

Summer 2009

## **Municipal Market Mid-Year Update**

*With the Treasury market under pressure and municipal yields at historic lows, we continue to recommend cautious geographic diversification and high-quality security selection.*

By Gary Gildersleeve  
Partner & Fixed Income Portfolio Manager  
Evercore Wealth Management LLC

Municipal bonds have significantly outperformed US Treasuries since the beginning of the year. Early in the year, this was caused by investors unwinding their "flight-to-quality" trade in Treasuries and returning to the municipal market, as their willingness to assume some risk returned. However, municipal bond investors remained discerning, purchasing mostly better known, upper investment grade issuers.

This summer, municipals have continued to outperform, as investors reinvested interest payments as well as maturing and called bonds. By June 30<sup>th</sup>, inflows into municipal bond mutual funds exceeded inflows for all of 2008.

This new buying power – combined with the virtually non-existent yields available on already large cash positions – has encouraged investors to move out on the yield curve. This, in turn, has caused yields through the four-year-maturity range to reach new lows. Credit yield spreads, which were historically wide, have also narrowed. Even the yield spread between high-grade municipal bonds and State of California bonds compressed during the worst of its recent budgetary debacle.

## **State budget problems abound**

The State of California has been hogging the headlines: first when it was downgraded to the triple-B category; then when it issued IOUs to public employees; and, most recently, when it unveiled its gimmick-laden budget agreement. California, unfortunately, is not alone in its ongoing budget travails. The Rockefeller Institute reported that state tax collections declined nearly 12% in Q1 2009, the sharpest decline in the 46 years for which quarterly records have

been maintained. Early indications point to even worse reductions – nearly 20% for total tax receipts – in Q2 2009.

Worse yet, the National Conference of State Legislatures reports that many states are likely facing at least two more years of serious fiscal problems and at least 15 states are forecasting gaps greater than 20% of their budgets for fiscal year 2010. In closing these budget deficits, states will be judged on whether they have implemented structural changes or merely applied stopgap measures and accounting gimmicks.

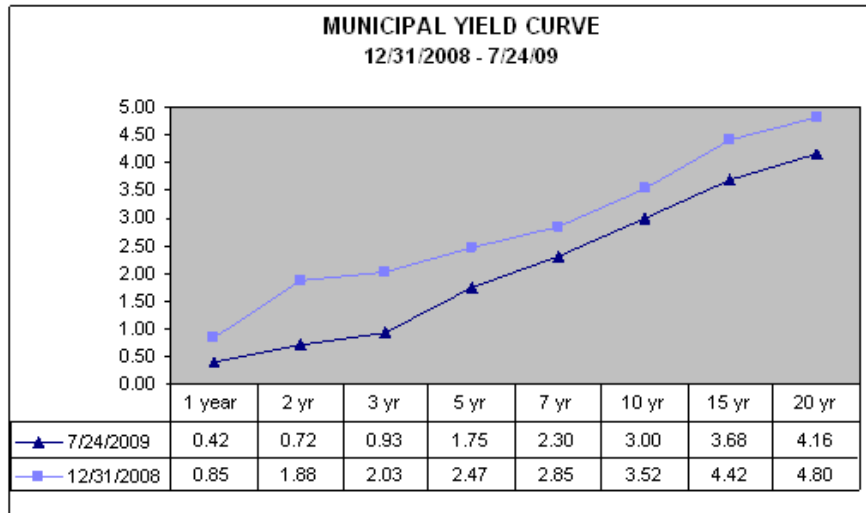
Evercore Wealth Management has avoided the general obligation and appropriation debt of all but a handful of states. While the ongoing negative news on state budgets has, to date, impacted the trading of only a few states, we prefer instead to purchase essential purpose revenue issues and dedicated tax bonds with stable, predictable revenue streams. Many of these are available at attractive levels because of well-publicized problems at the state level, even though these issuers are not directly impacted by these problems.

Reinvestment-related demand and significant cash on the sidelines earning anemic returns will continue to be a major factor in the second half of 2009, especially through August. New issue supply is projected to easily exceed that of the second half of 2008 – when supply was limited due to liquidity and quality concerns – but will remain historically modest.

### **Opportunities exist to restructure**

The ongoing issuance of Build America Bonds will, at a minimum, add to the perception that supply is insufficient to meet demand in the traditional municipal market. These positive technical factors, plus the threat of higher tax rates at the federal and state levels, are being offset by rock bottom rates on short maturity bonds and reluctance by many to invest near historic low yields on longer maturities. Headline risk for a number of states and large cities will also continue to loom large, with the potential to widen credit spreads that have recently tightened. Finally, the threat for US Treasury yields to move higher as the record federal deficit is funded gives us pause.

We recommend that investors use the improved liquidity caused by currently strong demand and still wide credit spreads to diversify geographically and, where possible, to improve the overall credit structure of their portfolios. We are very cautious on the market and selective in our purchases.



<u>Maturity</u>	<u>Municipals</u>	<u>Treasury</u>	<u>AAA/Treas.</u>
1 Year	0.42	0.50	85 %
2 Years	0.72	1.03	70 %
3 Years	0.93	1.61	58 %
5 Years	1.75	2.62	67 %
7 Years	2.30	3.30	70 %
10 Years	3.00	3.71	81 %
15 Years	3.68	4.65	79 %
20 Years	4.16	4.62	90 %

*Gary Gildersleeve joined Evercore Wealth Management as a founding partner in 2008 with over 33 years of experience in managing fixed income investment strategies for high-net-worth individuals.*

**Important Notice:** Evercore Wealth Management, LLC (“EWM”) is registered with the Securities and Exchange Commission under the Investment Advisors Act of 1940. EWM prepared this material for informational purposes only. This material should not be viewed as advice or recommendations with respect to asset allocation or any particular investment. EWM obtained this information from multiple sources believed to be reliable as of the date of publication; EWM, however, makes no representations as to the accuracy or completeness of such third party information. EWM has no obligation to update, modify or amend this information or to otherwise notify a reader thereof in the event that any such information becomes outdated, inaccurate, or incomplete. Specific needs of a client must be reviewed and assessed before determining the proper allocation for a client and must be adjusted to market circumstances. Any opinions herein reflect our judgment at this date and are subject to change. Upon request, we will furnish a list of all securities recommended to clients during the past year. This material does not purport to be a complete description of our investment services. Upon request, EWM will furnish a list of all securities recommended to clients during the past year. This letter does not purport to be a complete description of our investment services. It is not our intention to state or imply in any manner that past results are an indication of future performance.