tax-exempt munis to compress further on continued tight supply and taxable BAB spreads to widen on expectations for increasing issuance before year end.

Fig. 4. BABs versus Ind Corp spreads (bps)

BABs cheapen while corporates improve.



Source: BofA ML, UBS WMR as of 16 August 2010

Rating trends
According to Moody's, despite signs of economic recovery, the negative pressure on municipal ratings continued through the second quarter even as the ratio of upgrades-to-downgrades decreased modestly to 0.6-to-1 from the first quarter's 0.7-to-1 -- one of the lowest ratios in at least the last five years. The number of rating changes for the quarter was modest and the overwhelming majority of ratings remained stable throughout the quarter.

In terms of defaults and credit impairments, the bulk of activity is occurring in the non-rated and/or riskier sectors of the muni market, according to data compiled by Municipal Market Advisors, as has been true in past cycles. Of the USD 7.3bn of debt in actual payment default as of August 9, nearly 60% relates to bonds that were originally non-rated.

Portfolio strategies
While security selection is crucial to building muni portfolios given the significant changes to the muni market, including the reduced role of bond insurance over the last two years, our general portfolio recommendations include the following:

- **Consider profit-taking and rebalance overall portfolios.** Given the strong municipal market performance over the past 12 to 19 months, valuations on a significant portion of the muni market have risen, producing potential capital gains. Returns on the broad muni index by Barclays Capital are up 9.6% over the past 12 months and 18.9% since the height of the credit crisis in December 2008. Also, the AAA high-grade yield curve is at historic lows at various maturity points. This may afford investors an opportunity to capture gains and rebalance portfolios that may have drifted away from individual strategic asset allocation targets. We also suggest that clients with great concerns over headline risk (despite our view that there is little to suggest that widespread defaults are imminent) may consider reducing exposure given the recent technical strength of the tax-exempt market.

- **Upgrade sectors.** The lower rate environment has helped contribute to lower spread differentials between high quality and lower quality sectors in the tax-exempt market. We continue to advocate the high quality sectors of the muni market such as essential purpose revenue bonds in the water/sewer and public utility sector, special tax and full faith and credit general obligation bonds. In the relatively higher risk nonprofit health care sector, our outlook is cautious for the near to intermediate term given uncertainty surrounding the implementation of national healthcare reform along with a higher level of financial challenges resulting from the economic downturn. In this space, we target higher-rated credits that benefit from a substantial base of financial resources,

strong clinical reputations, established management teams and good disclosure practices. As expected, payment defaults are still concentrated in the riskiest segments of the muni market, specifically, land-based finance, multi-family housing and long-term care.

- **Reduce concentration to short maturities**. In our view, the earliest maturities on the muni curve are overvalued and may be trading at significant premiums. We continue to view the intermediate area as the best compromise between the attractiveness of earning extra yield by extending maturities given the steep tax-exempt yield curve, while limiting exposure to higher price volatility associated with longer-duration securities. Yields on AA and AAA high quality munis in the 7-year to 12-year range from 1.86% to 2.91% compared to below 1.00% on shorter-dated 2-year to 3-year munis. This maturity range has outperformed the other maturity buckets last month and year-to-date. (See Figure 5). When available, we prefer bonds with high-coupon structures as a way to increase current yields and provide some price protection against rising rates. Note that call risk is an important consideration.
- **For taxable fixed income buyers, consider BABs.** Taxable BABs offer value relative to Treasuries and Corporates as spreads have widened in recent months. (See Figure 6). Most BABs are long-duration securities and thus extend beyond our recommended maturity target for fixed income investors. However, they may be suitable for income buyers with long-term holding periods and who are not concerned about the higher degree of price volatility associated with long-term bonds. Incremental yield is offered in exchange for reduced liquidity relative to other taxable fixed income sectors. Security-specific risk factors, including federal subsidy risk and call provisions, are described in offering documents.

Figure 5: Muni total returns by maturity (%)

Intermediate segment has outperformed.

	July	YTD	Eff dur.
Municipal index	1.30	5.88	7.9
Municipals 1-3 Yrs	0.42	1.67	1.9
Municipals 3-7 Yrs	1.40	4.49	4.1
Municipals 7-12 Yrs	1.86	7.45	6.7
Municipals 12-22 Yrs	1.42	6.34	9.1
Municipals 22+ Yrs	1.23	7.10	11.6

Source: BofA/ML Indexes, UBS WMR as of 16 August 2010

Fig. 6 Taxable Build America Bonds (BABs) spot

BAB GO versus Treasury comparable spread (bps)

	10/10	15/10	20/30	25/30	30/30
AAA	+75	+135	+75	+85	+90
AA	+85	+160	+90	+100	+105
A	+215	+275	+225	+235	+240
BBB	+290	+355	+320	+335	+345

Note: BABs levels assume a make whole call feature.

Source: MMD as of 16 August 2010.

Credit updates

Moody's changes outlook on Puerto Rico to negative from stable

Moody's assigned a negative outlook to the Commonwealth of Puerto Rico's A3 general obligation (GO) bond rating on 10 August 2010, as well as to other Puerto Rico credits whose ratings are affected by the GO rating, including bonds supported by the Commonwealth's pledge to appropriate for payments, or bonds supported by its direct guarantee of payment. This development does not alter our stable opinion of Puerto Rico's credit profile as expressed in our report published 9 June 2010 for several reasons.

Moody's attributes the negative credit outlook to the weak funded status of Puerto Rico's pension funds. The pension funds have been notably underfunded for some time; we therefore do not consider this factor to be a new development warranting a change in our view. On a positive note, Puerto Rico previously indicated to the investment community that pension reform is among its more important long-term initiatives. While we concur with Moody's that economic and budgetary pressures may make it difficult for Puerto Rico to implement changes that materially impact the funded ratio, we consider this to be among the legacy issues facing the Commonwealth. Underfunded pensions, a high debt load, a high level of structural unemployment and chronic budget deficits historically have contributed to credit ratings that are well below the average of the typical U.S. state.

We believe that Puerto Rico has made a commendable effort to improve its fiscal and economic condition as it recovers from a recession that commenced in the fourth quarter of FY06 and works to address recurring budget deficits. Since 2009, Puerto Rico has implemented a series of difficult measures such as employee layoffs, reductions in operating expenses and tax increases to bolster its overall financial condition. Budgetary practices have improved, with actual revenues surpassing estimates in both FY09 and FY10, breaking the pattern of overestimating revenues to reconcile gaps. The approved FY11 budget of USD 9.1335 bn is approximately 19% below FY09 spending, a significant decrease. The FY11 structural gap is equal to roughly 11% of revenues, an improvement from a peak level of 45% in FY09. Puerto Rico targets a balanced budget by FY13.

There is clearly a wide split between Moody's A3 rating assessment of Puerto Rico's GO debt and S&P's BBB- opinion. Prior to recalibrating its municipal bond rating scale, Moody's rating was Baa3, equal to S&P's. The Moody's rating was elevated by three notches in April as an outcome of its recalibration process. The A3 rating is an all-time high for Puerto Rico despite the heightened level of fiscal stress locally, nationally and globally stemming from the economic downturn. S&P, which did not undertake a formal rating recalibration initiative, has maintained its considerably lower BBB- GO bond rating and stable outlook, having affirmed this position as recently as 15 July in a published report.

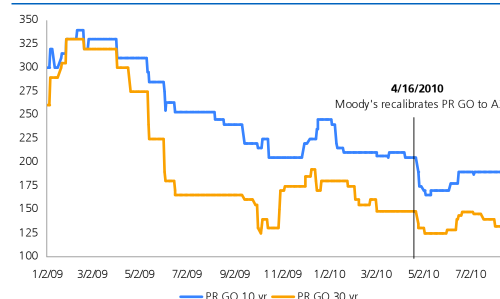
It would require a significant downgrade by Moody's to bring its rating on Puerto Rico's GO debt back in line with S&P's. We would not expect a downgrade of this magnitude to occur as a consequence of long-standing credit issues. In our view, fundamental credit factors influencing the rating such as the level of outstanding liabilities (both debt and pensions) have not changed, while the future budgetary and economic outlook remains challenged but appears to be improving. The main differentiating consideration that might be noted in the post-recalibration world is Moody's much higher rating of Puerto Rico and the challenges investors face in reconciling different approaches in rating methodology.

Additionally, pension reform can be influenced incrementally by a number of factors that might positively impact funded status over time. Unfunded public pension liabilities are amortized over a relatively long period and fluctuate significantly with the cycles in the financial markets. Stronger financial markets, therefore, would improve funding levels. We also expect the growing level of rating agency and investor scrutiny of pension funding status to support the political willingness to implement changes to benefit levels, the eligibility age for retirement or to make other adjustments to the various factors that determine the size of the ultimate payout to employees. Workforce reductions implemented as part of Puerto Rico's broader fiscal and economic recovery plan may also have been helpful to this effort. Puerto Rico has issued taxable pension obligation bonds (POBs) in the past to improve funded status. With taxable municipal rates low and a broader investor base for taxable municipals generally, perhaps further POB issuance will be part of Puerto Rico's solution. In light of the below average funding levels of Puerto Rico's pension plans, we will continue to monitor progress on this issue and its impact on the Commonwealth's overall credit profile closely.

Puerto Rico's GO bond credit spreads to Aaa/AAA general market levels narrowed by about 40 bps at the 10 year maturity and 23 bps at the 30 year maturity following Moody's rating recalibration on 16 April 2010. (See Figure 7). Spreads have since widened out from May lows by about 25 bps at the 10 year and 7 bps at the 30 year. At current levels (as of August 16), spreads on PR GO paper remain approximately

Fig. 7. Puerto Rico GO versus AAA general market spreads (bps)

Spreads narrowed modestly following recalibration.



Source: MMD Interactive, UBS WMR as of 16 August 2010

15 bps and 16 bps tighter at the 10 and 30 year maturities, respectively, than prior to recalibration. Given further expected issuance this year and the outlook change, we believe that some additional spread widening and pressure on bond valuations is possible.

For more information about the Commonwealth of Puerto Rico, please see our municipal credit report *"Credit profile: Puerto Rico"* published on 9 June 2010. We also discuss certain considerations regarding unfunded pension liabilities in a subsequent municipal report titled *"Credit thoughts amidst shaken confidence"* published 2 August 2010.

New York State closes the gap
It took 125 days after the initial deadline, but the New York State legislature finally adopted a budget for the fiscal year beginning 1 April 2010. The 125 day gap missed the previous record by 8 days. The budget features a combination of tax increases and spending cuts and notably does not rely on short term borrowing to finance the deficit. Revenues are raised primarily by ending the sales tax exemption on clothing and footwear purchases below USD 110 and reducing the value of charitable deductions for the wealthy. The budget also contains spending reduction provisions that would be triggered by the anticipated loss of some USD 1 billion in Medicaid funding from the federal government.

Passage of the measure ensures that the State's general obligation and annual appropriation debts will continue to be paid without further legislative action. Readers will note that debt service was paid in a timely manner through the enactment of regularly adopted emergency spending authorizations during the length of the negotiations. The willingness and ability to pay those debts on the part of the State legislature was never in doubt and as usual they took the actions needed to ensure payment regardless of the level of partisanship or rancor that accompanied these particularly contentious negotiations.

This action should reduce investor concerns about the repayment of the State's debts as well as the availability of funding for various state supported agency bond issues as well as aid to local school districts and funding under the State aid intercept support mechanism that supports their many outstanding bonds.

Illinois' GO Debt is Secure but Credit Profile Remains Strained
Illinois' persistent fiscal challenges, particularly over the past three budget cycles, contributed to negative rating actions at points from all three rating agencies, most recently in June 2010 by Moody's and Fitch. At current levels, the state's GO bond credit ratings of A1 by Moody's, A+ by S&P and A by Fitch are among the weakest of any U.S. state.

Budget solutions over this difficult period have relied heavily on nonrecurring measures including transfers from other state funds, the use of debt to finance current operations as well as annual pension contributions, and payment delays affecting areas other than debt service, such as payments to vendors, for example. The recently passed budget for FY11 closed an estimated USD 13 bn gap, equal to about 47% of budgeted general fund revenues, largely by relying on these types of initiatives. Possibly as a result of it being an election year, the lack of political willingness to implement structural changes to balance the budget appears amplified.

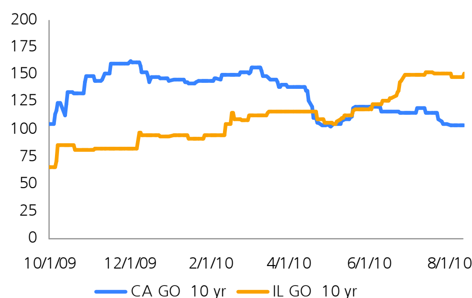
We consider certain centerpieces of the FY11 budget to be subject to uncertainty, setting the stage for further potential budget gaps ahead. These include a proposed USD 3.7 bn 8 year GO bond issue to finance the state's FY11 pension contribution which is still subject to legislative approval and the sale of a tobacco bonds in excess of USD 1.2 bn ten-

tatively scheduled for this fall. These items are in addition to the more customary concerns of revenues not achieving the level of recovery assumed, or spending reductions lagging targeted savings.

The state's 10 year GO bond credit spreads to 10 year AAA GO bond general market levels have widened by roughly 85 bps since October 2009, in comparison to credit spreads on 10 year California GO bonds, which are currently quite comparable to October 2009 levels. (See Figure 8). On 17 August, 10 year Illinois GO bond spreads were roughly 48 bps wider than the same maturity California GO bond, with 10-year Illinois GO's trading at a spread of 151 bps to AAA general market levels relative to California's spread of 103 bps at the same maturity.

Fig. 8. California and IL GO spreads versus AAA general market spreads (bps)

IL GO bonds cheapen while spreads on CA debt improve



Source: MMD Interactive, UBS WMR as of 16 August 2010

The state sold USD 1.3 bn of GO certificates in July that are scheduled to mature sequentially in April, May and June 2011. The emergency deficit funding notes were issued to address a portion of the state's FY10 payables outstanding in light of USD 6.5 bn of accumulated deficits from previous years being carried forward into FY11.

Longer term, growing liabilities bear monitoring, including a fairly high level of debt relative to U.S. peers and a low 50% pension funding ratio at the end of FY09 across its five retirement systems. On the first point, we feel that it is important to keep in mind that the state's net tax-supported debt, while rising, is affordable on an overall basis at 3.78% of gross state domestic product according to Moody's 2010 State Debt Medians Report published in May 2010. The FY11 budget projects total GO debt outstanding of roughly USD 27 bn, equal to about 75% of the aggregate state-authorized amount for GO bonds. The state's USD 31 bn, six-year capital program also includes significant borrowing but is excluded from this analysis as it is mostly supported by new revenue sources including gaming revenues, motor vehicle-related fees and taxes on alcoholic beverages and other products.

The state's GO-supported debt burden is largely driven by approximately USD 13.9 bn associated with the State's two pension obligation bond sales in FY03 and FY10, excluding the planned USD 3.7 bn sale for FY11. Total FY11 debt service of USD 1.605 bn attributed to both GO and state sales tax-supported Build Illinois bonds issued through March 2010 to total general fund and road fund budgets of USD 33.5 bn is equal to about 4.5% of spending for these funds. When factoring in the debt service associated with the FY03 and FY10 pension borrowings, this percentage increases to 8.51%, an above average amount relative to other state borrowers but still manageable. Other measures of affordability also remain supportive, with total debt per capita of USD 2,267 and total debt to state personal income of 5.45%, as reported in the Illinois State Budget for FY11. Nevertheless, pension obligation bond borrowing has clearly added significantly to the state's overall debt burden, responsible for nearly 50% of all GO debt outstanding.

Illinois approved pension reform legislation in March applying to future state employees which is expected to reduce unfunded liabilities, at least at the margins. It also introduced the five year "smoothing" of investment gains and losses into the net liability for the first time in FY09; previously a fair value approach was utilized. However, given the combination of Illinois' low funding ratio and challenges in meeting contribution targets, we expect increased scrutiny of the state's efforts to address pension funding gaps to be a focal point for investors and rating agencies going forward.

Illinois' credit ratings are currently assigned a stable outlook by Moody's, a negative outlook by Fitch and are on negative watch by S&P. We feel that further rating downgrades are possible unless the state begins to demonstrate its willingness to implement solutions that

may not be politically palatable but are otherwise necessary to arrive at a more structurally sound approach to addressing its persistent budgetary challenges and rising long-term liabilities. While we are certainly not dismissive of the significant obstacles facing the state ahead, we remain confident in its ability to meet its full faith and credit obligations even in periods of extreme fiscal stress.

Note, this section was extracted from WMR's previous municipal report, "*Credit Thoughts Amidst Shaken Confidence*", published 2 August 2010. For more information, please refer to the prior report.

Bond insurer update: FGIC bankruptcy

FGIC Corporation, the parent of bond insurer Financial Guaranty Insurance Company, filed for bankruptcy protection on August 3. The company attributed its decision to file for Chapter 11 to its inability to obtain any dividends from its principal operating subsidiary for more than two years. We do not believe that the bankruptcy filing by the bond insurer's parent will have any material impact on the underlying value of FGIC insured bonds as these securities have been trading based on their underlying credit quality for some time now.

As our readers may recall, approximately 90% of the FGIC book of insured municipal bonds was reinsured by National Public Finance Guarantee Corporation. The reinsurance contract included a cut-through provision whereby policy owners of defaulted obligations are permitted to submit their claims directly to National. National's website includes a user-friendly search tool whereby investors can determine whether their obligations have been reinsured.

Appendix

Terms and Abbreviations

Terms / 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

Table I: 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	08/03/2007	AA+	Stable	4/5/2010
Alaska	Aa1	Stable	4/16/2010	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	Stable	6/4/2010	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	03/10/2010	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	Stable	4/16/2010	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	Stable	4/16/2010	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

Table I: 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]
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-	Stable	5/22/2007			
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 16 August 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.

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.

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Appendix

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