

## Market Overview

Treasury yields increased sharply in May as some data suggested the economy might be approaching a bottom. Investors grew more comfortable with risk, which reduced their appetite for treasuries. The heavy supply of government borrowing also added to upward pressure on yields. In contrast, municipal yields were almost unchanged for the month reflecting solid demand from investors and the positive impact of the Build America Bond (BAB) program. As noted in last month's newsletter, the BAB program is redirecting a significant portion of new municipal issuance from the tax-exempt market to the taxable market. This has eased supply pressure in tax-exempts, especially in longer maturities. As a result the ratio of taxable and tax-exempt yields has returned to more normal levels.

## Spotlight on Municipal Bond Credit Quality

### *Historical Default Rates Extremely Low*

Budget woes faced by state and local governments as they prepare for FY2010 have received extensive press coverage, prompting investor questions on the credit quality of municipal bonds. The strong credit quality of municipal bonds is evidenced by their consistently low historical default rates, in times of economic growth and in recessions. In its 2002 municipal default report and 2006 update covering the period between 1970 and 2006, Moody's found the cumulative default rates for all investment-grade municipals was .07%, compared to .52% for Aaa-rated corporate bonds alone.

This excellent record of bond repayment rests on the unique nature of municipalities. Municipalities tend to be **monopolistic** providers of essential services, shielded from competition. **Taxing power is legally enforceable by bondholders** for repayment of general obligation debt. Municipal operations **require ongoing access to capital markets**, making debt service a high priority. Municipalities are **perpetual** in nature, rarely going out of business. These factors will continue to support credit quality through the current downturn.

## Tough Fiscal Challenges at State and Local Levels

### *Overall Municipal Debt Burden Remains Manageable*

Without question state and local governments face extreme budgetary imbalances going into the 2010 fiscal year. Thirty-eight states are experiencing revenue shortfalls from original projections. Sales, personal income and corporate income taxes through first quarter 2009 were 6.1% lower than last year. At the same time, greater demand for social services has driven increased expenditures. Year-end fund

balances, after peaking in FY2006 at \$69 billion or 11.5% of expenditures, are projected to be 5.5% of expenditures at the close of FY2009. Similar challenges exist at the local level where property tax collections have decreased or failed to keep pace with expenditures. State and local governments face tough choices to balance FY2010 budgets as mandated by law in virtually every state.

However, tough fiscal challenges do not imply default. Breckinridge remains confident in the ability and willingness of the vast majority of municipalities to make timely debt service. State and local debt levels remain manageable. Municipal debt as a % of GDP has held steady for 40 years even as corporate and household debt grew dramatically. Borrowing restraint is due largely to state constitutional restrictions on municipal debt and federal restrictions on tax-exempt subsidies. Additionally, debt service currently accounts for 7-8% of municipal expenditures for high-grade bonds and is given priority to preserve access to capital markets. With manageable debt levels and prioritized debt service, we believe credit quality remains strong for most municipalities.

## A Closer Look at California

### *Debt Service Carries High Constitutional Priority*

California faces a well publicized \$24 billion budget deficit spanning its 2009 and 2010 fiscal years. In a May 19 referendum, voters rejected five budget-related propositions, which in part would have authorized bond issues to shrink the deficit. Over the long term, this type of voter-imposed budget discipline protects creditors. In the short term, difficult budget decisions lie ahead, and rating trend actions and downgrades are not out of the question.

We believe, however, that principal and interest payments are not in jeopardy. Debt service in California carries a very high constitutional priority – second only to K-12 education expenditures. Debt service is a moderate 5.4% of FY2009 expenditures. While the overall debt load is slightly above the median for all states, it is still a manageable 4.5% of personal income.

## Credit Surveillance

On an ongoing basis, we analyze the economic stability, debt burden and underlying monopolistic qualities of municipalities. Our review process is an important part of our decision to sell bonds that no longer meet our credit parameters. Bond sales this year include a number of smaller private universities, and bonds backed by sales tax receipts and tax allocation deals. Breckinridge remains committed to fundamental credit analysis, opportunistic trading and above all, preservation of capital.