

## Cautionary Signs Persist in State Finances

### Market Overview

#### *Riskier Assets Outperform in Third Quarter*

Fixed-income markets performed well during the quarter as Treasury yields declined and yield spreads on both taxable bonds and tax-exempt bonds significantly narrowed. Yield curves flattened as yields of longer maturities declined more than shorter maturities. The primary driver was the movement of cash out of low-yielding money-market funds in the quest for higher yielding investments.

We are seeing some positive effects from the federal government's extraordinarily accommodative policies. Financial markets appear to have stabilized, interest rates remain low and investor fears have subsided. As a result, riskier financial assets are being rewarded.

Third-quarter fixed-income performance reflected this shift in sentiment as lower quality and longer maturity bonds outperformed high-quality bonds. The flight to quality that dominated the market late last year and early in 2009 has dissipated and risk-taking is now well rewarded.

#### *Reason for Caution*

While the financial markets appear to have stabilized, economic data remains mixed. High unemployment, high consumer and government debt, and the reluctance of banks to resume lending pose significant impediments to a strong economic recovery. State tax-receipts data present additional concerns regarding the prospects for a strong recovery. The financial condition of the states has many implications for the municipal bond market going forward, which we present in **The State of the States** section of this newsletter.

### Tax-Exempt Market and Strategy

#### *Yield-curve flattening favors barbelled structure*

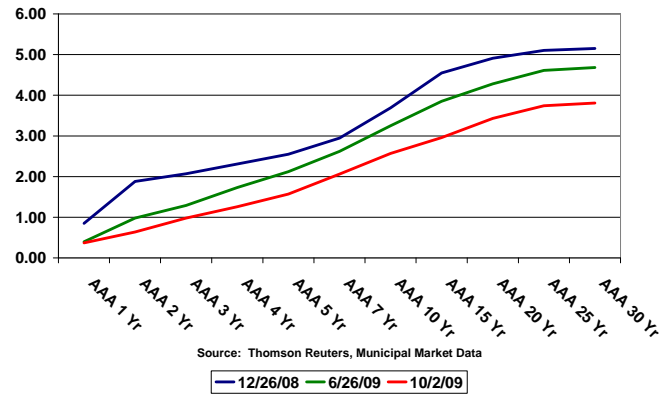
Tax-exempt municipal bonds posted strong performance during the quarter, outperforming taxable bonds. The outperformance was primarily a result of reduced supply combined with increased investor demand.

Demand was driven by two major forces: the search for higher yields as money-market fund yields dropped close to zero and the growing perception that income taxes will increase in 2010. In fact, higher taxes are a growing reality as many states already are increasing their tax rates, which should help sustain tax-exempt demand.

As we discussed in last month's newsletter, the supply of tax-exempt bonds has declined – especially in longer maturities – due to increased issuance of Build America Bonds. Decreased supply combined with higher demand has had a significant positive impact on the valuations of longer maturity tax-exempt bonds.

Our tax-exempt portfolios were well positioned for the yield-curve flattening that occurred in third quarter. In anticipation of a flatter yield curve, we have been targeting a barbelled structure that emphasizes short and long maturities. Shorter maturities provided protection against inflation while longer maturities preserve returns in times of deflation. Additionally, a barbelled structure offers better risk-adjusted returns in a yield-curve flattening environment than a bullet structure.

**Municipal Yield Curve**

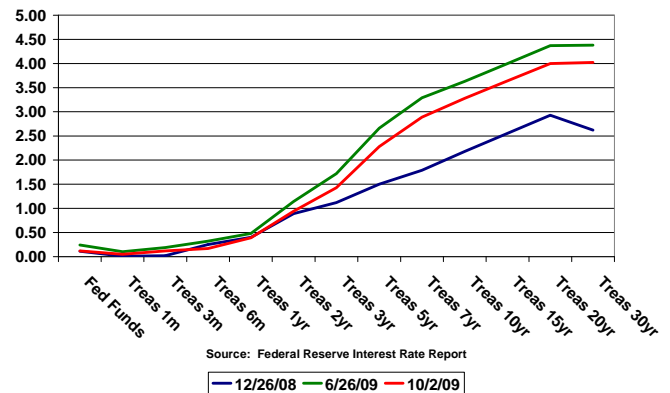


### Taxable Market and Strategy

#### *BAB acceptance drives outperformance*

Taxable municipal bonds also participated in the outperformance as investor acceptance of BABs increased. We continue to target a barbelled structure and are still emphasizing higher quality bonds. In general on a relative-value basis, taxable municipals still offer higher yields than comparably rated corporate bonds. Yield spreads on both corporate bonds and agencies have significantly narrowed. As a result, we are targeting a lower exposure to these sectors until spread relationships change.

**Treasury Yield Curve**



### The State of the States

#### *More challenges ahead in FY2010*

Following a tumultuous 2009 fiscal year, state finances will see little respite in fiscal year 2010, which began on July 1<sup>st</sup> for most state governments.

## *Cautionary tax-receipt, budget and fund-balance data*

Preliminary data collected by the Rockefeller Institute of Government for the second quarter indicate that total tax receipts fell 19 percent compared to the same quarter in the prior year. Personal income-tax collections fell an estimated 28 percent and sales-tax revenues fell 11 percent. Consequently we continue to closely monitor revenue bonds backed solely by a stream of tax receipts, especially sales taxes.

On the expenditure side, high unemployment and related economic conditions typically increase demand for public services at the state level. In particular, Medicaid expenditures, already a significant portion of most state budgets, are likely to increase.

State and local governments are struggling to balance their budgets, as legally required, in the face of lower tax revenues and increasing expenditures. The Center on Budget and Policy Priorities reports state budget shortfalls for FY2010 total \$168 billion. States are taking a number of steps to address the shortfalls such as increasing taxes, using federal stimulus funds, cutting services and dipping into reserves.

Fund balance levels stood at 5.5 percent of expenditures at the end of FY2009, which is close to historical averages. However, many states have seen their financial cushions

narrow. A survey by the National Association of State Budget Officers reveals 26 states with fund balances equal to or less than 4.9 percent of expenditures, including eleven states with fund balances at less than 1 percent of expenditures.

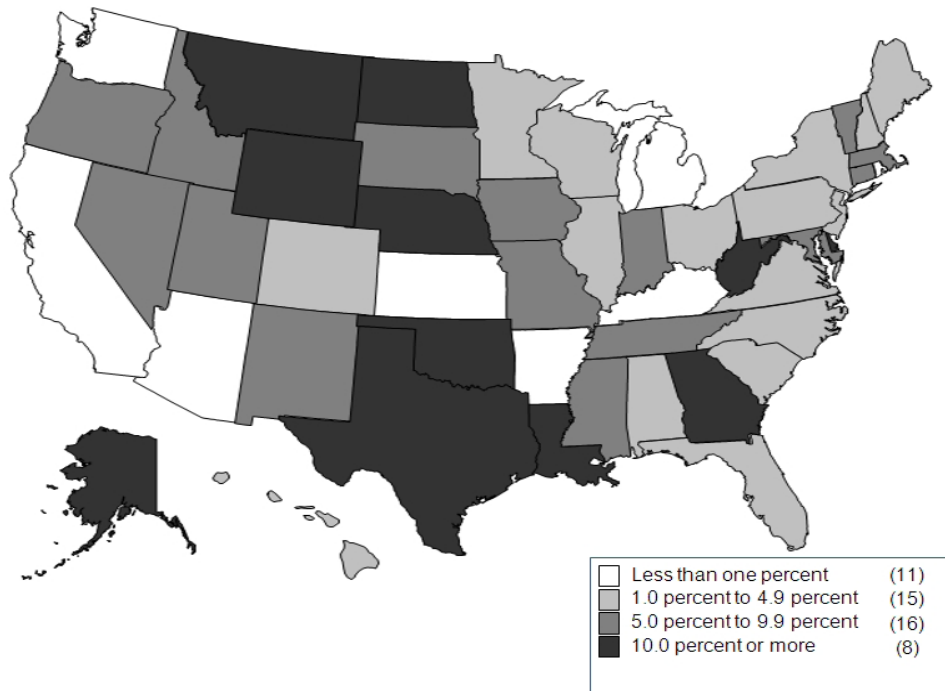
## *Additional headline risk in FY2010*

Although many economists believe the U.S. recession has ended, state and local revenues tend to lag improvements in economic activity. Steep job losses will limit state income-tax receipts. Restrained consumer spending due to home equity losses and tight credit conditions will limit sales-tax revenues.

States with diverse revenue sources may weather the economic storm better than states that depend on a single type of tax. According to the non-partisan Tax Foundation, Washington is the state most dependent on sales taxes, which account for 62 percent of state and local revenues. Oregon is the state most reliant on income taxes, which account for 44 percent of state and local revenues.

We remain highly confident that the overwhelming majority of general obligation and essential service revenue bonds will continue to prove extremely safe. However, headline risks persist: we expect states and municipalities to face fiscal challenges in the year ahead as they struggle to make tough budget cuts.

## Total Year-End Balances as a Percentage of Expenditures, Fiscal 2009



Source: National Association of State Budget Officers, 2009 Survey of States.