



Dissecting the Headline Noise in the Muni Market

RBC Global Asset Management (U.S.) Inc.



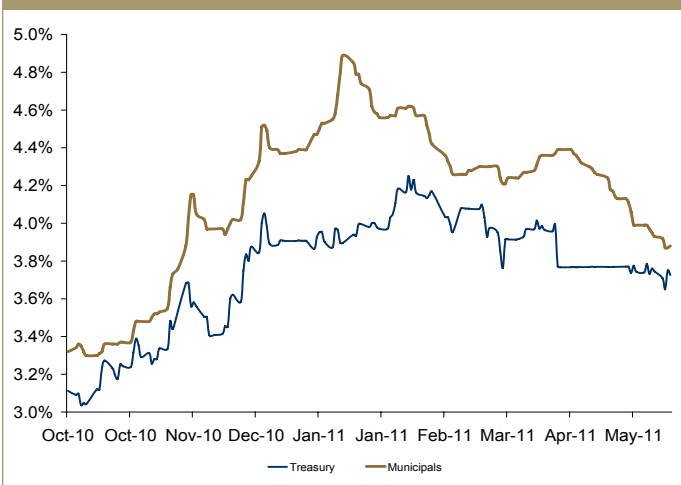
RBC Global
Asset Management™

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While state and local government entities continue to face mounting budget and revenue pressures, the municipal credit market remains an attractive sector for institutional and individual investors. Municipal bonds have historically been a safe haven as actual defaults among municipal issues are extremely rare and are typically confined to unrated smaller issuers or projects of a speculative nature. Despite recent media headlines of predicted widespread defaults in the municipal bond market, municipal bonds continue to attract investors, given the historical quality of the credits and significantly low default rates.

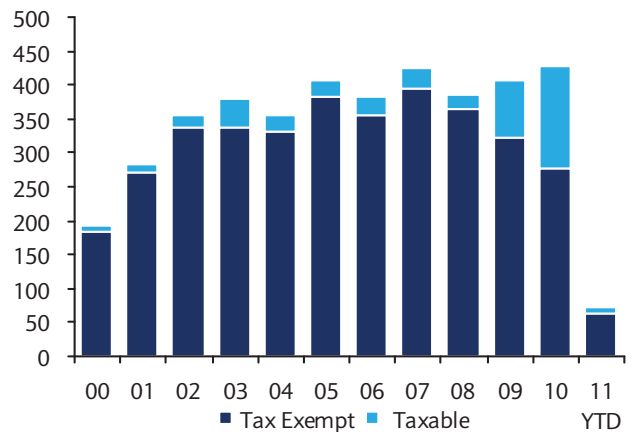
Since November of 2010, investors have withdrawn approximately \$47 billion from municipal bond funds amid speculation of sizable defaults, ongoing financial crises of state and local governments, and fear of possible increases in general long-term interest rates. The yield gap between 20-year AAA-rated general obligation bonds versus Treasuries widened as much as 100 basis points before opportunistic investors stepped back into the market. Spreads have tightened 80 basis points since the selloff with demand for investment grade credit outstripping supply as new issuance volumes are down almost 50% from this time last year.

Exhibit 1: AAA-Rated G.O. vs. Treasuries



Source: Bloomberg and RBC GAM

Exhibit 2: Municipal Tax-Exempt and Taxable Supply (\$bn)



Note: 2011 YTD supply as of May 20, 2011. Source: SDC

Source: Barclays Capital

The 5-, 10- and 20-year Barclays Municipal Indices returned 1.90%, 2.92% and 3.30% as of April 30, 2011 respectively. While we favor municipal bonds as a relative value enhancer and diversifier to portfolios, we continue to stress the importance of credit research and due diligence in scrutinizing not only the issuer but the cash flow supporting the repayment of the debt.

According to Municipal Market Advisors, 231 unrated bonds have defaulted over the past two years. Those defaults represent a mere \$5 billion of the \$3 trillion muni market. An often cited study by Moody's Investor Services shows that all rated municipal credits have lower default rates than their AAA-rated corporate counterparts. In addition, the recovery rate in the case of default is extremely high, as in the much publicized case of Orange County, California in the mid-1990s. In that case, the County exited bankruptcy in 18 months, regained an investment grade rating within 3 years and, most importantly, investors recovered 100% of their principal.

Exhibit 3: 10-Year Cumulative Default Rates as of 12.31.09

	Municipal Bonds	Corporate Bonds
Aaa	0.00%	0.50%
Aa	0.03%	0.54%
A	0.03%	2.05%
Baa	0.16%	4.85%
Ba	2.80%	19.96%
B	12.40%	44.38%
Caa to C	11.60%	71.38%
Investment Grade	0.06%	2.50%
Speculative Grade	4.55%	34.01%
All Rated	0.09%	11.06%

Source: Moody's Investors Service, February 2010. Study period was 1970 through 2009.

The states of Illinois, California and New Jersey are often cited as at "risk issuers" given the size of their deficits, pension obligations and acrimonious legislative processes. Yet earlier this year, Illinois raised its income tax to close a budget deficit, and in so doing, shored up investor confidence in its debt and for the municipal market as a whole. The advantage that municipal issuers have is that they generally cannot liquidate assets in bankruptcy and distribute the proceeds to debt holders like their corporate counterparts. Because municipalities do not disappear and continue to have financing needs to fund capital projects and other expenditures, they have a very strong incentive to not default on their debt. Furthermore, except for a few special cases, debt repayment is a manageable part of municipalities' annual expenses.

While municipal credits are often painted with a broad brush, it is important to understand the various types of repayment obligations securing the bond. This is where credit research and due diligence are critical in differentiating opportunities and risk. Municipal bonds are issued as either a general obligation (GO) of the sponsoring entity, or as a revenue bond backed by a dedicated future revenue stream to support repayment.

GO bonds are backed by the taxing authorities of the issuers and are generally considered a relatively safe investment for investors seeking safety of principal. Most investors view GO debt as akin to U.S. Treasuries given the ability of the issuers to levy taxes as needed to support repayment. In a normal economic environment, GO debts provide a superior credit profile to revenue bonds. However, given that sales, corporate and personal income tax revenues are currently depressed, and most legislatures are challenged by bipartisan climates, the ability to raise taxes differs from the political will to do so.

Revenue bonds, on the other hand, are supported by an enterprise activity of the issuer with repayment dedicated from user fees rather than a direct tax levy. Revenue bonds range widely in credit quality, from very safe to speculative, depending upon the type of project and the nature of the revenue stream. At one end of the safety spectrum are bonds backed by user fees such as utility rates, tolls, and waste collections. Because they are secured by user fees typically from a monopolistic provider, these essential services revenue bonds have fundamentally sound credit and can provide a yield advantage over GO bonds. In times of economic stress, essential services bonds are more resilient and stable due to the inelastic demand of the services provided. Existing legal precedent also supports the prioritization of essential service bond repayments in bankruptcy. At the other end of the safety spectrum are project development bonds backed by tobacco settlements, land-lease agreements, or discretionary user fees where the revenue stream is subject to a higher degree of uncertainty. It is typically these types of revenue bonds that end up distressed and ultimately in default. Municipal income investors need to distinguish between these nuances to appropriately assess the risk involved.

State and local issues will continue to be faced with structural deficits into the foreseeable future. Even though tax revenues are improving, the expense side of the income statement is still significant, with mounting OPEB (other post-employment benefits) liabilities, pension payments and rising health care costs. Our view is that the changes required to address these issues bring about investment opportunities. We believe bankruptcy and defaults will be contained to

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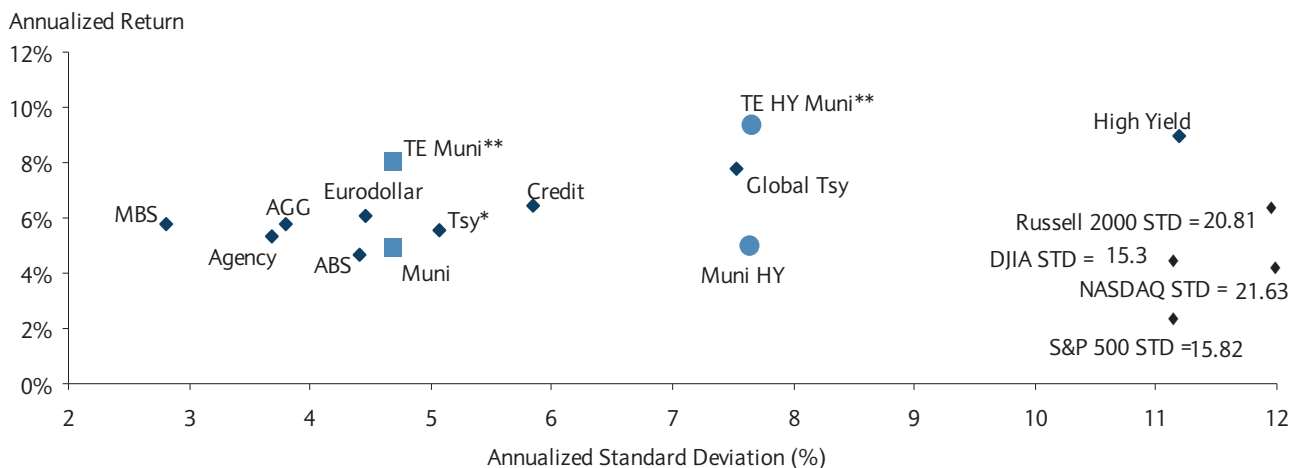
smaller issuers or larger issuers with unusual problems. Defaults should remain in line with historical lows for the municipal market, and will not be as widespread as some believe. Downgrades will likely occur in gradations of one or two notches from current levels as budget difficulties continue. With new issuance down significantly from years past, along with the end of the federally sponsored Build America Bond program, demand is currently outstripping supply after the selloff of the previous quarters.

At RBC Global Asset Management, we continue to view the municipal market favorably despite the headline

noise. We believe the risk/return profile of tax-exempt municipal bonds, as illustrated below, warrants an overweight allocation for total return tax-sensitive investors and an opportunistic allocation for other portfolios as well.

On a risk adjusted return basis, tax-exempt municipal bonds have outperformed most asset classes over the past ten years annualized. Only high yield fixed income securities have performed better but with significantly higher volatility. Within the context of managing a diversified high quality investment program, municipals have earned a place in portfolio construction.

Exhibit 4: Taxable Equivalent Returns - Last 10 Years Ending 4.30.11



Note:* U.S. Treasury income is exempt from state income taxes and is adjusted (3.25%) using a national state average (top bracket), net of federal income tax.
 ** Based on an equally weighted national average federal and state (top bracket) income tax rate: 38.45% before 2009, 38.48% in 2009, and 38.78% in 2010; local taxes have not been considered. All excess returns are based on 3m T-bill returns. Source: Barclays Capital

Source: Barclays Capital Municipal Indices

Past performance is not indicative of future results. There can be no guarantee that any investment strategy discussed in this brochure will achieve its investment objectives. As with all investment strategies, there is a risk of loss of all or a portion of the amount invested. No chart, graph, or formula can by itself determine which securities an investor should buy or sell or which strategies should be pursued.

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