

# Municipal Market Note

ING MARKET  
PERSPECTIVES



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## I Like You, But Not in That Way

Memo to the current administration: You're sending us some mixed messages. The proposal for tax reform, which would include a reduced cap on tax-exempt interest for municipal bonds, has shown up in various forms over the past several months. Administration officials seem to be grappling with a love/hate relationship with municipal bonds; the conflicting statements regarding a possible reduction of the exemption coming from the White House have market participants scratching their heads.

Back in September of 2011, as part of the American Jobs Act sent to Congress, President Obama proposed to limit the value of tax-exempt interest from municipal bonds. This move was nine months after the expiration of the highly popular Build America Bond (BAB) program that provided a 35% federal subsidy to issuers to help fund infrastructure projects. The BAB program was launched as part of the American Recovery and Reinvestment Act, and the goal was simple: Rebuild the country, and put people to work by providing municipalities lower borrowing costs. This all fell apart as the contentious debates around the debt ceiling intensified and austerity became the measure of the day.

The rhetoric around munis has grown even more confounding in recent days. Toward the end of January, White House senior economic advisors informed state and local government officials that tax-exempt bond interest is "off the table" and would not factor into the discussions surrounding the administration's proposed 28% cap on exclusions, deductions and other tax preferences for high-earning taxpayers. This was welcome news to municipalities, as a decrease in the amount of the exemption has the potential to scare off investors, in turn forcing issuers to offer higher rates to lure them back in. These additional expenses would raise borrowing costs and potentially delay or shelve needed infrastructure projects.

However, the president's fiscal 2013 budget will include the same reductions in exemptions previously proposed. While the current administration has said that they "understand the importance of tax incentives for municipal finance", their actions reflect the quandary they face. Municipal bonds offer state and local governments a way to independently finance projects to improve the quality of life for their citizens; at the same time, however, the administration

is taking a hard look at tax reform and changes to municipal bonds — one of the last remaining tax shelters — may be unavoidable. Our view is that the inclusion of the cap in the current budget proposal may serve as a placeholder for future tax reform: As we discussed in last month's Municipal Market Note, getting things done on Capitol Hill takes time.

Even if the tax exemption is reduced, the asset class should remain a strategic part of an investor's portfolio allocation. With upper-tier income earners (\$200,000/250,000 and above) generally targeted by the current administration, any remaining tax exemption should prove to be valuable. While it is possible that tax-exempt yields may have to rise in response to a diluted tax exemption, price appreciation is also a possibility given the current environment of state and local government austerity measures and somewhat scarce supply. Investors are cognizant of buying "in state" to preserve the double exemption of income on both a federal and state level as well. As marginal tax rates increase, each and every tax-advantaged vehicle becomes more important.

### Market Review

The FOMC announced that it will maintain low rates into 2014, and ten-year U.S. Treasuries moved lower as the municipal market experienced a brief correction. Ten-year tax-exempt yields moved approximately 17 basis points higher during the month. The correction remained mostly muted and short-lived, however; supply and demand seemed to mesh well and primary issuance was mostly oversubscribed, creating a firm tone that led to January 2012 being the third-strongest month since 1990. As month-end approached, yields began to trend lower again, leaving ten-year AAA tax-exempt paper near record-low levels of 1.68% according to Municipal Market Data.

Subsiding worries over pervasive defaults and positive mutual fund flows (reinforcing the concept of a retail presence in the market) have helped to contribute to the low absolute rate environment. Investors continue to recognize that state governments and local municipalities have options available to them to keep their budgets in check and minimize headline risk, including the power to levy and increase taxes, raise user fees and implement enhancement programs that can bolster investor confidence and support market

yields and secondary market activity. Other tools available to keep credit quality strong and budgets balanced include Michigan laws giving oversight managers more authority over a city's troubled finances, Pennsylvania's Act 47 for Distressed Municipalities and state intercept programs that help support school bonds.

### Market Outlook

Going forward, we expect the market will have a challenging and somewhat positive tone. "It is no surprise that state tax revenues continue to grow," according to The Rockefeller Institute of Government, which reported "overall increases in state tax revenue for 3Q11, the seventh consecutive quarter of growth." However, hurdles remain, including the slow economic recovery at home, concern over the housing market and declining tax revenue for local governments as decreasing property values catch up with assessments. (It is interesting to note that the challenge local governments face concerning property values catching up with assessments can be mitigated by increasing the tax rate, although that may be politically unpalatable with upcoming elections.)

Credit quality will be of utmost concern, as downgrades may continue to outpace upgrades. As Moody's reported in its fourth quarter 2011 tally of ratings changes, "Downgrades exceeded upgrades by a ratio of 4.8 to 1, down from the record 5.3 to 1 ratio of the third quarter, but above the full year tally of 4.1 to 1."

Supply may be matched with demand over the next few months. While supply could surge as issuers try to take advantage of the low-rate environment, it may prove to be unrealistic as fiscal year end approaches in June.

We will continue to pursue high-quality general obligation and essential service revenue bonds while continuing to avoid sectors such as tobacco, health care and lease revenue. Tobacco has done well in the past, but some issuers are now drawing on reserves. There are fewer people smoking, and litigation arises from time to time between issuers and the tobacco companies surrounding the Master Settlement Agreement. Health care has also done well but is exposed to volatility in the future as the Affordable Care Act of 2010 rolls out. Lease revenue can be volatile if subject to appropriation or extraordinary redemption provisions. We will pursue duration targets at or near benchmark levels. ■

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