

## Municipal Markets Update

Exodus Ended? Muni Outflows Give Way to Inflows

### Highlights

- ▶ The municipal market posted positive results in June, although performance was muted compared to the prior month's strength.
- ▶ Investor flows into municipal bond mutual funds turned positive after 29 consecutive weeks of outflows.
- ▶ New issuance picked up in June, but supply remains contained versus the prior year and longer-term trends.

### Market Overview

June was a positive month for munis, although performance was more moderate compared to May's returns. Notably, the market's return for the quarter ended June 30 was its best since 1992. For the month, short-term rates moved marginally lower (and prices higher) as the Federal Reserve maintained the 0% to 0.25% Fed Funds target it has held since December 2008. The intermediate sector had the greatest rate increase, at 10 to 12 basis points (bps), which tapered to a 5 bp increase for the longest maturities.

The market was supported by flows into municipal bond mutual funds, a welcome reversal after 29 consecutive weeks of outflows. Flows turned positive in the first week of June and remained positive for three out of four weeks. This favorable trend, combined with the reinvestment of some \$46 billion in maturing principal and interest payments, allowed the market to easily absorb the \$31.5 billion in bonds issued during the month. Although June issuance was the year's strongest, overall supply remains muted and, at \$115 billion issued to date, is 44% below 2010's mid-year total. The reduced supply can be attributed largely to spending restraint at the state and local levels as governments struggle to balance budgets.

Supply and demand factors appear favorable going forward as the market enters a seasonally slow period for new issuance and another strong reinvestment month, with \$32 billion of maturing principal and interest expected in July. Supply should remain manageable in the near term, but is expected to pick up by the fourth quarter. Continued mutual fund inflows also would be supportive of the market.

### Making Headlines

Most states entered their new fiscal years on July 1 with balanced budgets, thanks primarily to austerity measures. One exception was Minnesota, where the government shut down after the governor and legislature were unable to find accord and resolve the remaining budget gap by July 1. The governor proposed raising taxes on high earners, while the legislature prefers to close the gap via program cuts. Despite the negative headlines, the shutdown does not affect debt service on the state's general obligation (GO) bonds, as debt would continue to be paid under an ongoing appropriation. Likewise, local government debt service is expected to be uninterrupted. Moody's also noted that the shutdown would not impact the state's Aa1/stable credit rating.



BlackRock's Municipal Bond Management Committee sets investment strategy across all of BlackRock's municipal bond portfolios. The committee is led by Peter Hayes and includes senior members William Henderson, Ted Jaeckel, Walter O'Connor, James Pruskowski and Jim Schwartz.

### Current Municipal Investment Strategy

<b>Duration</b>	• Neutral
<b>Yield Curve</b>	• Short and long maturities (i.e., a barbell approach)
<b>Overweight Sectors</b>	• State tax-backed and essential service bonds, particularly the Southwest (Texas), Plains and Southeast (Virginia) regions • Dedicated-tax bonds • Housing issues
<b>Underweight Sectors</b>	• Land-secured bonds • Senior living bonds • Tobacco bonds • Bond insurers • Student loans • Local tax-backed issues, particularly in California, Nevada, Arizona, Michigan, Illinois, Rhode Island and Puerto Rico

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Equally noteworthy, state judges in Minnesota and Colorado dismissed lawsuits by retired public employees who challenged reductions in their benefits, ruling that state pension funds have the legal right to alter some post-retirement terms. According to the decision, Minnesota retirees did not have a constitutionally protected property interest in cost-of-living adjustments. This could represent a significant precedent as other states look to implement pension reform, although appeals are possible and could delay resolution of the issue for some time.

## By the Numbers

The S&P/Investortools Main Municipal Index returned 0.53% in June. Returns were positive across the curve, led by maturities over 20 years. Credit spreads improved, allowing the high yield index to close the month with a yield 434 bps higher than the GO index. As for sectors, tobacco issues performed well following reports of a potential \$2.1 billion settlement of a \$7.3 billion lawsuit with tobacco companies. Final details have yet to be worked out. Hospital and healthcare issues posted the strongest sector gains for the month, with respective returns of 1.17% and 1.15%. This is indicative of the credit spread tightening trend that has been in place for most of the year. Meanwhile, the more defensive pre-refunded and GO indices underperformed the main index by 41 bps and 30 bps, respectively.

## Strategy and Outlook

We maintain a neutral view for the market, but with a bias toward greater risk taking through increased exposure to municipal credit. Recent favorites have included names in the transportation and hospital sectors. We remind investors that careful credit research and selectivity remain important in the still uncertain economic and market environment.

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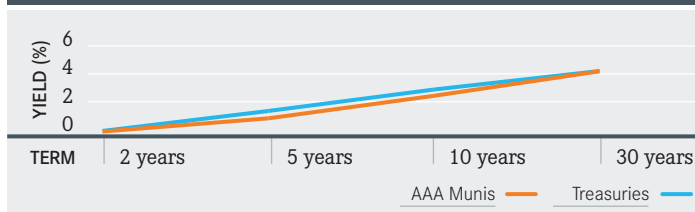
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## Monthly Change in Municipal and Treasury Yields

Term	AAA Muni Yield (%)		Treasury Yield (%)	
	5/31/11	6/30/11	5/31/11	6/30/11
2 years	0.44	0.42	0.47	0.46
5 years	1.23	1.28	1.70	1.76
10 years	2.65	2.75	3.06	3.16
30 years	4.30	4.35	4.23	4.37

## Municipal and Treasury Yield Curves as of 6/30/11



Sources: Thomson Municipal Market Data; Bloomberg.

## Municipal Markets Monthly Performance Analysis

	June 2011	May 2011
<b>S&amp;P/Investortools Main Municipal Index</b>	<b>0.53%</b>	<b>1.91%</b>
Long maturities (20+ yrs.)*	0.96	2.99
Intermediate maturities (3-14 yrs.)	0.28	1.62
Short maturities (6 mos.-3 yrs.)	0.23	0.50
High yield	1.41	1.99
Pre-refunded bonds	0.12	0.62
GO bonds	0.23	1.73
<b>Regions</b>		
California	0.68	2.16
Florida	0.49	1.98
New Jersey	0.71	1.81
New York	0.46	1.70
Pennsylvania	0.46	1.86
Puerto Rico	1.02	2.40

Source: Standard & Poor's/Investortools. Individual indices as represented by S&P/Investortools. \* Long maturities within the S&P/Investortools Main Municipal Index.

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