



## The Municipal Market

After a very strong start to the year, market weakness prevailed for much of February and March. Despite the pullback, the Barclays Capital Municipal Bond Index had a positive return of 1.75% for the quarter. The market weakness during the latter part of the quarter was a result of two factors: increased issuance, which created significant supply, and a rate boycott by investors, which caused demand to slow. While issuance has risen quite sharply from last year, much of the issuance is coming from issuers refunding their higher cost debt as a result of yields nearing historic lows. The amount of supply going forward will likely be interest rate sensitive, helping to keep issuance levels in balance should rates continue to rise.

**Credit:** While the overall credit picture has improved for many municipalities, several concerns remain. Despite negative rating trends and declining federal and state aid, default rates continue to be extremely low. In more than 60 years, there have been less than 500 municipal bankruptcy petitions filed<sup>1</sup>. Moody's has reported that since 1970, there have been only 71 defaults on Moody's rated debt<sup>2</sup>. Defaults have been and continue to be concentrated within the non-rated space. State and local governments continue to implement a number of initiatives to adjust to current fiscal realities, such as reducing their workforce, addressing pension reform, increasing or implementing fees and taxes and even entering into shared-services agreements. In addition, municipalities appear less willing to take on new projects as tight budgets, slow revenue growth and conservative attitudes toward spending remain strong deterrents. With an aging infrastructure in this country, the risk is that municipalities are "kicking the infrastructure can" down the road. For now, this is helping municipalities to balance budgets, but it will

certainly have to be addressed in the future. Municipalities continue to make the necessary adjustments needed to maintain their credit worthiness. We believe that while there may be headline news about municipal bankruptcies, this will not become a systemic problem for the municipal market.

**New Issue Volume:** Increased levels of new issuance during the latter part of the first quarter have had a negative effect on the municipal market, as volume has increased 56% over the levels seen during the first quarter of 2011<sup>3</sup>. Much of this issuance has resonated from issuers refunding their higher cost debt. Municipal issuers continue to cautiously access capital markets to fund new infrastructure needs. The market experienced very low levels of issuance for much of last year providing a backdrop for exceptional performance, therefore the effect of elevated volume will need to be watched closely. Should municipal yields spike higher, refunding of existing debt will become less economically feasible, thereby slowing the level of issuance.

**Demand:** Strong investor demand has aided in the placement of the increased new issue calendar. Although, following almost 30 weeks of positive municipal mutual fund flows<sup>4</sup>, which are a good indicator of investor demand, demand is now slowing. The beginning of March through the middle of April has historically represented a weak seasonal period for municipals. In addition, volatile interest rates and a strong equity market have served as a distraction.

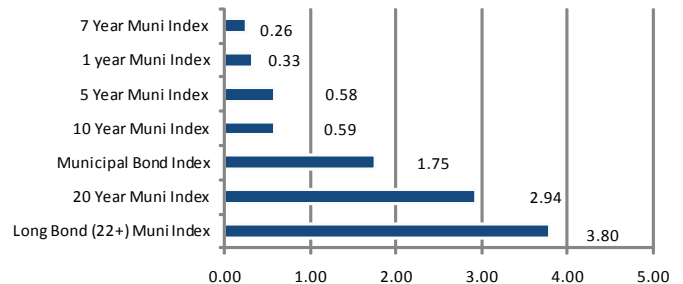


**Outlook:** As 2012 continues into the second quarter, the expectation is that tax revenues will improve, helping municipalities to strengthen their balance sheets following the prolonged recession. There will likely be little decided in Washington that will affect the relative value of tax-exempt income until after the November elections. There is the potential risk for higher interest rates as the economy improves, however municipal yields will typically move only a fraction of what yields for U.S. Treasuries and other fixed income asset classes experience. In addition, municipals are currently yielding more than similar maturing U.S. Treasuries, while offering a predictable stream of tax-exempt income, and principal protection. Therefore, we continue to believe that tax-exempt municipal bonds will continue to be an important asset class for clients with a goal of wealth protection and tax-exempt income.

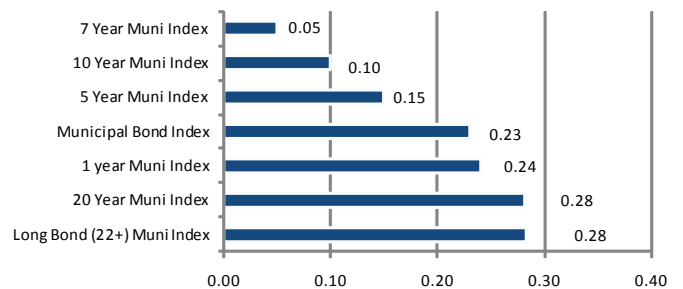
## Tax-Exempt Municipal Bond Team

	Investment Experience
Timothy Heaney, CFA	22 Years
Lisa Leonard	26 Years
John Catarius	3 Years

### First Quarter Fixed Income Sector Returns (Pre-Tax)



### First Quarter Fixed Income Return per Unit of Duration



Source: Barclays Capital

<sup>1</sup>USCourts.gov, Bankruptcy Basics, November 2011.

<sup>2</sup>Moody's Investors Service, March 7, 2012. Data covers the municipal long-term bond market over the period 1970-2011.

<sup>3</sup>Citigroup Global Markets, Municipal Market Comment, March 30, 2012.

<sup>4</sup>Lipper FMI, Robert W. Baird & Co., Municipal Bond Market Weekly, April 3, 2012.

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