

Investment Viewpoints

2009 Municipal Bond Market Outlook

Caution, selectivity, and diversification can help investors capture attractive values

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Editor's Note: 2008 was an exceptionally difficult year for municipal bond (muni) investors due to several well-publicized events, including the credit crisis, the recession, and the resulting difficulties of bond insurers, hedge funds, state finance managers, and non-Treasury bond sectors in general.

To gain perspective on the muni market outlook and investment opportunities for 2009, Colleen Ambrose ("CA"), Vice President, Client Portfolio Manager interviewed Steven Permut (Sr. Vice President, Sr. Portfolio Manager, and head of Municipal Investment Management & Research at American Century Investments) and David Moore (Vice President and Director of Municipal Research, whose team works closely with Permut and the rest of the municipal group). Their answers were combined and attributed collectively to the municipal team ("MT").

CA: Many investors were stunned by developments in the muni market in 2008, and are still trying to sort out what happened and why. What is your overview?

MT: 2008 will go down as a year in which everything investors thought they knew about munis was turned upside down. A financial tsunami affected virtually all asset classes, and munis were not immune. As a result, munis became dramatically cheap compared with Treasuries of comparable maturity.

For example, at the end of 2008, 10-year investment-grade munis were trading at yields that were nearly 180% of Treasury yields of comparable maturity, a historically high ratio. For frame of reference, the long-term historic average yield ratio has been about 90% of Treasuries, due to tax considerations and benefits for qualified investors. When muni yields exceed 100% of Treasury yields, the tax benefits come essentially free of charge.

CA: What were the main drivers of this high muni yield ratio over Treasuries?

MT: First, financial markets have been heavily affected by a flight to quality in all asset classes, which has favored Treasuries and hurt most sectors of the muni market. Secondly, since mid-2008, a supply-demand imbalance has occurred as issuers have continued to bring bonds to market while some traditional buyers have moved to the sidelines. Thirdly, yield spreads to Treasuries (the yield difference between munis and similar-maturity Treasuries) were driven higher by the forced selling of hedge funds and some muni mutual funds that had loaded up on leveraged munis. And last but not least, the lack of AAA bond insurance reduced demand for munis.

CA: Do you regard muni yield spreads to Treasuries as attractive? Could they go even higher?


MT: This is certainly a better buying opportunity than a selling window—we believe muni yields that are over 150% of Treasury yields are an overreaction to current and expected market conditions. It's our belief that munis represented very attractive values at those yield levels—we would even say a historic opportunity—not only for traditional buyers of tax-exempt securities but also for buyers of taxable bonds. Recently, American Century Investments allocated \$200 million of muni investments into our taxable funds, which normally do not invest in tax-exempt munis. Even if spreads go higher in the near term, we expect to see the high spread to Treasuries compress at some point as the economy and municipal bond prices rebound.

CA: How are your muni portfolios positioned for 2009?

MT: There's no question that this will be another challenging year because of the weakening economy, so we are cautious. Therefore, all of our muni portfolios now have a little less duration (price sensitivity to interest rate changes) than their benchmarks. We are also cautious with regard to credit quality. Over the past year, we have reduced our overweight in lower-quality bonds and emphasized higher quality bonds with more liquidity. At the start of 2009, we are overweight essential service (like water, sewer, and public power) revenue bonds and high-quality hospital bonds, and underweight state and local general obligation (GO) bonds, due mainly to concerns over state and local government deficits.

CA: Do you believe we will see a sharp rise in municipal defaults over the next year or two?

MT: Except for isolated incidents in local governments, we do not. We think tax-backed bonds will experience stress in 2009 but not a rash of defaults. Historically, according to a study conducted by Moody's, an A-rated municipal bond is 10 times less likely to default than an AAA-rated corporate bond, and this is true even during recessions. You could look at fairly deep regional recessions such as Texas in the late 1980s or California in the early-to-mid 1990s, and municipal bond defaults were very rare. Even in Louisiana after Hurricane Katrina, the worst natural disaster in U.S. history, there were no defaults. Most municipal issuers are positioned to withstand downturns in the economy. And we think states should also benefit from a federal stimulus package, given the important role state governments play in providing services to residents.



CA: Are you as confident about California, given the state’s deteriorating revenues and rising deficit?

MT: We are underweight California GO bonds in our muni portfolios, but not because we believe the state will default on its debt. We are more concerned about the potential for a downgrade in the state’s GO rating. We are seeing attractive opportunities in some California essential service revenue bonds, which we have been able to buy at very attractive prices.

CA: Why are essential service revenue bonds so attractive to you at this time?

MT: We like these bonds because they currently offer very attractive spreads to Treasuries, and our credit analysis indicates that they are in non-economically sensitive sectors that are in good shape to weather the recession. These bonds are issued by municipal agencies or authorities that provide services that are not very sensitive to economic cycles, such as local water and sewer systems, and public power. The issuers often have monopoly positions to provide these services, plus the flexibility to raise rates to cover debt service. In our credit analysis and security selection, we look for issuers with stable service areas, high debt service coverage ratios, and solid liquidity.


CA: How do you typically conduct your muni credit analysis and research?

MT: We rely primarily on our own internal muni research team, which is very experienced and has an excellent track record. All four credit analysts on the team have worked together at American Century Investments for the past 10 years. During that time, our muni portfolios have experienced relatively few individual credit-related price declines, especially our high-yield muni portfolios. We evaluate every single muni credit on a case-by-case basis. Each analyst specializes in a particular sector and follows about 150 credits, on average. For each credit, we develop an internal rating and then a determination of whether the trend in that rating is likely to be stable, positive, or negative going forward.

Another advantage we have is that our muni credit research team works very closely with our muni portfolio management team. The two teams are in constant contact and share research in a database that can be referenced in real time to help make trading decisions easier.

CA: In today’s muni market, do you think a strong internal credit analysis team gives American Century Investments a competitive advantage?

MT: Yes, we definitely think so. Maybe the biggest permanent change in the muni market over the past year has been the virtual disappearance of the so-called monoline bond insurance companies (companies that guaranteed timely repayments of bond principal and interest). The monolines helped to make the top tier of municipal credits more homogenous and more accessible for less-experienced and non-traditional muni buyers. Now, “newbie” buyers can no longer acquire these bonds on the basis of insurance guarantees. You have to look closely at the underlying credits, one by one, as we do.



CA: In summary, what should financial advisors tell their clients about muni opportunities in 2009?

MT: First, municipalities, in general and in aggregate, have had a strong track record of avoiding defaults during prior recessions. Second, while fundamental factors (such as credit quality) of munis (especially tax-backed bonds) have deteriorated as credit conditions and the economy have weakened, most of the muni market turmoil (reflected in the record high spreads over Treasuries) and devaluation has been the result of forced selling by hedge funds and high-yield muni funds that needed liquidity to meet redemptions and/or margin calls. So, at these value levels, this may be an opportune time to increase exposure to munis, especially if investors believe higher income tax rates are coming.

Lastly, this is a time for investors to be cautious and well diversified. We do believe muni defaults may occur in isolated situations for specific reasons (inadequate operating reserves, risky investments in or reliance on volatile debt instruments, etc.). We think such isolated, though ever-present, situations are a good reason to participate in the current muni market through the use of a professionally managed mutual fund, rather than through individual bonds.

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