ROCKFLEET financial services

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MUNI MARKET UPDATE

September 13, 2010

INSIDE THIS ISSUE:

ILLINOIS BUDGET UPDATE

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Most investors are aware of the severe budgetary problems many state and local governments are experiencing as the Great Recession wreaks havoc on their revenue bases. While California has garnered most of the attention due to the prominence of the state and the size and scope of its deficits, Illinois' budget issues now exceed those of California on a relative scale. Not only is Illinois confronting a $13 billion deficit for its current fiscal year, but the state is also dealing with a $6 billion backlog of unpaid bills and massive unfunded pension liabilities.

Illinois' finances, in poor shape at the start of the recession, have worsened dramatically since mid-2008. A large part of the state's long-term fiscal difficulties stem from a failure to impose the necessary discipline on state finances. The budget crisis has prompted the rating agencies to downgrade the state's bond ratings multiple times over the past year. Increasingly dependent upon the capital markets to bridge its funding gap, Illinois must enact tough financial reforms or face further erosion of investor confidence in its credit and a possible liquidity crisis.

Persistent Deficits

In a report on how the states are responding to their budget crises, the Center on Budget and Policy Priorities charted the deficits for the 46 states facing 2011 budget shortfalls. Illinois' accumulated budget gap of $13.5 billion going into fiscal 2011 represents 41.5% of its 2011 budget. Only the State of Nevada, at 54%, had a higher budget gap to budget ratio

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ADDITIONAL BURDENS IN HEALTHCARE

McKinsey & Company released its report regarding new regulations requiring healthcare providers to use electronic health records, computerized-physician-order-entry systems, and strict data-coding standards. McKinsey's research concludes that while the costs associated with these enhancements is expected to be approximately $120 billion — an average cost of $80,000-100,000 per bed — hospitals should be able to realize significant operating efficiencies — up to $40 billion annually.

Legislative and regulatory changes implemented by the American Reinvestment and Recovery Act of 2009 ("ARRA"), the Health Insurance Portability and Accountability Act ("HIPAA") and the switch to ICD-10 are expected to affect up to 80% of existing hospital information technology applications.

While ARRA provides limited financial incentives under Medicare, the spending gap is expected to be $60,000-80,000 per bed. McKinsey reports that costs are rising approximately 10% annually, outpacing revenues, thereby burdening already strained hospital budgets. ♣

Read the entire report.

THIS WEEK'S CALENDAR

E.D.T.	Amount	Ratings	Issuer	State	Structure	
Tuesday, September 14						
10:30AM	45,695M	Aa2/AA+	Norfolk	VA	2011-2040	
11:00AM	14,600M	Aaa/AAA	T/O Cary	NC	2017-2022	BQ
11:00AM	120,000M	UR/UR	Washington Sub San Dist (T/E) Series A	MD	2011-2020	
11:00AM	120,000M	UR/UR	Washington Sub San Dist (T/E or BAB) Ser B	MD	2021-2030	
11:00AM	147,530M	NR/A+	Orange Co Tourist Dev Bonds	FL	2019-2024	
11:15AM	7,630M	UR/UR	Monroeville	PA	2011-2016	BQ
11:45AM	1,633M	UR/UR	Tewksbury Twp BOE	NJ	2012-2025	BQ
12:15PM	12,835M	UR/NR	Waynesboro Area Sch Dsit	PA	2011-2025	BQ
1:15PM	35,000M	UR/UR	Williamsport Sanitation Auth	PA	2015-2040	
Wednesday, September 15						
11:00AM	34,500M	UR/UR	Gloucester Co	NJ	2011-2025	
11:00AM	10,160M	UR/NR	Spackenkill UFSD	NY	2012-2025	BQ
11:00AM	8,0268M	NR/UR	Woodbridge Borough	NJ	2011-2026	BQ
11:30AM	4,195M	UR/UR	Edwards-Knox CSD	NY	2011-2024	BQ
1:30PM	313,305M	UR/UR	S/O WA Various Purposes GO Rfdg	WA	2011-2027	
2:00PM	325,355M	UR/UR	S/O WA Motor Vehicle Fuel TAX GO Rfdg	WA	2011-2027	
Thursday, September 16						
11:00AM	15,455M	UR/UR	Dobbs Ferry UFSD	NY	2010-2020	BQ
11:00AM	26,850M	UR/UR	Hornell CSD QZAB - TAXABLE	NY	2012-2025	
11:00AM	3,116M	UR/UR	Swampscott	MA	2011-2022	BQ
11:00AM	2,552M	UR/UR	Johnstown	NY	2011-2029	BQ
11:00AM	12,000M	Aa2/NR	Ramapo	NY	2011-2022	
11:30AM	135,000M	UR/UR	City of San Francisco COPs	CA	???????	

Click here for calendar updates.

MARKET UPDATE

Meredith Whitney, formerly an analyst at Oppenheimer who now runs her own firm, predicted that securities firms worldwide will cut as many as 80,000 positions during the next 18 months, or roughly 10% of total employment. In an August 31 report, Whitney forecast that the reduction will follow 2010 compensation. "The key product drivers of Wall Street's revenues and profits over the past decade have been in structural decline over the last three years," according to the report.

Companies jammed the bond market with fresh debt last week and yield hungry investors showed little sign of back-

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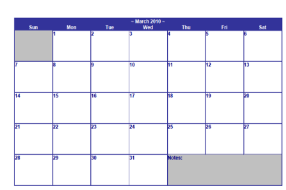
VISIBLE SUPPLY

Total supply for the week of September 13, 2010 is \$8.18 billion. \$5.75 billion is tax-exempt, while \$2.44 billion is taxable.

The 30-day visible supply is calculated by The Bond Buyer and reflects the total dollar volume of bonds to be offered at competitive bidding and through negotiation over the next 30 days.

Source: Thomson Reuters.

ECONOMIC CALENDAR



MARKET UPDATE (CONT'D)

ing away — though it would appear that the day of saturation grows nearer. An estimated $51 billion of new corporate bonds and leveraged loans hit the market on Tuesday and Wednesday alone, according to Dealogic and S&P's Leveraged Commentary and Data Group. Corporate borrowers are enjoying a golden moment of super-low interest rates combined with a scramble by global investors for higher yielding assets given that cash is yielding nothing.

The Securities and Exchange Commission will kick off its much awaited series of hearings on the municipal market this month, holding the first on Tuesday, Sept. 21, in San Francisco. The hearings will include local market participants and will examine such issues as the MSRB, Build America Bonds, investor protection and education, financial reporting and accounting, market stability and liquidity and other issues. "We are taking significant steps to hear the broadest possible range of views, and look forward to receiving suggestions for speakers and topics for the upcoming meetings," said SEC spokesman John Nester.

Federal lawmakers return to work next week, but market participants warn it is unlikely they will take ac-

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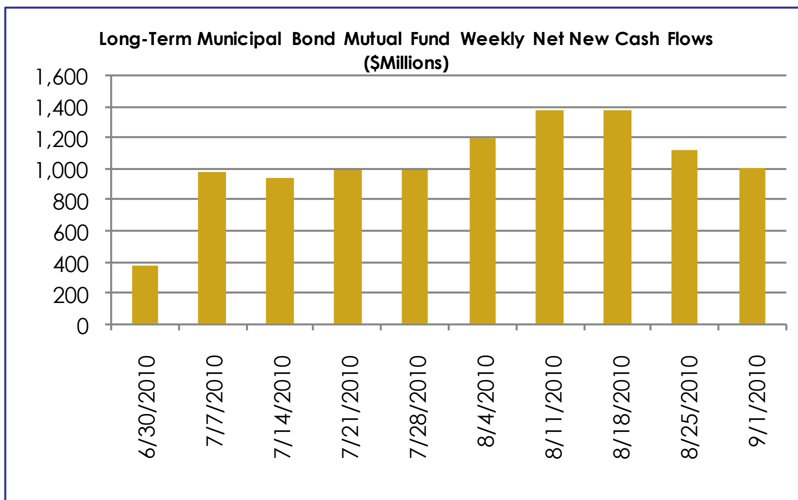
MUTUAL FUNDS AND MONEY MARKETS

Long-Term Mutual Fund Flows

Total estimated outflows from long-term mutual funds were $4.31 billion for the week ended Wednesday, September 1, the Investment Company Institute reported.

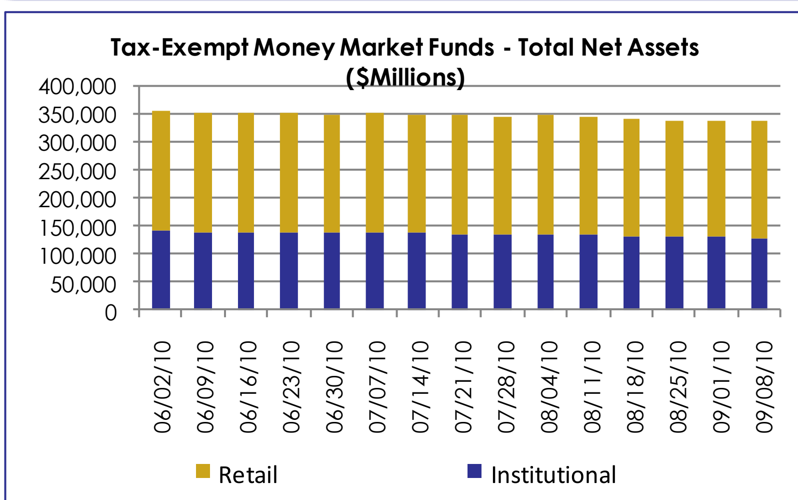
Flow estimates are derived from data collected covering more than 95 percent of industry assets and are adjusted to represent industry totals.



Money Market Mutual Fund Assets

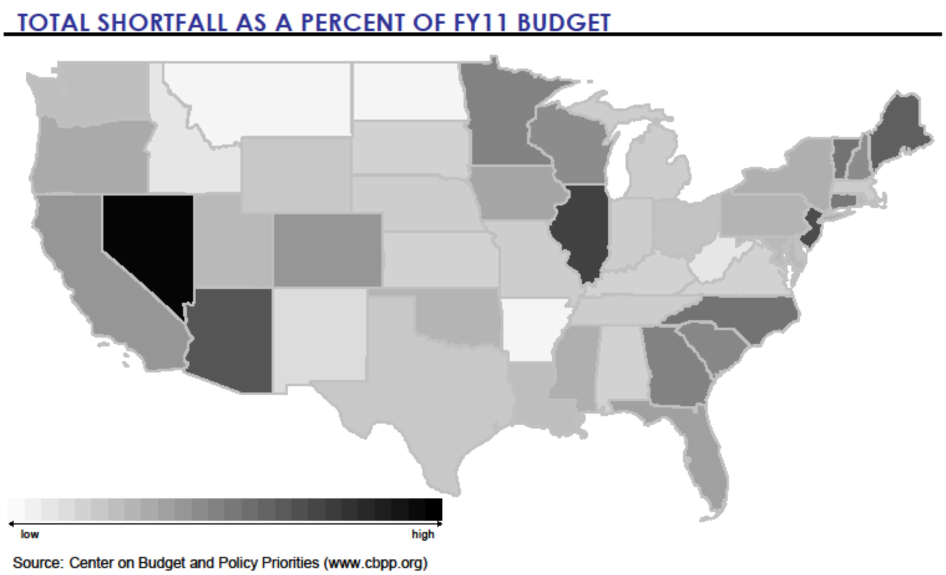
Total money market mutual fund assets increased by $10.55 billion to $2.839 trillion for the week ended Wednesday, September 8, the Investment Company Institute reported.

Taxable government funds did not change by a significant amount, taxable non-government funds increased by $9.91 billion, and tax-exempt funds increased by $640 million.♣



(Source: Investment Company Institute. September 8, 2010.

ILLINOIS BUDGET UPDATE (CONT'D)



for 2011, and Nevada's budget is only one-eighth the size of Illinois' budget. California's budget gap was higher at nearly $18 billion, but its budget gap to budget ratio is considerably lower at 21.6%.

Illinois' budget problems are nothing new; the state has not balanced its budget in a decade. Every year since fiscal year 2001, the state has reported a year-end budget deficit.

The state's deficit ballooned over the past two years from $834 million to $13 billion due to a combination of falling income and sales taxes, rapidly rising pension costs and growing debt service outlays. This mismatch between ongoing revenues and expenditures is called a structural deficit in that it is built into the financial structure and not the result of periodic unanticipated drops in revenues or spikes in spending. Key contributors over the years include rapid growth in both Medicaid and education spending and a revenue base that has failed to keep up with inflation.

> ***A structural deficit occurs when a state posts a deficit even when the economy is operating at its full potential.***
>
> ***In the case of a cyclical deficit, any borrowing that is needed during the low point of the economic cycle will be repaid when the economy turns higher and there is a cyclical surplus.***

Illinois' flat income tax rate of 3% differs from that of most states, which have progressive systems where tax rates rise with higher income levels. The flat tax structure prevented the state from fully tapping into income growth during periods of economic expansion as a disproportionate share of that growth mostly occurred among the upper income classes. Neither has growth in the state's 5.0% sales tax reflected the economic expansion

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UPCOMING EVENTS

Public Pension Financial Forum: 2010 Annual Conference
September 12 – 15, 2010
St. Paul, MN

Battery Park City Authority Meeting of the Members
September 14, 2010 – 10:00 a.m.
Live Webcast

Housing Trust Fund Corporation (NY) Board Meeting
September 14, 2010
Webcast

Smith's Research & Gradings High Yield Municipal Bond Conference
September 14 – 15, 2010
Greenwich, CT

IAWatch AML Programs Reloaded: Why Dodd-Frank May Change the Landscape for RIAs
September 14, 2010 – 2:00 – 3:30 p.m. ET
Live Webinar

Bloomberg Cities and Debt Briefing: Defusing the Municipal Pension Bomb
September 15, 2010
New York, NY

NYS Division of the Budget Public Authorities Control Board Meeting
September 15, 2010 – 2:00 p.m. Live Webcast

CDFA Intro Energy Finance Course
September 16 - 17, 2010
Washington, DC

More events...

ILLINOIS BUDGET UPDATE (CONT'D)

state's 5.0% sales tax reflected the economic expansion of the mid-2000s. Sales tax regulations exempt most categories of consumer services, which have been the fastest growing segment of the economy since 2001.

Illinois has been able to muddle through its fiscal difficulties utilizing a number of stratagems. These include payment deferrals, especially to providers of Medicaid services, under-funding the pension system (discussed later), and issuing bonds to fund current operations. Skimping on pension payments and bonding for operations serve to push higher costs onto future taxpayers.

The state's structural deficit, compounded by the recession, is having a profound effect on Illinois' cash position. As cash reserves dwindle, the state has been deferring payment on an increasing amount of its bills.

At the end of fiscal 2009, the amount of unpaid bills totaled $2.8 billion and the average delay in paying vouchers was 99 days. By June 30, 2010, delinquent payments had grown to $4.7 billion with an average payment delay of 153 days.

Worse yet, state vendors had 60 days after the end of the fiscal year to submit their bills and officials expected that the state's prior payment obligations would eventually exceed $6 billion. Recently, the state legislature extended the time when all prior year bills had to be paid from the end of August to the end of 2010. Despite the extension, this welter of claims against the state present a daunting challenge to its fiscal officers and a drain on current and future year operations.

Inadequate Pension Funding

As of June 30, 2009, Illinois reported that its unfunded pension liability for its five pension plans equaled $62.4 billion. This represents the present value of the state's aggregate pension liability less the value of assets set aside to cover them. The funded ratio, i.e., the value of assets divided by the present value of the liabilities, of 50.6% was the lowest of all of the states. Most states report funding ratios in the 70% to 80% range.

The unfunded pension liability would have been higher and the funded ratio lower had the state not changed its accounting for unanticipated investment gains or losses in 2009. At that time, the state adopted asset smoothing, which distributes investment results over five years rather than taking the full gain or loss in the year it occurred. Because of the switch to asset smoothing, substantial investment losses incurred during fiscal 2009 are only partially reflected in 2009 asset valuations. Without asset smoothing, the 2009 unfunded liability would have reached nearly $78 billion.

The extent of Illinois' pension obligation is a result of years of inadequate funding of the pension system, prior benefit increases, and recent market conditions. Annual state pension contributions were frequently insufficient to keep the unfunded liabilities from growing. For a number of years, the state took full or partial 'pension holidays' from making its required pension payments. The only year in the recent past in which Illinois adequately funded its system was in fiscal 2004, when the proceeds of a $10 billion pension bond issue in fiscal 2003 were used to reduce unfunded liabilities.

In the spring of 2010, the State Legislature passed a pension reform program that establishes a two-tiered pension system. Under the plan, new employees will receive less generous benefits, including an increase in the minimum age when benefits are paid and a lower salary cap from which benefits are calculated. While the new legislation does not reduce present pension liabilities, state officials believe that the restructured pension system will cut the growth of pension costs in the future.

State pension contributions are projected to increase by 12.2% annually from $4 billion in fiscal 2010 to over $21 billion in 2045 in order to meet a statutorily-required 90% funded ratio. These rising pension costs will put additional pressure on a financial system that is already over-burdened.

Fiscal Year 2011 Budget: More of the Same

Illinois ended fiscal year 2010 with a negative balance of approximately $6.5 billion in its General Funds. Although facing a potential $13 billion budget gap for fiscal 2011, legislative leaders were unwilling to take any substantial steps to reduce the deficit given that 2010 is an election year both for both the governor and most legislators.

Governor Quinn had proposed an increase in income taxes, but lawmakers showed little interest. Instead, the Legislature approved

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ILLINOIS BUDGET UPDATE (CONT'D)

the Emergency Budget Act, which gives the governor the unilateral power to reduce the budget by up to $2 billion among other measures. Governor Quinn did announce $1.4 billion in 2011 budget cuts, but these reductions are inadequate given the overall deficit situation.

In terms of its overall budgetary practices for the fiscal 2011 budget, Illinois followed its recent playbook of using temporary revenues, debt, and payment deferrals to cover the gaping budgetary holes. The fiscal 2011 General Funds budget projects approximately $27.7 billion in revenues and $33.5 billion in expenditures for an operating deficit of $5.8 billion. Combined with the accumulated deficit of $6.5 billion, the budgeted fiscal 2011 year-end deficit would be over $12 billion.

The state intends to cover the payment gap in several ways, including a $1.2 to $1.7 billion securitization of its tobacco settlement revenues, a $1.0 billion of inter-fund borrowings, an already issued $1.3 billion short term GO issue, and a proposed $3.7 billion GO Pension Bond issue, estimated to cover most of the state's required 2011 contribution. Ending fiscal 2011 cash balance for the General Funds is $130 million, the same ending balance as in fiscal 2010.

The 2011 budget does not cut the accumulated deficit nor does it shave much of the estimated $6.6 billion of accounts payables. Illinois continues to pass its growing obligations onto future budgets.

A Recommendation for Fiscal Reform

In early 2010, The Institute for Illinois' Fiscal Sustainability at The Civic Federation, an independent, non-partisan government research organization issued its report entitled, 'A Fiscal Rehabilitation Plan for the State of Illinois'. The report analyzes the state's fiscal crisis and sets out a recommended plan of action for how to solve it. The fiscal rehabilitation plan suggests the following actions to be taken by the state:

- Reform the employee retirement systems by requiring higher employee contributions and lowering benefits for new workers.
- Institute general spending cuts of up to $2.1 billion and maintain overall spending at 2007 levels except for Medicaid and general aid to education.
- Only after pension reforms and recommended spending cuts are enacted, then enact revenue-raising measures such as an individual income tax increase of 2% to 5% and a corporate income tax rise from 4.8% to 6.4% . The report estimates that these actions would raise about $6 billion.
- Increase cigarette taxes by a $1 a pack.

The Civic Federation projects that if its budget plan had been adopted for fiscal 2011, the state would have paid down $10 billion of its nearly $13 billion deficit. The remaining $3 billion would be paid off in fiscal 2012 as long as the state kept total spending at 2007 levels.

While few aspects of the plan have been adopted so far, with the exception of the pension benefit reductions for new employees, the Fiscal Sustainability Plan could serve as an ultimate blueprint for fixing Illinois' finances.

Illinois Pays the Price for its Profligacy

Illinois' deepening credit problems are reflected in the recent yields that it is

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UPCOMING EVENTS

The Carolinas Municipal Advisory Council and Securities Dealers of the Carolinas 77th Annual Conference
September 16 - 17, 2010
Charlotte, NC

Municipal Forum of New York Luncheon
September 16, 2010
New York, NY

Council of Institutional Investors 2010 Fall Meeting
September 19 – 21, 2010
Coronado, CA

IAWatch 10th Annual IA Compliance Fall Conference 2010
September 20, 2010
Philadelphia, PA

The Bond Buyer's 501(C) 3 Super Conference: Capital for Hospitals, Higher Education, Cultural Institutions
September 20 - 21, 2010
New York, NY

Advanced Learning Institute's Social Media for Government
September 20 – 23, 2010
Chicago, IL

Securities and Exchange Commission Field Hearing on the Municipal Securities Market
September 21, 2010
San Francisco, CA

More events...

ILLINOIS BUDGET UPDATE (CONT'D)

paying on its bonds. As the rating agencies downgrade the state's credit rating to the second lowest of any state (California has slightly lower ratings), investors are demanding higher returns for what they perceive to be a riskier credit.

in June 2010, Illinois sold a $300 million GO bond issue in which the yield on the 2035 principal maturity was 297 basis points above the 2040 U.S. Treasury Bond to which it was benchmarked. A basis point is .01 of a percent. This represented an over 40% increase from April 2010, when the state sold two GO bond issues with yield spreads of 205 and 210 basis points over U.S. Treasuries. The June 2010 yield spreads exceeded those of California for the first time. The situation has deteriorated further with the sale of $900 million of GO Bonds in July 2010 with a yield spread of 325 basis points.

All of the bonds cited above were sold under the Build America Bonds ("BABs") program, which allows state and local governments to sell taxable bonds and then be reimbursed by the federal government for 35% of their interest costs. The net yield on BABs taking into account the reimbursed interest costs approximates an equivalent tax-exempt yield.

Illinois' GO BABs have elicited significant interest from foreign investors who view the state's credit profile favorably in the context of Greece and other troubled sovereigns. However, despite the extremely low interest rate environment, Illinois is paying a significant premium on its bonds over what it would have paid had it managed to successfully address its structural deficits. This translates into hundreds of millions of extra interest costs over the life of the bonds to be borne by future taxpayers.

The state's financial problems are the result of years of unwillingness to take the hard measures required to eliminate the structural deficits and enact sustainable budgets. The Great Recession magnified an already bleak financial situation maintained under a series of dysfunctional state governments. With the City of Chicago and a diversified economic base, Illinois possesses the potential revenue resources to turn its finances around. However, state officials must implement a genuine recovery plan soon or dig themselves into an even deeper hole. ♣

Larry Levitz is a contributor to Muni Market Update. The opinions expressed are his own.

MARKET UPDATE (CONT'D)

tion on proposals to extend expiring tax programs like BABs. The most recent extenders bill was introduced in late July by House Ways and Means Committee chairman, Michigan Democrat, Sander Levin. Levin's bill would extend BABs by two years, while lowering the subsidy rate from the current 35% level to 32% for bonds sold in 2011 and 30% for those sold in 2012.

The Bond Buyer reported Sunday that Pennsylvania Gov. Rendell will speed-up nearly $3.6 million of pension assistance and fire protection payments it must make to the city later this year. Harrisburg will receive the $3.6 million "almost immediately," Rendell said. Harrisburg has a $3.3 million payment due Wednesday on Series 1997D and Series 1997F bonds.

Despite outflows of over $4.3 billion from long-term mutual funds for the week ended Wednesday, September 1, bond fund continued to see strong inflows. Bond funds had estimated inflows of $6.66 billion, compared to estimated inflows of $5.90 billion during the previous week. Taxable bond funds saw estimated inflows of $5.66 billion, while municipal bond funds had estimated inflows of $1.00 billion, according to the Investment Company Institute. (See related chart on page 3.)

The Investment Company Institute's July 2010 data shows a continuing trend towards bond funds. Bond funds had an inflow of $30.04 billion in July, compared with an inflow of $20.60 billion in June. Taxable bond funds had an inflow of $26.23 billion in July, vs. an inflow of $18.69 billion in June. Municipal bond funds had an inflow of $3.81 billion in July, compared with an inflow of $1.91 billion in June.

Municipal yields moved higher last week as tax-exempts prices moved lower while Treasuries gave back some of their recent strong gains. As measured by MMD's AAA scale, 10 year yields have gained 25 basis points since the 8/25 low yield point — 2.17 to 2.42. ♣

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