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## **Municipal Market Update**

*Municipal bonds have significantly outperformed U S Treasury bonds thus far in 2009.*

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Municipal bonds have significantly outperformed U S Treasury bonds thus far in 2009. Concerns about reduced tax exempt supply (especially on the long end resulting from the successful issuance of Build America Bonds), expectations for higher Federal and state income tax rates, anemic cash yields, and a steep yield curve collectively led to lower yields for municipal bonds across the maturity spectrum (see Muni AAA yields). At the same time, Treasury yields were increasing due to the unwinding of the “flight to quality” trade, early signs of an economic recovery which contributed to a shift to equities, a steady stream of Treasury supply and international fears that financing of the multi-trillion dollar Federal budget deficit would require higher yields. As a result, the municipal/Treasury yield ratios for maturities 5 years and longer have returned to more historically “normal” levels (see Muni/Treasury ratios).

Significant amounts of cash remains on the sidelines earning paltry returns and will likely be exacerbated by the considerable demand expected in the June-August reinvestment period (as a result of maturities, calls, and coupon payments). Nevertheless, volatility, inconsistent liquidity, and greater credit yield spreads have returned to the municipal market, which is facing formidable new issue supply. Further, the State of California’s budget plight, which is unique only in its extreme, highlights the difficulties most states are continuing to encounter and may be a harbinger of more negative credit news still to come from the general obligations of many states and municipalities.



