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Tax-exempts see spreads narrow in the first half

According to spread data compiled by BofA Merrill Lynch, each tax-exempt sector (excluding tobacco) saw spreads tighten in the first six months of 2010. High-yield sectors were buoyed by investors stretching for yield in lower-rated credits. For example, spreads to AAA Munis tightened by 31 basis points in the single-family housing and airport sectors, tax-exempt hospitals (following healthcare reform) and industrial development / pollution control revenue sectors issuers tightened by 29 and 28 bps, respectively. Demand for high-grade sector issuers (general obligations and essential services) were boosted by Moody's and Fitch's recalibrations that resulted in thousands of rating upgrades this past April and May. As we've commented in the past, we believe that solid municipal credit evaluation and guidance – that we offer – can help investors exploit value opportunities.

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Trader's View

Municipals within the 6-to 15-year maturity range began a strong rally in the second half of June to reverse weakness earlier last month. According to data from Thomson Reuters, the 10-year AAA Muni/Tsy ratio at 86.9% is a significant improvement from levels that had been as high as 94.9% (as shown in the table on page 2). So far in July, we continue to see resilience of high-grade tax-exempts against the decline of ratios to Treasuries, to some of the lowest yields of the past year. Reinvestment cash, thin dealer inventories and relatively light primary market volume have supported a continuation of Muni out-performance versus Treasuries over the last several weeks, with higher-quality names getting attention. We continue to view the middle range of the curve (15-year range) as most attractive to value players.

AAA Muni Yields as Percent of US Treasury Yields

Muni/Treas	4/16/2010 to 7/12/2010					7/13/2009 to 7/12/2010			
	CURR%	AVG%	#SD	MAX%	MIN%	AVG%	#SD	MAX%	MIN%
1 yr / 1 yr	107.1	97.5	1.12	116.0	75.7	92.2	1.07	129.6	60.9
5 yr / 5 yr	78.8	78.2	0.11	88.3	67.6	71.1	1.09	88.3	57.7
10 yr / 10 yr	86.9	86.6	0.06	94.9	78.0	82.9	0.89	94.9	74.6
15 yr / 15 yr	92.7	89.0	0.72	98.5	80.7	86.0	1.33	98.5	77.8
20 yr / 20 yr	97.4	93.2	0.88	102.5	85.7	90.9	1.27	102.5	82.1
30 yr / 30 yr	98.5	95.2	0.76	103.4	87.5	95.2	0.58	107.8	86.0
Max = Muni Cheap to Treasury					Min = Muni Rich to Treasury				

Source: Thomson Reuters as of 7/12/2010

How Financial Reform May Affect Regulation of Munis

At the time of writing this commentary, Senate Democrats had secured the 60 votes needed to push through the most significant changes to financial regulations since the Great Depression. On June 30th, the House passed the conference bill by a vote of 237 to 192.

While key provisions of the legislation could take about a year to implement, should President Obama sign the measure into law, it would dramatically change the regulation of the municipal market and seek to further elevate the importance of municipals as a priority of the SEC. With regard to derivative transactions, the Commodity Futures Trading Commission (CFTC) would author registration rules and standards of conduct for swap dealers and participants in the municipal market. The legislation would also mandate that most swaps (those that are entered into by financial entities) be centrally cleared and more rigorous margin and collateral posting requirements would be imposed on non-centrally cleared swaps.

Additionally, the framework of the Municipal Securities Rulemaking Board (MSRB) would be changed. The board would need to be mostly comprised of public officials, rather than market participants, and the number of board seats (currently 15) could increase. Furthermore, the MSRB would be given authority over non-dealer financial advisors, such as swap advisors and guaranteed investment contract brokers. Beginning October 1st, the MSRB would gain the authority to create rules and change its framework to put greater focus on the fiduciary responsibilities of market participants, and develop requirements for compliance examinations, testing and continuing education of advisors. The legislation also provides for the ability to collect a portion of fines the SEC and FINRA charge dealers or financial advisors for violations. In summary, the sweeping legislation is aimed at tightening industry standards related to derivatives, and putting a priority on the “financial duty” of advisors to their clients.

States Go to Great Lengths to Protect Market Access, Build Investor Confidence

Despite the well-publicized financial and budgetary difficulties facing many states, all have gone to great lengths to protect their access to capital markets by maintaining debt service on their bonds (see the Bloomberg article published this week). Albeit states are cutting funding for public services, laying off workers, and delaying vendor payments, investors have been getting paid on time. We think this speaks directly to the importance that states place on their general obligation debt and preserving market access. As we've said in the past, while state GO bonds have the potential to experience spread widening over the next 12 to 18 months, we don't foresee debt payment defaults at the state level.

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