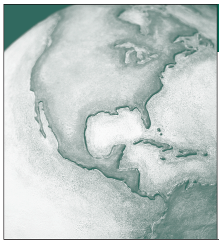

Insights on…

MUNICIPAL BOND MARKET

BUYER'S MARKET IN MUNICIPAL BONDS

Reduced supply, demographic trends and the potential for higher federal tax rates have provided a positive backdrop for the municipal bond market.

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As conditions in the tax-exempt market have inched closer to what passes for normal amid the worst economic downturn in generations, now is an opportune time to consider where the municipal market has been – and where it might be headed.

Last year, a virtually unprecedented array of economic and market factors caused municipal bonds to become extraordinarily cheap relative to Treasury securities. In addition to the global rush to safety during the financial crisis, the municipal market suffered from a glut of supply due to the impairment of the auction rate securities market, the demise of monoline insurers and the abrupt deleveraging of hedge funds. At the peak of the credit crunch in December 2008, yields on 20-year general obligation bonds reached an astounding 175% of similar-maturity Treasuries; by comparison, that same spread averaged just 89% between 1994 and 2007.[1]

We noted on several occasions last year that such an extreme imbalance between supply and demand represented a significant buying opportunity for municipal bond investors. We argued that it was only a matter of time before the municipal market stabilized and traditional relationships between taxable and tax-exempt yields re-emerged. That process now is well along; by early July, tax-exempt yields had declined by about 78 basis points (one basis point equals 0.01%) at the short end of the curve and by almost 60 basis points on AAA-rated 20-year general obligation paper over the previous six months.[2]

The reversal of last year's imbalance between supply and demand unleashed a buyer's market for municipals through the first half of 2009. Buyers were (and have remained) able to require that important credit features be added to deals, including:

- Debt-service reserve funds on revenue bonds;
- Limitations on the ability of authorities to issue more debt if coverage ratios fall below a specified threshold;
- Rate covenants mandating minimum pricing for revenue services; and
- Generous terms on debt-service coverage, in some cases up to 10-times larger than the annual debt service.

BARGAINS HAVE REMAINED

Despite the municipal sector rally – some of which occurred alongside a sell-off in the Treasury market – tax-free yields have remained compelling, especially at the mid-point of the yield curve. As of July 6, 2009, 15-year AAA-rated general obligation paper still yielded 4.11%, providing a

1. Yield on Bond Buyer General Obligation 20-Bond Municipal Bond Index, 20 years to maturity, mixed quality; Yield on 20-year Treasury bonds, constant maturity.
2. http://www.bloomberg.com/markets/rates/index.html

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taxable equivalent of 5.71% for investors in the 28% marginal tax bracket at a time when 15-year Treasuries yielded about 3.8%. And in a clear reflection of the massive liquidity pumped into the financial system by the Federal Reserve, the municipal yield curve has remained unusually steep, with a nearly 500 basis point spread between overnight and 30-year AAA-rated general obligation bonds.[3]

In recent weeks, the rally in municipal bond prices has given way to consolidation and volatility caused by uneven supply in the context of reduced broker-dealer risk appetites. Historically, broker-dealers have been willing to step into the secondary market in an effort to provide liquidity, but with the industry still risk-averse, that support is no longer present.

In the near term, we believe technical factors will boost volatility in both directions. Roughly $80 billion in tax-exempt bonds are scheduled to mature this summer; as those funds are redeployed, municipal bond prices may move higher. We expect a brief pullback in the fall, however, when the supply-demand equation is likely to become more problematic. But while volatility can be unnerving to investors, we would view any correction in the municipal market as an opportunity, given our forecast that we believe the municipal asset class is in a favorable secular environment.

LESS SUPPLY, MORE DEMAND

We have several reasons for our optimistic longer-term outlook for the municipal bond market.

Saving money is back in style again after a 15-year consumption and debt binge that stressed household balance sheets. Demographic trends also suggest heightened demand for fixed-income securities as more of the 77-million member baby boom generation leave the workforce in coming years. The likelihood that marginal tax rates will increase for upper-income Americans as the federal government tries to plug gaping budgetary holes could potentially bolster demand as well. Finally, municipal supply should be reduced by the Build America Bonds program, which was created as part of the recent stimulus package.

Unlike traditional munis, interest on Build America Bonds is taxable, thus requiring the issuing municipality to offer a higher yield to attract investors. However, the federal government subsidizes 35% of the interest cost, a feature that actually lowers the net borrowing cost below what the municipality would have had to pay in the tax-exempt market.

MUNICIPAL BOND YIELD

FEDERAL INCOME TAX BRACKET	3%	4%	5%	6%	7%
	Taxable Bond Yield Required to Match After-Tax Muni Yield				
10%	3.33%	4.44%	5.56%	6.67%	7.78%
15%	3.53%	4.71%	5.88%	7.06%	8.24%
25%	4.00%	5.33%	6.67%	8.00%	9.33%
28%	4.17%	5.56%	6.94%	8.33%	9.72%
33%	4.48%	5.97%	7.46%	8.96%	10.45%
35%	4.62%	6.15%	7.69%	9.23%	10.77%
40%	5.00%	6.67%	8.33%	10.00%	11.67%
45%	5.45%	7.27%	9.09%	10.91%	12.73%
50%	6.00%	8.00%	10.00%	12.00%	14.00%

Rates apply to ordinary income, not capital gains. Does not take into consideration state or local taxes, or rates under the alternative minimum tax. For illustrative purposes only. This is not meant to predict any future tax rates.

3. www.bloomberg.com. Yields as of July 6, 2009.

The roughly $15 billion of Build America Bonds issued through June was met with robust demand. We expect Build America Bonds issuance to reach $75 billion this year and $100 billion in 2010 as the vast universe of taxable fixed-income investors, including pension and sovereign wealth funds, gain understanding and experience in this new asset class. Since total annual issuance in the traditional municipal market is only about $350 billion, we believe that such a dramatic reduction in supply should have a positive effect on municipal bond prices, especially at the long end of the yield curve, where the bulk of Build America Bonds issuance should be concentrated.

Of course, a resurgence of inflation would have a negative effect on municipal bond prices. But while some of the steps taken by the Federal Reserve to backstop the economy are theoretically inflationary, an enormous excess capacity remains in the product and labor markets, the typical main sources of inflationary pressure. As such, we believe inflation appears to be well contained for the foreseeable future, especially with economic growth projected to remain below trend through at least next year.

STRONG CREDIT RESEARCH IS KEY

The overall credit profile of the municipal sector has weakened significantly under the prolonged fiscal strain of the recession. Though the high-profile budget crisis in California leaves a somewhat distorted impression of state and local government finances, sound credit analysis is crucial during these turbulent economic times.

At Northern Trust we have been finding value in unlimited tax general obligation bonds, essential service revenue bonds (water, sewer, public power and transportation), and some pre-refunded municipal bonds that are tax-free but backed by U.S. Treasuries. However, we typically have avoided smaller project-specific bonds and issues that require ongoing appropriation.

We believe the pronounced weakening of municipal balance sheets during the last two years makes the potential benefits of owning tax-exempt bonds through mutual funds especially compelling. Mutual funds offer a level of diversification, liquidity and transactional efficiency that even large institutional investors have difficulty achieving on their own.[4]

Some funds also may make it easier for investors to access all parts of the yield curve without taking unwanted interest-rate risk. For example, our municipal bond managers scour the market for so-called "cushion" bonds, which are long-term paper with short-term call provisions. That combination seeks to provide the best of both worlds: the potential for elevated income streams available at the longer end of the yield curve with the relative price stability of shorter-duration bonds.

NORTHERN TRUST'S EXPERTISE

With $263.8 billion* in fixed-income assets under management – including $63.7 billion in the municipal market – Northern Trust provides an array of conservatively managed tax-exempt funds and portfolios designed to meet the needs of its individual and institutional clients. Besides a broad-based tax-exempt fund, we offer a short-intermediate fund, an intermediate fund, a high yield fund, three state-specific funds and a variety of tax-exempt money market funds.

All of these tax-exempt funds employ Northern Trust's longtime commitment to exhaustive and independent credit analysis. A strong credit culture defines what we do. We have never relied on ratings agencies for the final word on creditworthiness and place no value on bond insurance.

**Assets under management as of March 31, 2009.*

4. Diversification does not guarantee a profit nor protect against a loss.

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FOR MORE INFORMATION

If you would like to discuss whether investing in the tax-exempt bond market may make sense for your portfolio, please contact your relationship manager or visit northerntrust.com.

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Timothy A. McGregor joined Northern Trust in 1989 and leads the municipal fixed income group, which has responsibility for $16 billion in assets under management. He is a portfolio manager for the Northern Tax-Exempt Fund and the Northern Intermediate Tax-Exempt Fund as well as individual accounts. McGregor received his B.A. degree in economics from Indiana University and is a member of the CFA Institute and the Investment Analysts Society of Chicago.

Arch King
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Arch King joined Northern Trust in 1979 and oversees Northern Trust Global Investments' Tax Advantaged Equity and Municipal Fixed Income capabilities. A CFA charterholder and former board chairman of the CFA Society of Chicago, King earned a B.A. degree from Dartmouth College and an M.M. degree in marketing, finance, and accounting from Northwestern University.

Bond Risk: Bond funds will tend to experience smaller fluctuations in value than stock funds. However, investors in any bond fund should anticipate fluctuations in price, especially for longer-term issues and in environments of rising interest rates.

Tax-Free/Alternative Minimum Tax Risk: Tax-exempt funds' income may be subject to certain state and local taxes and, depending on your tax status, the federal alternative minimum tax.

The municipal market is volatile and can be significantly affected by adverse tax, legislative, or political changes and the financial condition of the issuers of municipal securities. Interest rate increases can cause the price of a bond to decrease. Income on municipal bonds is free from federal taxes but may be subject to federal alternative minimum tax (AMT), state and local taxes.

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