Municipal market: Smooth sailing or rough waters ahead?

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After years of relative obscurity, the municipal bond market was thrust into the spotlight as we entered 2011. Negative headlines surrounding budgetary pressures, ballooning longer term pension liabilities and some notable analyst projections stoked fears of widespread municipal defaults. This was a big shock to many investors, who had historically viewed the municipal market as essentially riskless. Interest rates moved higher as investors fled the market. Although credit rating downgrades increased, defaults in relatively safe sectors of the municipal market (state and local general obligations, water and sewer bonds, and other essential service debt) remained very rare. The lack of new issue supply as we progressed through 2011 eventually helped stabilize the market.

As we enter 2012 and assess the status of the municipal market, we see four key investment themes for municipal investors:

> **Maintain a longer-term perspective** — Municipal bonds have generated strong long-term returns that rival many other asset classes.

> **Opportunities exist despite low rates** — The steep yield curve and wide credit spreads offer attractive value.

> **Credit research is essential** — Defaults should continue to be rare, but downgrades may create additional noise that leads to selling.

> **Watch for potential game changers** — Although we do not expect any immediate changes to the tax code related to municipal debt, changes to the tax exemption could dramatically alter the landscape. In addition, massive federal spending cuts could negatively affect credit quality.

**Long-term perspective reveals compelling relative returns**

There is no questioning that municipal market volatility has increased in recent years. The loss of bond insurance, investor deleveraging brought on by the financial crisis of 2008 and fears of wide-scale defaults have all contributed to heightened market volatility. Although the upward shift in volatility is difficult for many market participants to absorb after years of little to no volatility, it is important to remember that the municipal market has produced some of the strongest taxable-equivalent returns in comparison to any other asset class (see Exhibit 1).
Over the past five years, the Barclays Capital Municipal Bond Index generated an annualized taxable-equivalent return of nearly 7.8%, which was the largest taxable-equivalent return of any major market index, including U.S. Treasuries, equities and taxable fixed income. The return for each unit of risk, as measured by the Sharpe ratio, was also one of the highest of any market during that same five-year time period. On a 10-year basis, the risk-adjusted returns of municipal bonds beat nearly all other markets; annualized taxable-equivalent returns were around 8% with less than 5% annualized standard deviation in returns (see Exhibit 2).

Source: Barclays Capital, as of November 30, 2011
Past performance does not guarantee future results.

* U.S. Treasury income is exempt from state income taxes and is adjusted (3.25%) using a national state average (top bracket), net of federal income tax.

** Based on an equally weighted national average federal and state (top bracket) income tax rate: 38.45% before 2009, 38.48% in 2009, and 38.78% in 2010 and 2011; local taxes have not been considered. All excess returns are based on 3-month Tbill returns.
We believe that maintaining a longer term perspective on the municipal market’s performance and its relative stability is important as the market experiences more frequent periods of disruption. While the equity-like returns that occurred in recent years are unlikely to be repeated, in our view, municipal bond returns over a longer period of time should be relatively stable and a meaningful component of any portfolio.

**Climbing the yield curve and reaching for lower quality has value**

It is hard to get excited about buying bonds with rates at historic lows. With rates going nowhere but higher eventually, investor unwillingness to commit to today’s fixed-income markets is understandable. Yet, the cost of sitting in cash can be significant if rates remain low for an extended period. Based on current rates and assuming a one-year investment horizon, interest rates would have to increase by more than 60 basis points for the loss in value on a five-year bond to eliminate the income contribution. Beyond this basic analysis, the market is currently offering two ways to attain higher yields — duration and credit — and both come with risks. We think a moderate combination of the two offers a compelling option given wide credit spreads and a very steep yield curve.

**Exhibit 3: Yield spread between 2–10 year AAA rated municipal bonds** (basis points)

<table>
<thead>
<tr>
<th>Year</th>
<th>AAA</th>
<th>AA</th>
<th>A</th>
<th>BBB</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>0.0</td>
<td>0.5</td>
<td>1.0</td>
<td>1.5</td>
</tr>
<tr>
<td>2007</td>
<td>2.0</td>
<td>2.5</td>
<td>3.0</td>
<td>3.5</td>
</tr>
</tbody>
</table>

Source: MMD, as of November 30, 2011

Since fewer investors are willing to invest in lower quality investment-grade bonds (single A and BBB rated), sophisticated investors can take advantage of attractive spreads without too much credit exposure. For example, the yield on a AA-rated state bond maturing in 11 years was 2.71%. Without reaching too far down the credit curve, an investor could have earned around a 3.98% yield on an 11-year bond issued by an A-rated health network in that state.

It is important to understand the short-term volatility that comes with a strategy like this, especially given the expected increase in the number of lower investment-grade credits resulting from credit rating downgrades. Although spreads may be slow to tighten due to the potential increase in outstanding A- and BBB-rated bonds, above-average yields provide some compensation. Exhibit 4 shows how the return volatility of single A and BBB-rated bonds diverged from higher quality bonds in 2007 and remains higher today.

**Exhibit 4: Annual return volatility**

Source: Barclays Capital, as of November 30, 2011

The yield curve is steep largely because the front end is anchored by the Federal Reserve’s accommodative policy. All rates are expected to move higher once tightening commences. However, the relative magnitude of rate
increases in longer maturity bonds is likely to be more muted than in shorter maturity bonds. Since municipal yields across the maturity curve currently exceed U.S. Treasury rates and are relatively cheap historically, we believe municipal bonds are likely to outperform Treasuries as rates rise. (Credit ratings typically range from AAA (highest) to D (lowest) and are subject to change.)

Bonds in the intermediate part of the curve (10-15 year maturities) with lower credit ratings are an attractive alternative without greatly increasing duration. In addition, we believe inflation will occur alongside economic improvement, which should benefit many of these lower rated credits, potentially offsetting price declines as yields increase. This strategy relies heavily on security selection and analytical resources to identify opportunities that can enhance fixed-income returns in this very low rate environment.

Credit research can help navigate downgrade noise

Although predictions of widespread municipal defaults in 2011 were proved wrong, negative headlines related to government budgets continue to dominate the news. Rating agency downgrades outnumber upgrades, and there has been an increase in the number of so called “super downgrades,” where ratings are dropped at least three notches. Multiple notch rating moves highlight how difficult it is for rating agencies to maintain updated ratings in a market with thousands of issuers, especially in this environment.

We continue to believe that budgetary pressures are significant and will result in further credit rating downgrades. In 2010, two of the largest ratings agencies mechanically recalibrated their ratings, mostly higher, based on historical default rates. This upward recalibration amplified the number and magnitude of downgrades that would have naturally occurred in a recessionary environment. Therefore, while we believe independent credit research can reveal opportunities and expose potential risks in a large, disaggregated market like the municipal market, we cannot ignore the damage that rating shifts have had on the retail investor psyche, which may result in heightened volatility.

The spread of single A and BBB-rated municipal bonds remains wider than historical averages in most sectors due, in part, to the massive increase in issuers now falling into these rating categories as they have lost bond insurance. Further credit downgrades into these categories may prevent tightening and may even widen spreads if the effect is large enough. As we have seen in the past, a greater supply of bonds in a certain area of the market can add volatility, creating selling pressure and spread widening. As such, the market can be very technical and dependent on net cash flows to determine market yields. We encourage investors to stay the course, given current attractive yields relative to other fixed-income investments and use any potential market disruption as an opportunity to lock-in above-average yields.

Game changers

It is always difficult to predict implications of legislative changes, but the current political environment has made it almost impossible. However, federal budget negotiations could potentially change the rules of the game, or at least create a more difficult operating environment in two ways.

> Tax reform. Various tax reform proposals on the table could affect the tax exemption of municipal bonds. Given significant public discourse surrounding the municipal tax exemption, it appears increasingly likely that some type of change is inevitable. Common sense would argue for adoption of more moderate alternatives, such as some type of curtailment of who can issue tax-exempt bonds. However, there are extreme proposals calling for either complete dissolution of tax exemption or partial taxation of municipal bond interest, as proposed in President Obama’s jobs bill. These cannot be completely discounted.
Assuming outstanding bonds are grandfathered in any legislative change, the loss of tax exemption on new issuance would immediately create a scarcity, making all outstanding tax-exempt bonds very valuable. On the other hand, if municipal bonds lose a portion of their tax exemption, the market may require an adjustment to higher rates, partly to compensate for a reduction in the attractiveness of municipal bonds. The magnitude of increases is debatable, especially since current market rates already assign limited value to the exemption. Of course, municipal bonds would become even more attractive if existing tax cuts implemented by President Bush are allowed to expire and the tax exemption remains in place. We believe changes to the tax-exempt market are likely to be an issue dealt with in 2013, following the next presidential and congressional election.

**Federal government cutbacks.** Hospitals and other health care organizations will feel operational pressure if Medicare and Medicaid reimbursements are cut deeply. Affordable housing projects would be negatively affected by further capital grant funding cuts and/or housing subsidy reductions. Defense cuts could affect those areas of the country that have overly concentrated military or defense contractors. Of course, significant across-the-board cuts that slow economic growth would ripple through most sectors of the market. While many credits maintain inherent strengths that have proven out through the most recent recession, credit pressures would increase in another economic downturn.

The municipal market has become much more difficult to navigate in recent years, but this does not mean it should be ignored altogether. While volatility is likely to remain elevated over historical levels, investors who prudently manage credit risk and employ strategies to take advantage of short-term disruptions are likely to see stable returns in an asset class that has proven its worth and investment credibility over longer periods of time.

There are risks associated with fixed income investments, including credit risk, interest rate risk, and prepayment and extension risk. In general, bond prices rise when interest rates fall and vice versa. This effect is more pronounced for longer-term securities.

Standard deviation is a measure of the dispersion of a set of data from its mean. The more spread apart the data, the higher the deviation. Standard deviation is calculated as the square root of variance.

The Sharpe ratio measures risk-adjusted performance. The Sharpe ratio is calculated by subtracting the risk-free rate - such as that of the 10-year U.S. Treasury bond - from the rate of return for a portfolio and dividing the result by the standard deviation of the portfolio returns.
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