Bond Market Perspectives

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Debacle in Detroit

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Highlights

Aside from a short-term psychological impact, we see limited municipal market impact from Detroit as supply-demand dynamics should remain a primary driver of market movements.

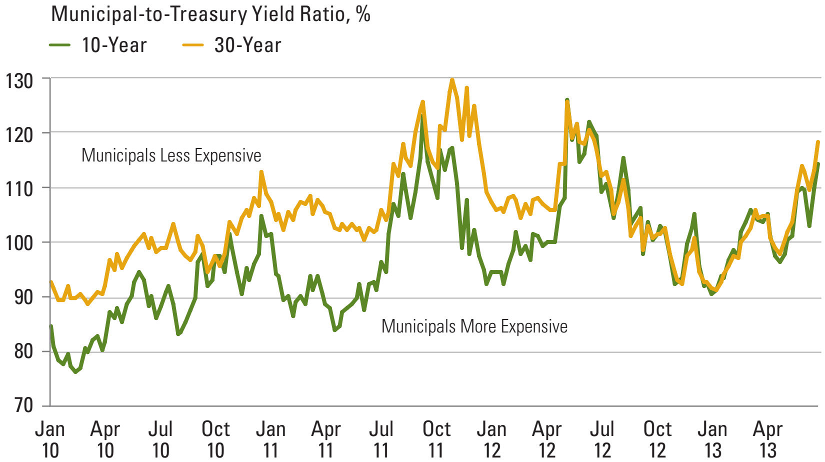
We do not see Detroit as the harbinger of a municipal bond default wave. Bankruptcies and defaults should remain isolated cases and not representative of the broader health of the municipal bond market.

Detroit made history last week by filing the largest Chapter 9 bankruptcy on record. For most in the municipal bond market, the news was not surprising. Detroit's demise was years in the making and several factors played a role in the city ultimately filing bankruptcy including, but not limited to: a declining revenue base in response to a population that shrunk by more than half since the 1950s, financial mismanagement that witnessed the city often spend more than incoming revenues, and high, unfunded pension liabilities.

The likelihood of a bankruptcy increased rapidly in recent weeks following the city's emergency manager, Kevin Orr, filing a bold plan to restructure all of Detroit's debt liabilities—not just municipal debt obligations. Orr proposed an extremely aggressive approach with bondholders receiving only pennies on the dollar as settlement, which in turn limited the potential scope for any negotiations. Last Wednesday, July 17, 2013, two Detroit pension systems sued Orr and Michigan Governor Rick Snyder (who appointed Orr) to block a possible bankruptcy filing. Orr filed for bankruptcy Thursday, July 18, 2013, just ahead of a preliminary hearing on the lawsuit from the two pension systems to shield the city from that other potential litigation.

The municipal market impact of the Detroit news has largely been a psychological one with buyers remaining on the sidelines despite attractive

1 Attractive Valuations Have Yet to Lure in Buyers Suggesting a Psychological Impact From Detroit News



Source: Municipal Market Advisors, LPL Financial 07/22/13

Yield Ratio depicts a comparison of the expected yield of one bond to the expected yield of another.

The Yield Ratio of Municipal Bonds to U.S. Treasuries is a common barometer of Municipal Bond valuations.

valuations. Although difficult to quantify such an impact, following a violent sell-off in May and June municipal bond investors understandably remain skittish, and negative headlines from Detroit do not engender confidence or help the healing process. Average municipal-to-Treasury yield ratios [Figure 1] remain near the highest levels of the past few years but have so far failed to attract buyers, perhaps as investors look for further insight and developments on how Detroit may impact markets.

In general, however, we expect the municipal bond market impact to be limited based upon the following:

- **Supply-related forces continue to dominate.** Last week's underperformance of municipal bonds relative to Treasuries was largely due to another week of significant new issuance. New issuance last week (July 15–19, 2013) totaled $8 billion, the most since the last week of June 2013, when coincidentally, the municipal market also witnessed similar valuation metrics as defined by municipal-to-Treasury yield ratios. And new issue supply has been augmented by heavy secondary market supply as mutual fund redemptions led to a steady amount of bonds looking to be sold, adding to downward pressure on prices. Please see the July 16, 2013 *Bond Market Perspectives: Light at the End of the Tunnel* for more on the drivers of recent municipal market weakness.
- **Majority of Detroit bonds are insured and/or secured.** A majority of Detroit bonds are insured, meaning that many investors will not experience interest payment interruptions as the municipal bond insurer will make up the difference while in bankruptcy. However, should a bond mature while Detroit remains in bankruptcy there may be a delay in principal repayment. Water and Sewer bonds, which comprise roughly $6 billion of the just over $8 billion in Detroit municipal debt, will continue to pay interest, even during bankruptcy, due to their first lien on revenues and strong legal protections.

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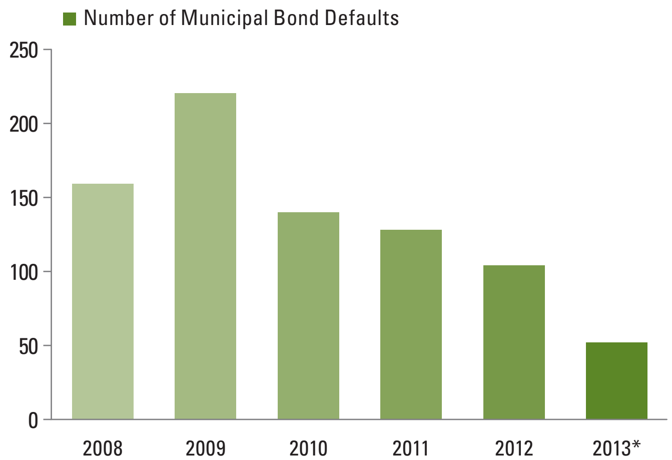
The scope for intermediate and long-term adverse impacts exist in the form of broader weakness in Michigan municipal bonds. While every bond issue is unique with its own credit quality dynamics, Michigan municipal bonds may witness modest price weakness and slightly higher yields to compensate for greater risks. In the restructuring plan, emergency manager Kevin Orr lumped general obligation (GO) bonds together with all other forms of debt, including lower ranking debt claims such as pension-related debt and unfunded pension liabilities. GO bonds are typically the most senior of a municipal issuer's obligations backed by the full faith and taxing power of the issuer with principal and interest of GO bonds paid before other expenses and taxes increased if necessary to pay the debt service. Mr. Orr's plan undermines this protection and together with the state's apathy toward respecting bondholder rights may result in higher borrowing costs for Michigan GO (and other) municipal bonds.

Depending on the outcome of the bankruptcy proceedings, or proposed settlement, investors may view GO bonds nationally, not just Michigan, more skeptically. However, the process may take years and given the variety of issuers and states' different approaches to protecting bondholder laws, the risk of contagion to the broader municipal bond market is relatively low.

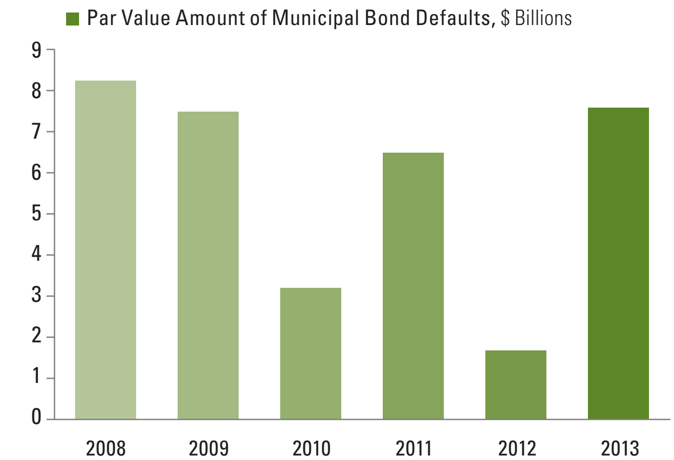
2 The Number of Municipal Bond Defaults Continues to Decline



Source: Municipal Market Advisors, LPL Financial 06/30/13

*= annualized pace of 26 YTD defaults through 06/30/13

3 Due to Several Large Issuers the Dollar Amount of Defaults Is High



Source: Municipal Market Advisors, LPL Financial 06/30/13

2013 amount represents YTD par value through 06/30/13

Therefore, we do not see Detroit as the harbinger of a municipal bond default wave. The number of municipal bond defaults continues to decline with defaults through the end of June 2013 running at roughly half the pace of 2012 [Figure 2]. The dollar amount of municipal bond defaults may surpass the 2008 total [Figure 3], but this is primarily due to a few large issuers — Detroit, MI, Jefferson County, AL, and Stockton, CA — finally defaulting in 2013 and pushing up the dollar amount significantly amidst a smaller number of defaults. Municipal bankruptcies and defaults are likely to continue but should remain isolated cases and not representative of the broader health of the municipal bond market.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

Municipal bonds are subject to availability, price, and to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise. Interest income may be subject to the alternative minimum tax. Federally tax-free, but other state and local taxes may apply.

Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

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