The United States federal government takes center stage this month as the budget standoff in Congress led to the first shutdown of the federal government since 1996. A long term government shutdown would likely be detrimental to our economy, having ramifications across all markets, municipals included. Concerns over the necessity to raise the debt ceiling further complicate the matter as failure to raise the debt limit could result in a default on US debt for the first time in the history of the United States.

Debt Ceiling will be reached October 17th

The last time the debt ceiling talks came to an impasse in summer of 2011, the US government was downgraded by S&P from AAA to AA+ while Moody's kept the Aaa rating but assigned a negative outlook. Only this summer (two years later) did both agencies adjust their outlooks on the United States back to stable from negative. S&P has recently released a report stating that the current debate is unlikely to change their rating on the US government as this kind of politicking is incorporated and, in fact, a main driver of the US government's current AA+ status. However, S&P also acknowledges that failure to raise the debt ceiling and subsequently defaulting on the debt is not part of their "base-case assumptions". If a default occurs, the US would be rated "SD" for selective default and it is unclear what the sovereign rating would be once the delinquent principal and interest are eventually paid. Moody's has released a report stating current events in Washington are unlikely to affect the sovereign's rating and that they do not believe the US government would allow for a default to occur. Moody's also argues that even if the debt ceiling was not raised, the US would continue to make interest and principal on Treasury debt. Again, there has been much speculation in Washington that the President could intercede and unilaterally raise the debt ceiling citing powers in the 14th Amendment. While President Obama's administration has stated that they did not believe that was legally within his powers, the Senate has discussed proposing a bill that would empower the President to act unilaterally to raise the debt ceiling.

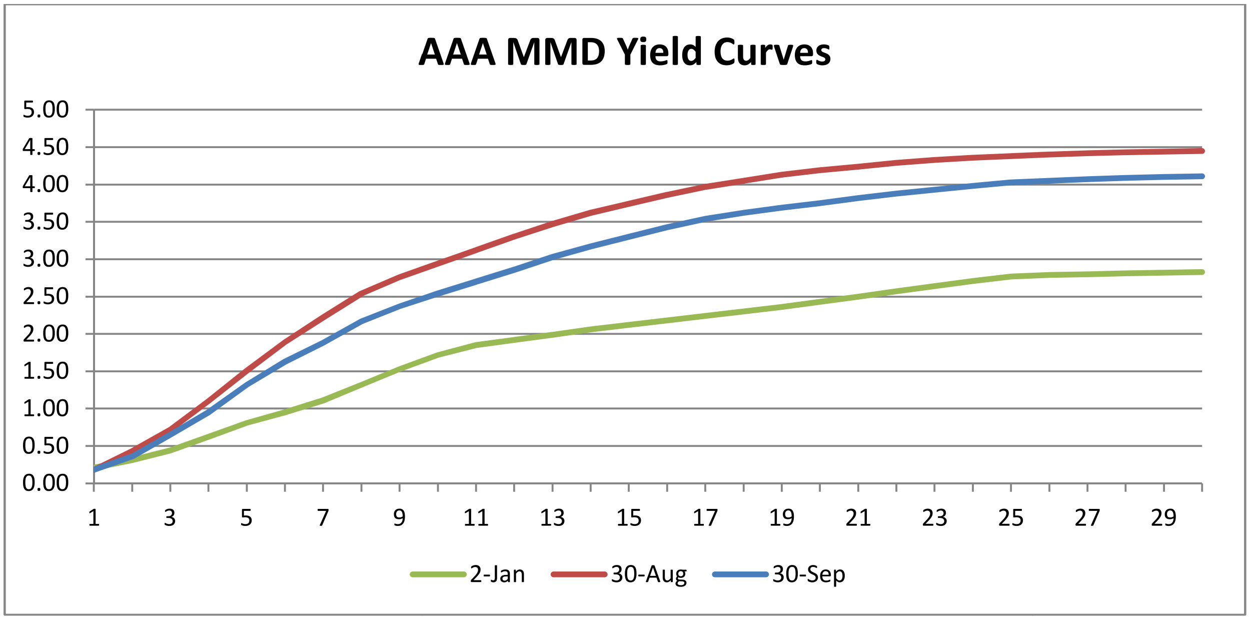
In addition to having larger negative economic implications, the last time the US government's sovereign rating was downgraded several municipal bonds were downgraded in tandem. These credits had either direct linkages to US government debt (i.e. housing and agency debt) or indirect links such as cities or states that derive a large part of their economy from US government presence (i.e. military base or general proximity to Washington, DC). Mindful of the past implication of the 2011 downgrade, we have re-evaluated our credits with close links to the US government in anticipation of this current round of debates in Congress and ongoing impasse.

TRADING MARKETS

No taper surprised the market

The municipal bond market was surprised in September when the Federal Reserve decided to maintain the current monthly $85 billion bond purchase program. After Chairman Ben Bernanke mentioned the word 'taper' in a speech earlier this summer, it was widely assumed by many market participants that the Fed would reduce the amount of bonds purchased even though economic fundamentals continue to be weak. The announcement by the Fed contributed to a fixed income market rally toward the end of the month which was further fueled by a reduction of municipal bond fund outflows and one of the lightest September issuance since 2001. As September wore on, the undervaluation of the muni market lead to performance by high quality GO and revenue bonds. Lower rated credits were closely behind, buoyed by the recovery of Puerto Rico credits coming back down under a 10% yield and a rapid compression of spreads in the A rated and BBB rated sector.

The end of the September saw inflows into long-term and high yield funds and the NAV of some of the larger mutual funds increased. However, there was a noticeable slowdown of large transactions on the longer end of the curve as high quality names trading above 5.0% began to disappear. Cross-over and individual buyers looking for the real high yield of tax-exempts and individual buyers enjoying north of 9.0% taxable-equivalent yield have kept a lid on higher rates. We believe municipal bond market continues to be attractive as the yield curve continues to be steeper compared to historical averages.



Source: MMD

As we head into October, the market is focused on Washington while the government shutdown over the budget continues. Since the last standoff over the debt ceiling debate was just a few short years ago, many market participants believe a resolution will be reached and that no default on our US Treasury obligations will occur. Historically, October performance in the municipal market has been on the weaker side. However, with continued lower supply and cash coming back to the market, we expect to see a firm, range-bound market in the near future.

CREDIT MARKETS

Puerto Rico's Wild Ride Continues

Puerto Rico continues to make headlines in the municipal market. At the beginning of October, Moody's and S&P affirmed the Commonwealth's general obligation rating one notch above junk at Baa3/NEG and BBB-/NE, respectively. However, Moody's did lower the senior lien on the COFINA (sales tax supported debt) by two notches to A2 and assigned a negative outlook. Puerto Rico has passed legislation to increase the sales tax increment dedicated to COFINA, within the existing 5.5% rate structure, from 2.75% to 3.50%. This additional COFINA increment is to be securitized as a third lien on COFINA revenues and is estimated to bring in an additional $2.285 billion that would be used to fund operating expenses, balance the budget for the next two fiscal years and repay debts to the Government Development Bank. Puerto Rican government officials point to the constitution of the Commonwealth as security for bond holders, as it gives the Commonwealth the authority to "claw-back" revenues from various agencies to pay general fund obligations. While it has been widely interpreted that monies dedicated to COFINA would not be subject to the claw-back provisions, in a recent presentation to the Municipal Analysts Group of New York, the President of the Senate of Puerto Rico, Eduardo Bhatia, stated the Attorney General of Puerto Rico would soon release an opinion on the matter.

As we wrote in our September commentary, the credit concerns come from a variety of economic and fiscal issues facing Puerto Rico. The island territory entered into a recession long before the mainland United States; it has been hit harder and continues to struggle to recover. Unemployment has ticked up again slightly and is significantly higher than the U.S. at 13.9% in August. Average income levels (indication of poverty levels) remain well below 50% of the U.S. median while population has slowly declined, down by 3%, since 2005. At the end of September, the Government Development Bank of Puerto Rico released its Economic Activity Index which showed economic activity had declined 5.4% in August.

We continue to emphasize that Puerto Rico is a unique outlier in the municipal credit space. Years of slow growth and structurally unbalanced operations have plagued the Commonwealth's economy and financial health. There is speculation that the United States federal government could intervene and assist the Commonwealth, especially now that it is facing the prospect of limited market access and that according to Morningstar, about 77% of US mutual funds hold some sort of Puerto Rico debt. The President's Task Force on Puerto Rico, established under the Clinton Administration, shifted its focus to strengthening the fiscal situation and economic outlook of Puerto Rico and is working closely with Governor Padilla's administration to make sure that "federal resources are fully utilized for maximum impact for the people of Puerto Rico". That said, it is still considered highly unlikely that the US government would take a more direct active role such as offering a bailout or buying Puerto Rico's debt.

Detroit's Defaults and Secures Aid

The city of Detroit officially defaulted on $600 million of its general obligation bonds on October 1st, prompting S&P to lower the city's GO rating to 'D'. Most of the defaulted debt was insured and the insurers have indicated they will make timely payments to bondholders. The Emergency Manager, Kevyn Orr, classifies the city's general obligation as unsecured, a matter that is expected to be widely contested in bankruptcy court. The next hearing on Detroit's Chapter 9 bankruptcy petition is scheduled for October 23rd when the judge will hear objections to Detroit's legal right and eligibility to be in bankruptcy. Prior to that, however, Michigan Governor Rick Snyder will be deposed on October 9th regarding the city's move to file for bankruptcy which may give some indication as to how the court is leaning.

Some good news came for Detroit in the last week of September when the Obama administration proposed almost $300 million in federal and private aid to help Detroit work toward fiscal recovery. They have indicated the aid would be used to redevelop blighted areas, improve transportation systems, overhaul city management systems and bolster the police force. While the Administration has stated there may be additional aid, the $300 million is a small fraction of the city's current bankruptcy claim of $18 billion outstanding liabilities.

CONCLUSIONS

As October moves along, the municipal bond market remains in a "wait-and-see" mode. Lower trading volumes indicate market participants are waiting to see how the crisis in Washington is resolved. While the U.S. House of Representatives and the President battle out it out over the budget and debt ceiling talks, one piece of certain information has emerged. Federal Reserve Vice-Chairwoman, Janet Yellen, has been nominated to succeed Chairman Ben Bernanke when his term ends in January. Ms. Yellen is considered to be a dove and has been an ardent supporter of the Fed's current stimulus policy. It is widely expected her nomination hearings will go smoothly and her transition to Chairwoman will mean a continuation of current Fed policy. We expect this will help stabilize the municipal market in the coming months, which may be a welcome relief from the recent volatility. We continue to focus on credit as it has become a driving factor in the space. Detroit could have long term ramifications as important issues such as priority of payments to pensioners versus bond holders are argued in court. The market is also watching Puerto Rico for an indication of what might happen when a state must take steps to re-structure its debt (states are not allowed to enter into Chapter 9) as they continue to attempt to fix their financial woes. Despite the negative headlines on these two large issuers, MMA recently released a report stating they believe that 2013 will see fewer than 75 municipal issuers defaulting for the first time. This would be significantly lower than default activity for the last four years which indicates even the smaller, more esoteric municipal bond issuers are gaining solid financial footing post-recession. As municipals continue to outperform treasuries with strong credit fundamentals, we continue to believe that this is a great time for investors in the municipal sector.

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