



Municipal Strategy Report January 2012

The 2012 Outlook for the Economy: 2011 Lite?



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The consensus is that 2011 will close on a positive note with growth of real GDP in the fourth quarter GDP of over 3.0%. That level of growth does not appear to be sustainable as we move into 2012, however, and consequently, the economy should settle down to about a 2.50% growth track for the year. With the election year providing certainty that Congress will be as truculent as ever and with no apparent quick fix in Europe, the temptation is to expect 2012 to be another, perhaps more bland version, of 2011. There are few visible new trends that offer hope of significant improvement in economic performance or, thankfully, any renewed threats of a relapse into recession. If our expectation of 'more of the same' is realized, then the trend may not be our friend, but rather just a familiar companion.

The increased consumer spending that boosted last quarter's growth has occurred as a result of a draw-down in savings to about 3%. Furthermore, the current level of household savings is now low compared to wealth as a percentage of disposable income (BCA), suggesting that any renewed concerns could result in a reduction in consumption and a move towards increased precautionary savings. Poor income growth will keep consumer spending mildly favorable, at best, until labor market conditions improve substantially.

Lack of income growth will continue to constrain the consumer—70% of the economy. At the same time fiscal policy is politically compromised. The generous two-month extension of the payroll tax cut reminds us that you can't underestimate Congress' apparent desire to make the simple complicated. On the monetary side of the ledger, all the Fed has available is a little more of what they are already doing. The bag of tricks is functionally empty. Our economic future rests squarely on the private sector and its enthusiasm, or lack thereof, to upgrade plant and equipment, rehire, to expand output, boost R&D, and so on. This is where the spark will have to come from.

The capacity of the corporate sector to provide immediate and ongoing stimulus is significant. Large corporations, in aggregate, have done a terrific job of cutting costs and maintaining profitability in the face of substantially reduced output. According to The Bank Credit Analyst, U.S. domestic non-financial profit margins are at their highest levels since 1966. Given concerns about aggregate demand, the uncertainty

inherent in an election year and the Eurozone financial crisis, it is not surprising that there is idle cash on corporate balance sheets patiently awaiting a new economic environment. Consequently, corporate capital expenditures relative to cash flows are at record lows and are currently below prevailing levels from the 1960s to the 2000s. Unfortunately, at the moment, there is not much incentive to expand plant and equipment or to hire more labor. One promising note: the passing of the election could reduce uncertainty and motivate some spending that has been held back.

Two years into the recovery, the labor market has finally begun to improve meaningfully. Initial jobless claims are solidly around 375K; job openings and job hires have been increasing, and of course we had the "breakout" December jobs report with the larger than expected increase in payrolls along with a longer workweek and higher average hourly earnings. The report, a breath of fresh air, is not likely to be followed up by simultaneous improvement in the trio of payrolls, average workweek and average hourly earnings until later 2012 at best. We look for monthly growth of nonfarm payrolls of about 150K or slightly better. Conditions suggest that the unemployment rate should remain about 8.5%, or perhaps slightly lower, as 2012 progresses.

As we move in to 2012, the argument for more of the same rests on the lack of any apparent benefit forthcoming from fiscal policy, monetary policy, or resolution in Europe. Positive development we believe is possible is that cash flow starved investors, hunting for dividends, will drive the stock market up by about 10%. The boost in optimism and the small wealth effect that would result, along with continued improvement in the labor market, could be a catalyst as well as a welcome departure from 2011.

IN THIS ISSUE WE FEATURE

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Factors Supportive of Lower Rates

- The stock market has fallen 5% off its 2011 high.
- Unemployment remains elevated but has fallen below 9% for 3 months.
- The stagnant housing market points toward continued weakness. The Federal Reserve has a purchasing program to drive interest rates lower.
- Lower Treasury rates have done little to stimulate borrowing and spending. Cash is being hoarded on corporate balance sheets.

Factors Supportive of Higher Rates

- Commodities prices have fallen about 12% due to concerns about growth in China. Gasoline futures have fallen 6% providing a small “tax cut” for consumers.
- Low dollar threatens rise in import prices, while boosting exports. (Flagging growth in Europe remains a concern.)
- Inflation appears to have solidified around the 2% level.
- Will there be a solution for Greece, Italy, Portugal and Spain or is the Euro toast?
- Recent consumer confidence figures have responded quite favorably.

Data Diffusion Index vs. 10-Yr Treasury Yield



Data Diffusion Index

We calculate the Data Diffusion Index based on 30 different weekly and monthly economic releases, such as construction spending, capacity utilization and new home sales. If the number came above the consensus estimate (which is positive for economic growth) the index would increase by one, and vice versa. The Treasury yield is expected to track the data diffusion index (the yields would increase and decrease as the economy expands and contracts).

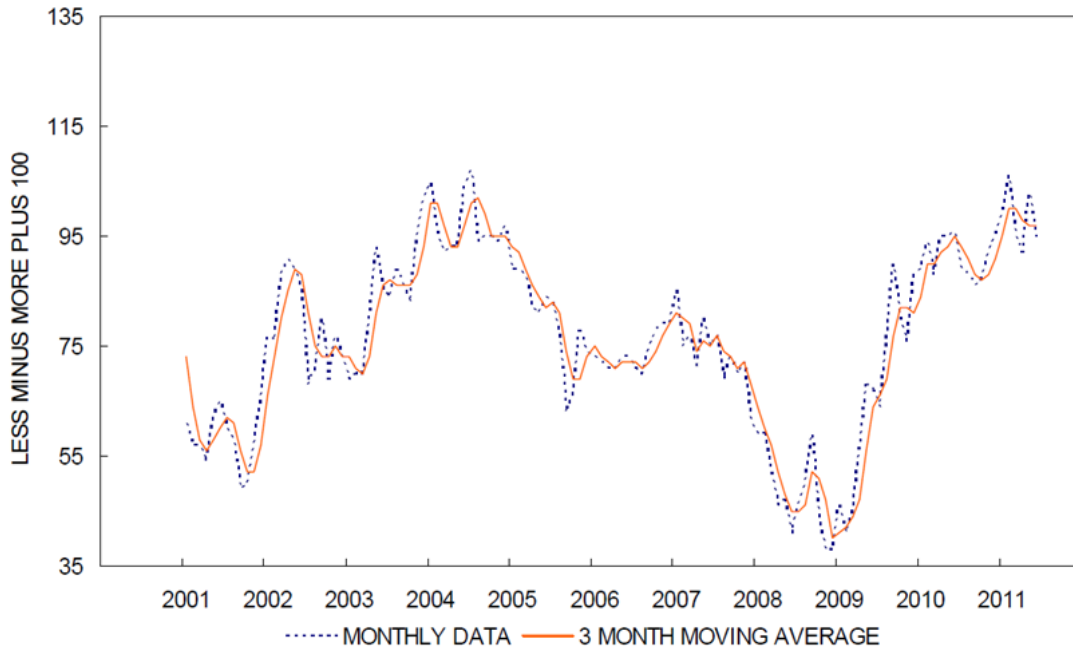
Economic and Interest Rate Forecast — January 2012

	4Q'10	1Q'11	2Q'11	3Q'11	4Q'11	1Q'12	2Q'12	3Q'12	4Q'12	1Q'13
Economic Indicators										
Real GDP (QoQ % SAAR)	2.30	0.40	1.30	1.80	3.00	2.25	2.25	2.50	2.75	2.50
Core PCE (%)	0.96	1.06	1.31	1.63	1.80	1.90	1.80	1.75	1.70	1.75
Short-Term Interest Rates*										
Targeted Federal Funds (%)	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3-Month LIBOR (%)	0.30	0.30	0.25	0.37	0.58	0.50	0.50	0.50	0.50	0.60
Long-Term Interest Rates*										
2-Year U.S. Treasury Note (%)	0.60	0.83	0.46	0.24	0.24	0.40	0.50	0.60	0.70	0.90
5-Year U.S. Treasury Note (%)	2.01	2.28	1.76	0.95	0.83	1.34	1.52	1.78	1.85	2.07
7-Year U.S. Treasury Note (%)	2.70	2.92	2.50	1.43	1.35	1.77	1.96	2.28	2.34	2.55
10-Year U.S. Treasury Note (%)	3.30	3.47	3.16	1.92	1.88	2.20	2.40	2.75	2.80	3.00
30-Year U.S. Treasury Bond (%)	4.34	4.51	4.37	2.91	2.90	3.00	3.10	3.35	3.40	3.50
Tax-Exempt Interest Rates*										
MMD Yield Curve Slope (bps)	431	448	412	330	330	335	340	350	365	370
30-Year MMD (%)	4.68	4.80	4.35	3.55	3.55	3.50	3.60	3.75	3.90	4.00
7-Day SIFMA (%)	0.34	0.25	0.09	0.16	0.10	0.15	0.20	0.25	0.25	0.30

Source: Loop Capital Markets' Analytical Services Division and Short-Term Desk
 Black Text: Actual Gold Text: Forecast as of January 11, 2012
 * Values at end of period

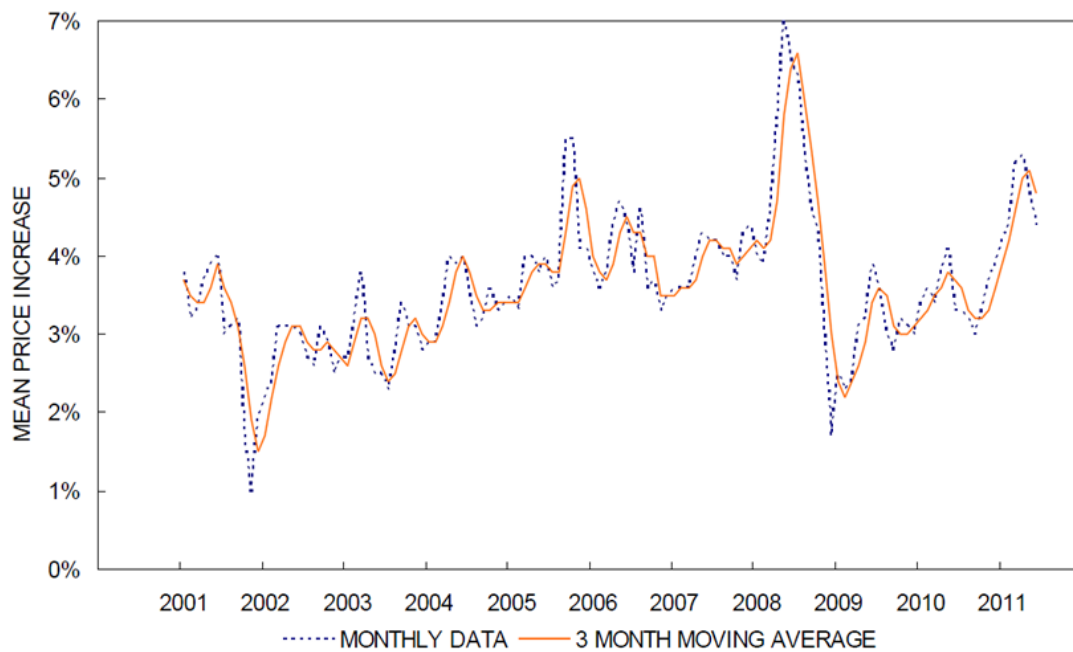
Charting the Economy

EXPECTED CHANGE IN UNEMPLOYMENT



Current attitudes about unemployment are as good as they have been since 2004.

MEAN EXPECTED PRICE INCREASE OVER THE NEXT 12 MONTHS



Consumer expectations regarding inflation have risen steadily during the recovery, similar to the period after the previous recession. The presumption is that consumers are less worried about growth prospects.

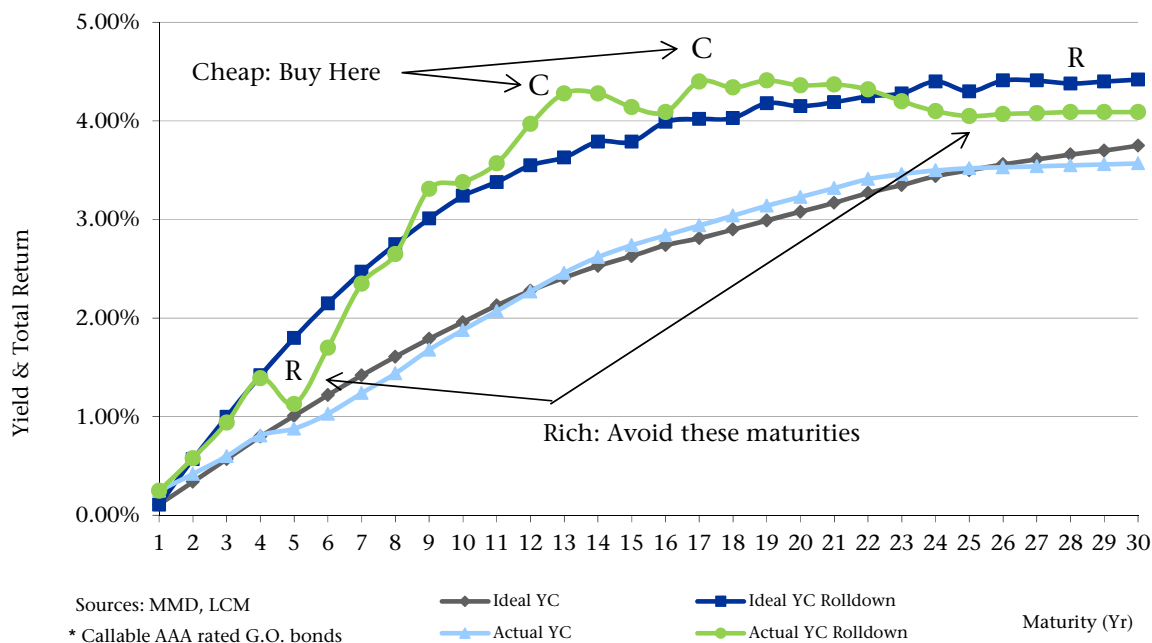
Source: Index of Consumer Sentiment, University of Michigan

Market Review — The Yield Curve

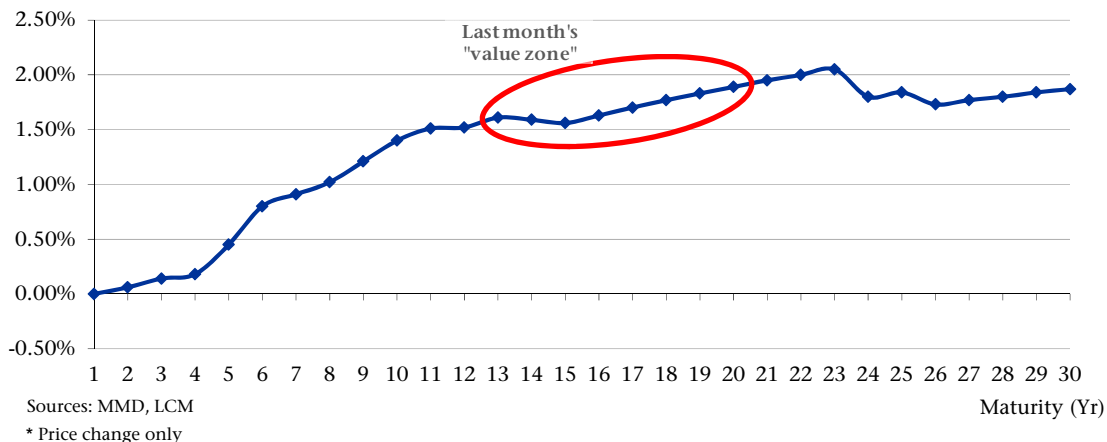
The actual curve has both a convex and a concave area, which causes roll-down returns to differ significantly depending on maturity, assuming no change in the yield curve. For example, 5 year maturity, which hardly benefits from roll-down since 4-year point has almost identical yield, offers subpar return. On the other hand, 13-year maturity offers relatively high roll-down return, because of the steep decline in yields in the 5-13 year area.

The chart indicates that investors should avoid rich points on the curve, such as the 5 to 8 year area and that the 12-21 year area is relatively cheap.

1-Year Forward Roll-down—AAA MMD Curve (January 4, 2012)

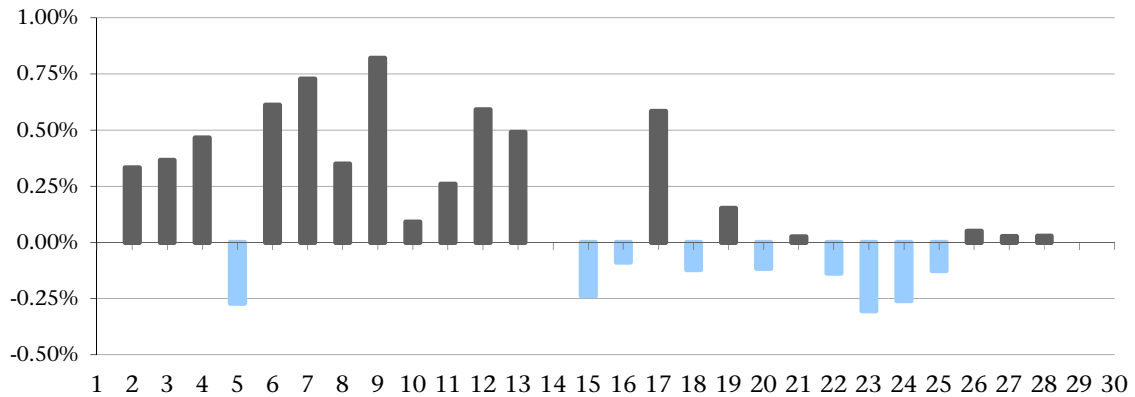


Monthly Returns—AAA GO Bonds* (12/5/11 — 1/4/12)



The value zone established in the previous month continues to do a fairly good job of identifying points or areas on the curve that offer better returns than proximate areas. This month the value zone should have identified the 21 to 23 year areas.

Incremental Return / Incremental Duration Across Maturities (January 4, 2012)*

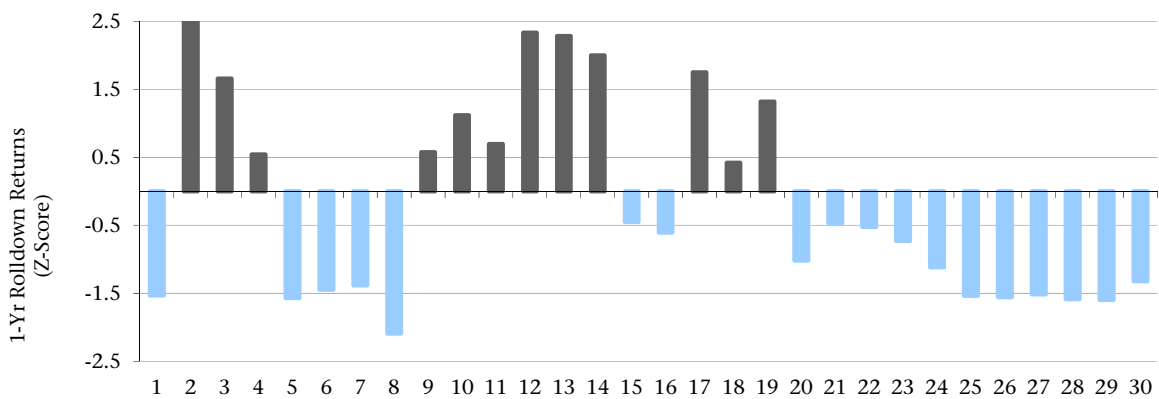


Sources: MMD, LCM

* Callable AAA rated G.O. bonds

Maturity

Rich-Cheap Areas of Non-Callable Curve Based on Rolldown Returns*



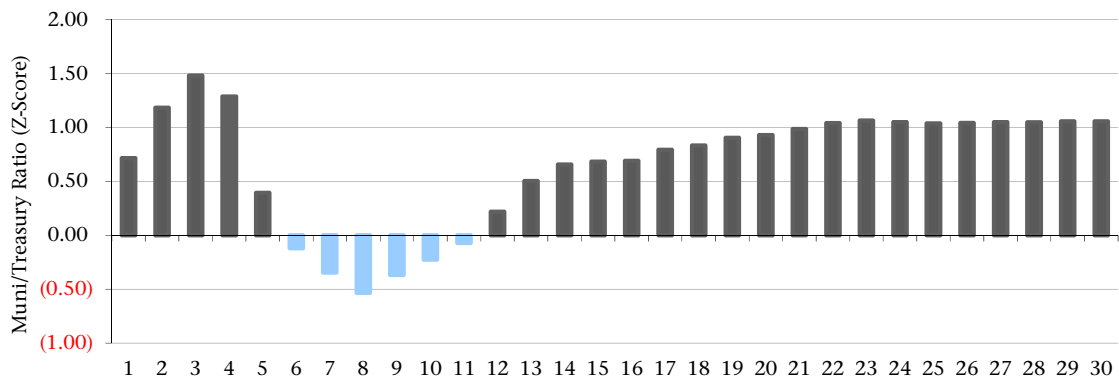
Sources: MMD, Bloomberg, LCM

* Using 12-month history

Ratios greater than 0 indicate that munis are cheap

Maturity

Rich-Cheap Areas of Non-Callable Curve Based on Muni/Treasury Ratios*



Sources: MMD, Bloomberg, LCM

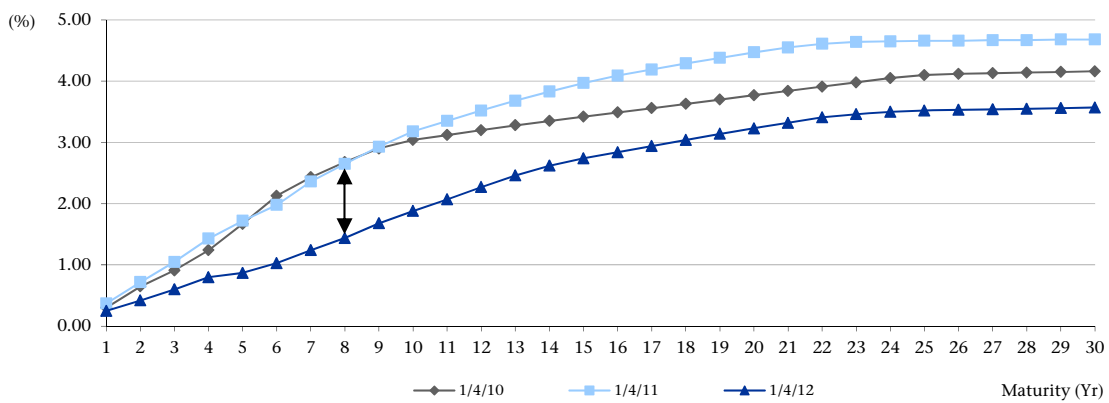
* Using 12-month history

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Maturity

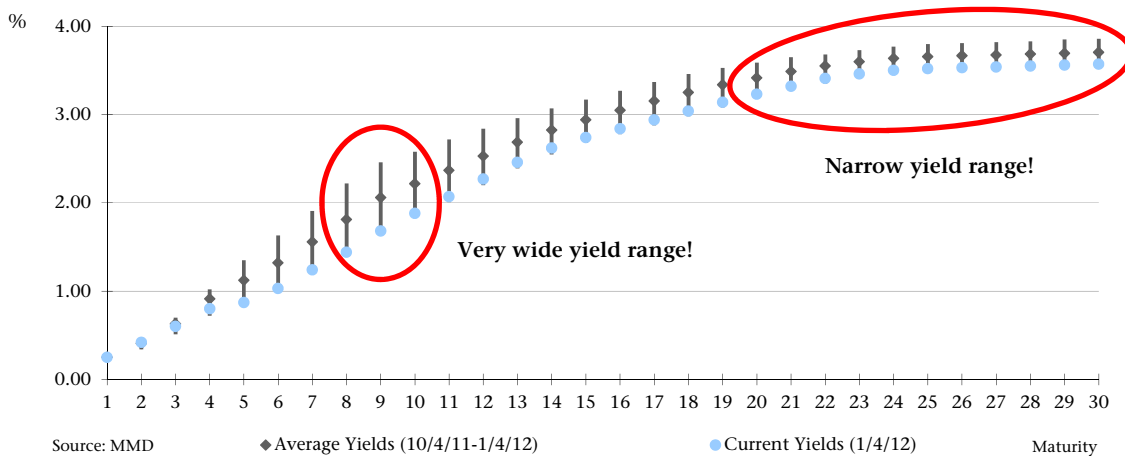
Muni/Treasury ratios have lost relevance except perhaps as a "hedged" speculation on Treasury prices.

Current vs. Historical Municipal Yield Curves



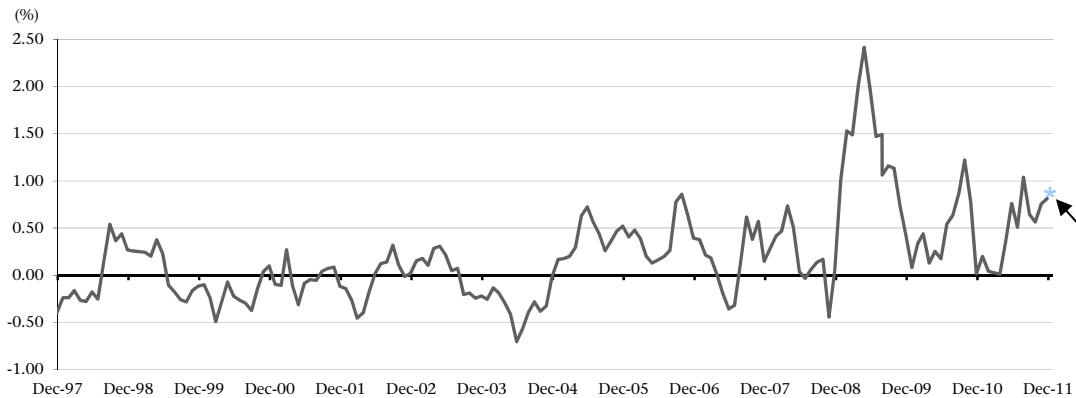
The large gap between the 6-year and the 10-year that exists for the current curve relative to the two previous curves suggests that the Fed's "Operation Twist" is impacting the muni curve.

AAA MMD Yield (3-Month Average)



Yields are currently at their lowest over the most recent 3-month period.

10-Year Treasury Relative Value Indicator*



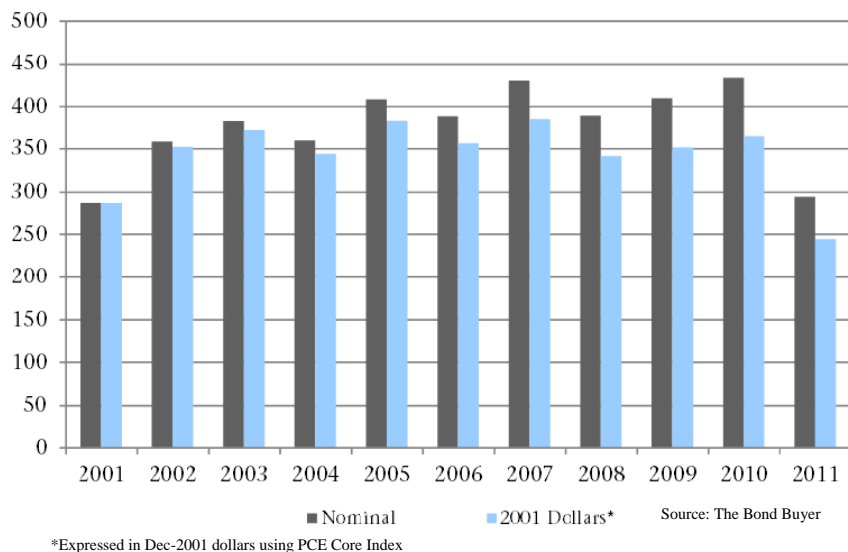
Treasury 10-year remains rich compared to other bond sectors.
Current value: 0.81%

*Positive values indicate richness, while negative values indicate cheapness

Outlook for New Issue Volume

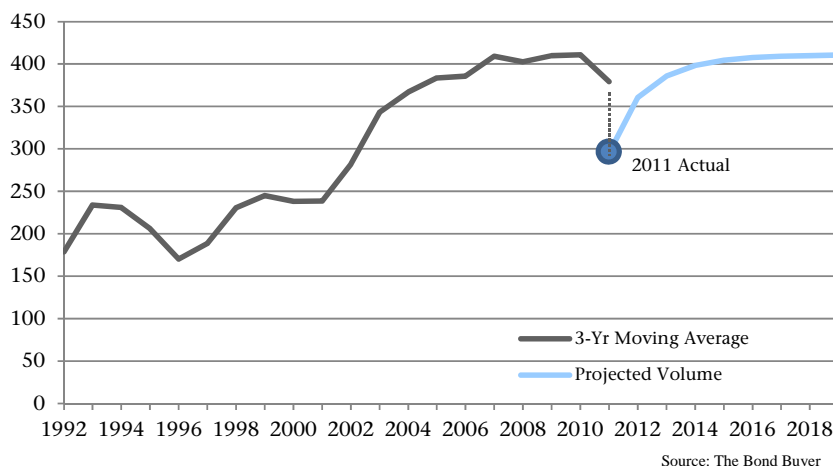
- Market contraction has been so severe that on an inflation-adjusted basis, new issue volume in 2011 was lower than in 2001.

MUNICIPAL NEW ISSUE VOLUME (\$ Billion)



- But, inflation-adjusted Compound Annual Growth Rate (CAGR) from 2001 to 2010 (the last year with “normal” volume) was 2.7%, about the trend growth rate of the economy.
- Moderate growth in municipal new issue volume, combined with substantial infrastructure needs, suggests that the drop in volume in 2011 will be short-lived.
- The American Society of Civil Engineers estimates that over the next 5 years, the U.S. will invest less than half of what is required to address the infrastructure needs.

HISTORICAL AND PROJECTED VOLUMES (\$ Billion)

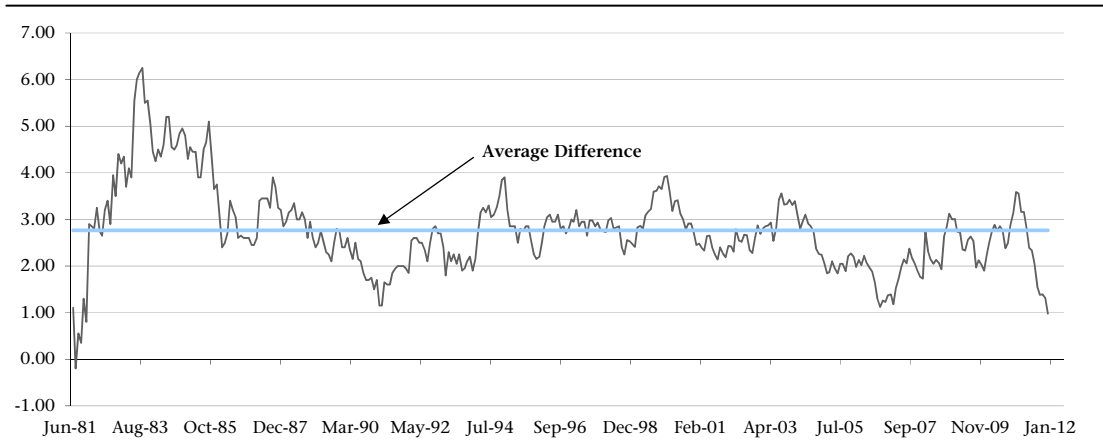


- We estimate the decay rate of this political reaction to be 50% of the balance each year, suggesting that volume will be close to previous levels in 3 to 4 years.

Outlook for Municipal Yields

Three indicators shown below suggest that munis are expensive relative to other asset classes. Munis appear cheap only when compared to Treasuries, which benefited tremendously from the flight to quality, and mortgage rates, which are generally priced off of Treasuries.

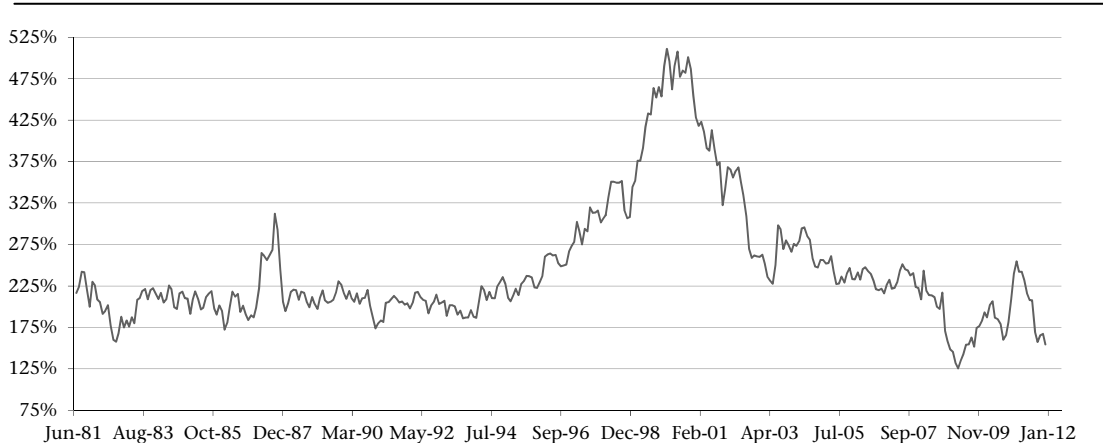
20 YEAR MUNI—CORE CPI YOY SPREAD



10 YEAR MUNI-CORPORATE RATIO



20 YEAR MUNI S&P500 DIVIDEND YIELD RATIO

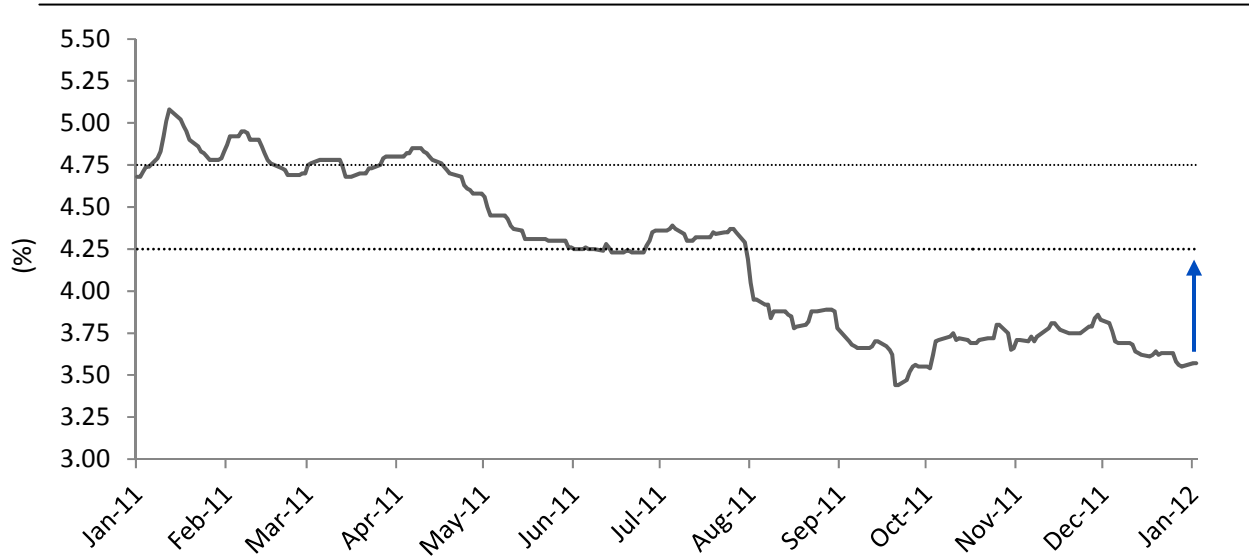


Sources: Bloomberg, MMD, Yale's Shiller

Concerns for Issuers and Buyers

Municipal yields are sharing in the same flight-to-quality phenomenon that has gripped the Treasury market. If the European crisis subsides, muni yields could rise by 75 to 125 basis points very rapidly.

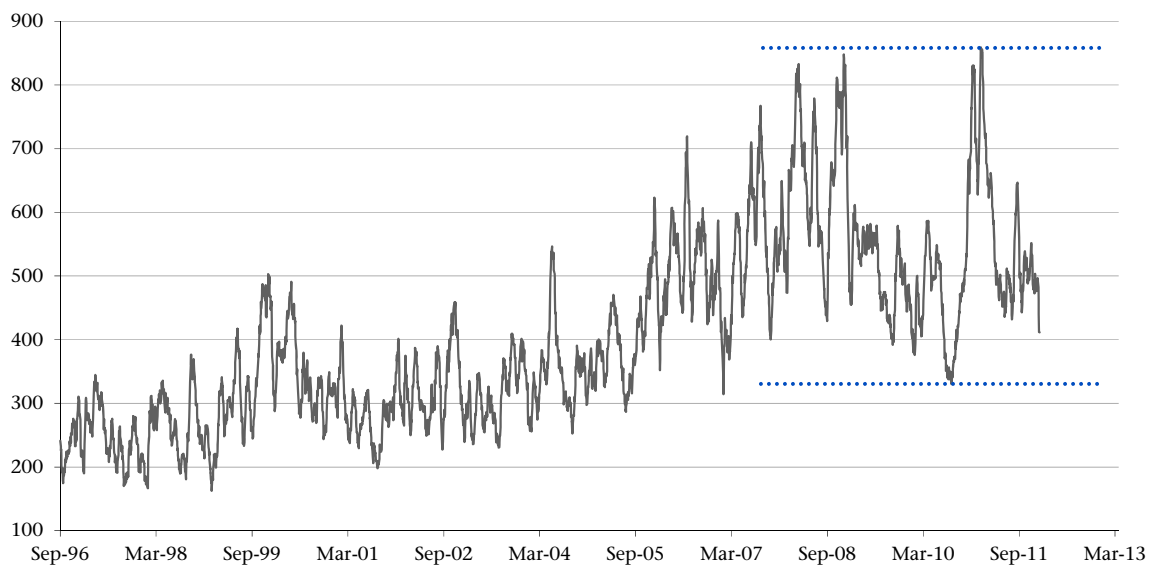
30-YR AAA MMD YIELD



Source: The Bond Buyer

There are some liquidity concerns—will buyers be there when issuers need to sell?

MUNI BIDS WANTED ITEMS LISTED ON BLOOMBERG* (\$ Million)



* 1-Month Moving Average

Source: Bloomberg

There may be some downsizing among large municipal broker/dealers—large firms have announced cutbacks. A smaller muni market (if volume remains low) is not as attractive to large dealers.

The Cost of Tax Exemption

There has been some discussion recently about the “cost” of maintaining the tax-exempt bond market to the federal government. With the feds on the hunt for budget savings, particularly those that offer less political resistance, the price tag on the tax-exempt muni market is on the radar screen. From a cash flow perspective, there is no direct loss of revenue from the tax exemption, which is not the case with the vast majority of federal government programs. There is, however, a “tax expenditure,” which in the parlance of the Treasury Department means that the federal government believes that it would take more money in through tax revenues if municipal bond issues were taxable. No one disputes that there is a cost to the tax exemption. There is an argument raging over what that cost is.

The federal government has a few different numbers floating around, depending upon the source. The CBO is the official arbiter of all matters relating to budget and taxation, but the Treasury’s historic disdain for the muni market is such that they have their own number. On the state and local side, the best estimates are provided by a study published in June by MIT economics professor and Chairman of the National Bureau of Economic Research (NBER) James Poterba. There are other fine articles from various industry participants—both sell side and buy side—and we would be happy to direct readers to these research pieces if they have not seen them already.

The value in Poterba’s piece is two-fold. First, it is a recent study offered as a follow-up to the federal government estimates, and it makes a standard academic argument that is well accepted in both the academic world and the private sector. The argumentation relies on the principle that investors would react to the loss of tax-exemption of municipal bonds by altering their investment decisions. The changes that are made represent the next best after-tax portfolio allocation, which would mitigate some of the costs estimated by the CBO. The work is straightforward and uncontroversial in its approach. The second major benefit of the paper is that the author is a marquee economist of the first order and the equal of authors of the CBO’s or the Treasury Department’s methodologies.

The field of what “the number” is has gotten more crowded and there is a solid representative sampling of estimations floating around. My small contribution to the discussion is to ask an obvious question that I haven’t seen either side utter as of yet:

Is the estimate of the tax expenditure, whatever it may be, significant? Is it enough to make a difference in the budget cutting process? Or is attacking this tax expenditure just ‘easy pickings’ for a Congress that cannot even be trusted to safeguard the nation’s credit rating?

Fortunately, the question is fairly easily answered. Currently the federal budget stands at a hair below \$4 trillion dollars. The annual tax expenditure, depending upon whom you believe, is estimated to be between \$10 billion and about \$30 billion. That means that the budgetary burden of keeping municipal bonds tax-exempt is somewhere between one-quarter of one percent and three-quarters of one percent. That level of burden places no value whatsoever on the benefits the lower cost of capital has on promoting infrastructure. Undoubtedly, most politicians would respond by saying, “we have to cut everywhere we possibly can!” or maybe they would invoke Everett Dirksen’s famous quote (“A billion here, a billion there...”), but the reality is that the cost of tax exemption can in no way be considered a material burden on the budget of the United States.

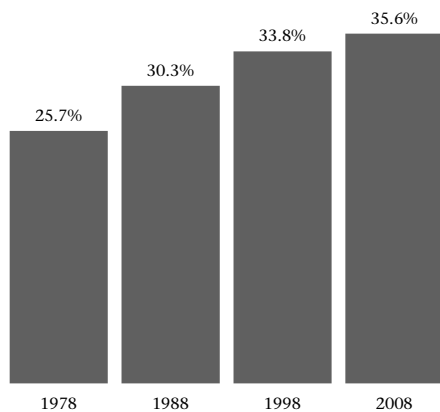
While nailing down the cost of tax exemption—and getting it right—is a worthy goal, my concern is that it is a distraction from the bigger goal of lobbying Congress to keep their hands off of muni market. If the public finance world gets bogged down in the discussion of “What does it cost?” then I am concerned that we would be playing into the hands of the Treasury Department. Those who understand the benefits should work to get all of the various municipal lobbying groups together in a unified counter attack formulated on stressing the values of the program, which far exceed the modest costs—whatever they may be.

2012 Outlook for State Finances

States' overall fiscal condition continues to improve as we enter 2012. The positive outlook is driven predominantly by better revenue performance, as tax collection in most states has either stabilized or grown. As the Rockefeller Institute reports, "We've now had seven straight quarters of gains after five quarters of sharp revenue decline ended in late 2009." This growth in overall tax collection is a trend expected to continue throughout 2012. Whether this level of growth is sustainable remains in question, as economic recovery remains sluggish.

States rely on the majority of their revenue coming from personal income, sales and corporate income taxes. Among these revenue sources there has been a shift in dependence from sales to personal income tax. While personal income tax collection has increased by over 9% from third quarter 2010 to 2011, concern remains as this form of tax collection is much more volatile than that of sales tax.

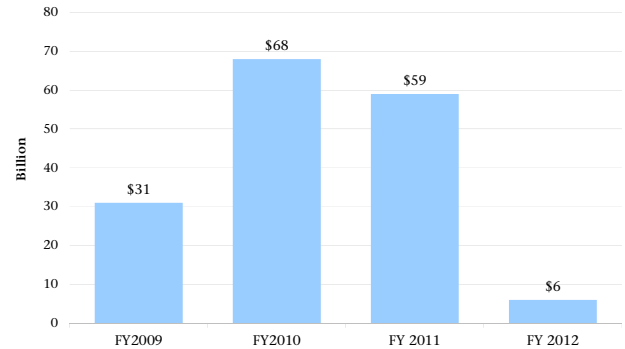
Reliance on PIT



Source: Pew Center on the States and The Nelson A. Rockefeller Institute of Government, 2011, based on Tax Policy Center analysis of U.S. Bureau of the Census data.

Another concern is that while state tax collections have now surpassed pre-recession levels, states have lost about 15% of historical revenue growth level over the last three years. This loss in projected revenue growth, coupled with a decrease in federal aid, will force states to continue enacting spending cuts. While these cuts to state services are not expected to be as drastic as those made over the last three years, any level of service cuts can reduce overall economic activity.

Few Recovery Act Funds (Including August Extension) Available After 2011



Source: CBPP analysis using data from U.S. Department of Health and Human Services, US Department of Education, and Congressional Budget Office

Besides the projected spending cuts as a result of decreased federal aid, many states face the possibility of midyear cuts due to an increase in revenue estimating errors. Forecasting is always inexact, but there are a number of factors that increase a state's ability to accurately predict revenues, including the state's tax structure, economic base, and budget processes in place. A small error can have a major impact. For example, a 1% forecasting error in Montana represents one half of the state's judicial budget.

Fewer States Get it Right

Percentage of forecasts off by 5% or more

■ Shortfalls ■ Overages

1990 to 1992: 3 years of fiscal crisis



2001 to 2003: 3 years of fiscal crisis



2009: The first significant year of the ongoing fiscal crisis



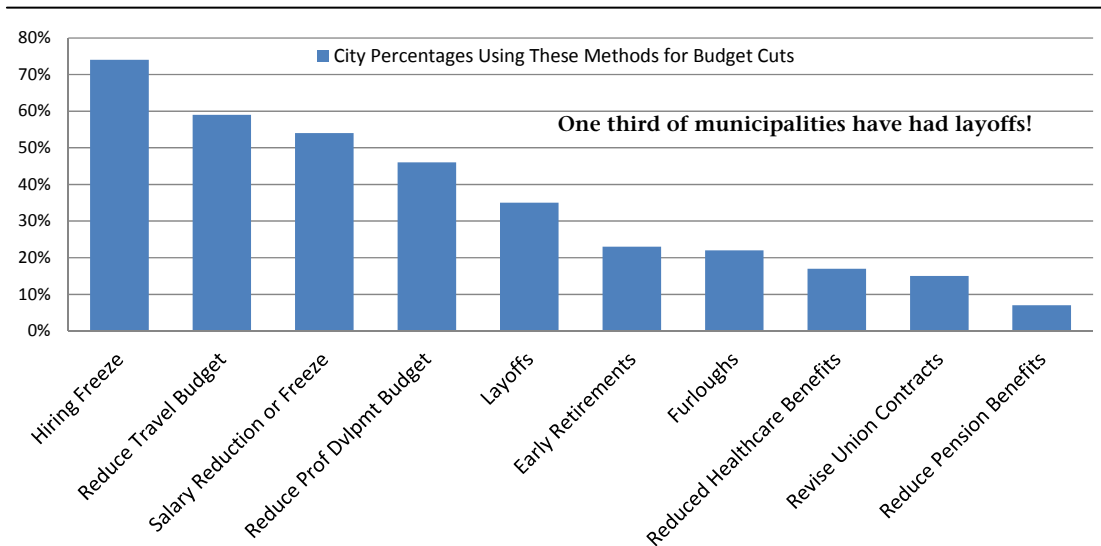
Source: Pew Center on the States and The Nelson A. Rockefeller Institute of Government, 2011, National Association of State Budget Officers and the National Governors Association

While states overall fiscal outlook for 2012 is positive, many challenges remain. The current economic malaise, turmoil in Europe, and question about what impact congressional action to reduce the federal deficit will have on state budgets, could not only stall, but even reverse the recent improvements in states' fiscal condition.

An Update on Public-Private Partnerships (P3)

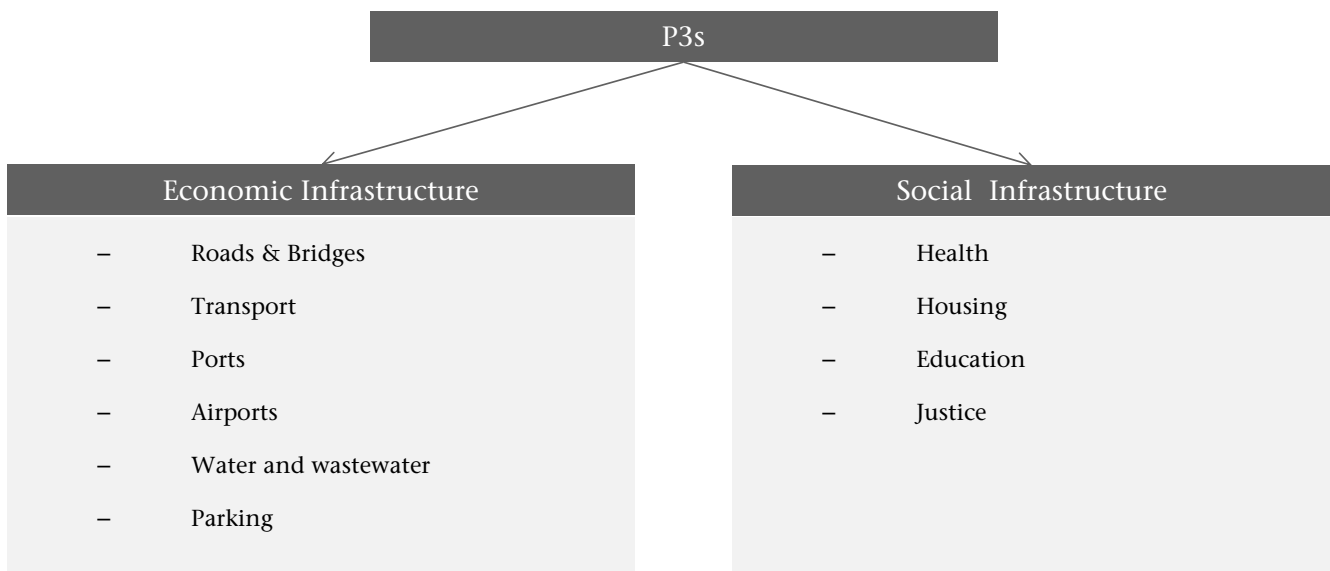
- Faced with fiscal pressures, most municipalities have used at least a few of the most typical budget solutions (layoffs, salary reductions, hiring freezes, furloughs, reduced benefits, etc.)
- Many municipalities have also considered or have used options outside of the typical budget management toolkit:
 - Consolidation of overlapping units of government
 - Restructuring debt
 - Issuing commercial paper for short term borrowing
 - Privatization/P3
 - Ch. 9 and/or threat of Ch. 9 to seek forbearance with creditors
 - Drawing down reserves

Budget Cut Choices for Municipalities



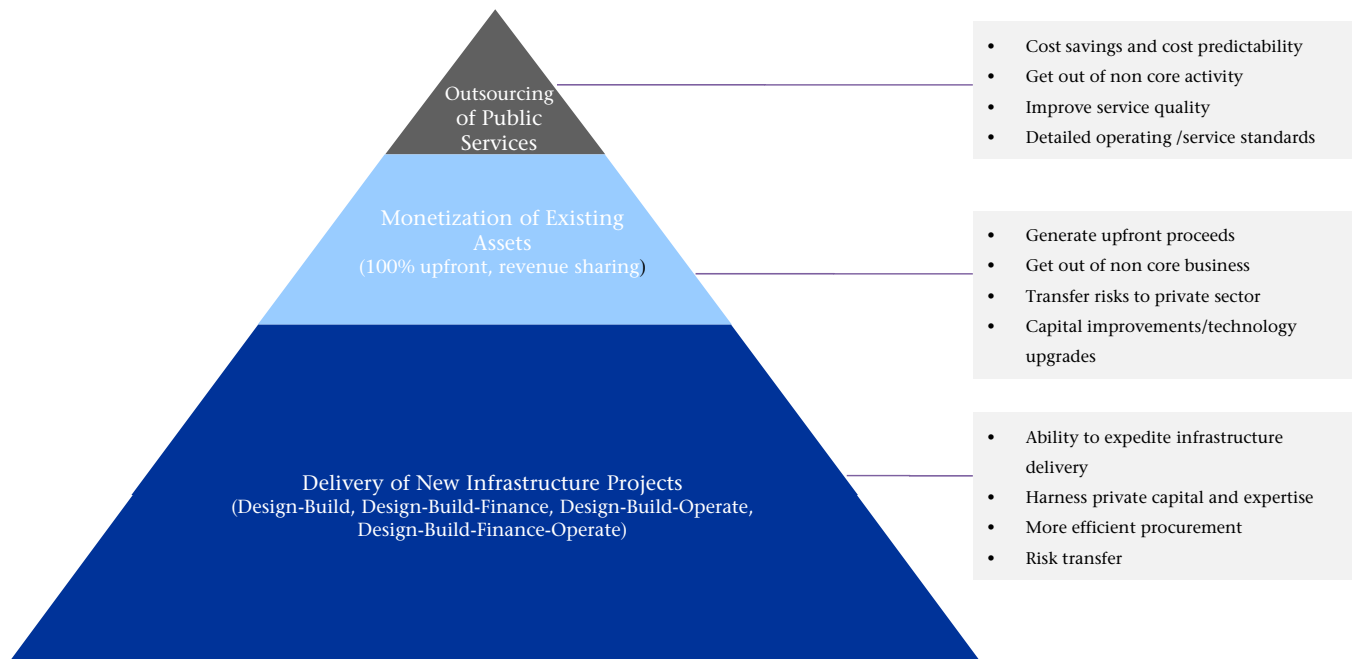
Source: National League of Cities. Cities Fiscal Conditions, 2010

- The following chart shows two distinct P3 market segments and sub-segments. Most activity is on the economic infrastructure side, but the market is evolving to include social infrastructure as well:



- Current P3s in the market come with differing motivations and objectives:

P3 Categories



P3 Categories

Market Drivers	Uncertainties	Financing
Growing infrastructure gap (greater than \$2.2 trillion over 5 years) according to American Society of Civil Engineers	Policy makers and stakeholders yet to be convinced about benefits of P3s	Greenfield P3 structures consider maximum possible use of tax exempt debt and federal financing programs
Public sector fiscal deficits at all levels of the government	Lack of clarity regarding federal funding and financing programs (TIFIA, Transport Bill Reauthorization etc)	Use of tax-exempt debt financing is blurring, to some extent, the financing difference between traditional public sector approach and P3s
Volatility in the tax-exempt market, challenges for weaker municipal credits	Investor skepticism due to failure of some high profile P3s has caused infrastructure funds to focus on private sector power/energy deals or look abroad	Equity capital still interested but not as much appetite for riskier project revenue based deals
Substantial capital raised by infrastructure funds ; total amount of dry powder available to unlisted infrastructure funds as of October 2011 stands at \$64.2bn with almost half of it focused on North America resulting in purchasing power of close to \$150 billion		Bond markets open for low investment grade P3 credits but seemingly only for the tax exempt (PAB) product and for lower risk availability payment type deals Bank debt mostly provided by European and Canadian banks; uncertainty due to European crisis, spreads range from 250 bps to 350 bps over LIBOR for upto 7 year maturity

Loop Capital Markets Upcoming Presentations

Date	Event	Topic	Location
1/11/12	Webcast	California Debt and Investment Advisory Commission	Virtual
1/11/12	Chicago Municipal Analysts Society	Municipal Outlook (Chris Mier) Economic Outlook (Diane Swonk) Analysts Outlook (Various)	Chicago, Illinois
2/27/12	Municipal Bond Buyers Conference	Presentation to be determined	Naples, Florida

Loop Capital Markets Upcoming Negotiated Calendar

Date	Par Amount (\$ mil)	Issue	Lead Manager
1/11/12	181.0	State of North Carolina Grant Anticipation Revenue Vehicle Bonds	Bank of America / Merrill Lynch
1/12/12	78.0	Jacksonville Electric Authority	Bank of America / Merrill Lynch
Jan-12	96.0	University of Indiana	Morgan Stanley
Jan-12	13.0	Mass Housing Finance Agency Notes	Loop Capital
Jan-12	290.0	Orlando and Orange Co. Expressway Authority FRN's	Wells Fargo
Jan-12	100.0	University of Mississippi	Morgan Stanley
Jan-12	105.0	City of Detroit, MI Capital Grant Receipts Revenue Bonds	Loop Capital
Jan-12	180.0	Tampa Hillsborough Expressway Authority	Bank of America / Merrill Lynch
Jan-12	300.0	University of Chicago	Bank of America / Merrill Lynch
Jan-12	30.0	Atlanta, GA Development Authority Tax Allocation	Raymond James
Jan-12	125.0	Los Angeles Municipal Improvement Corporation	Loop Capital
Feb-12	100.0	Long Beach Bond Finance Authority (Aquarium of the Pacific)	Loop Capital

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