

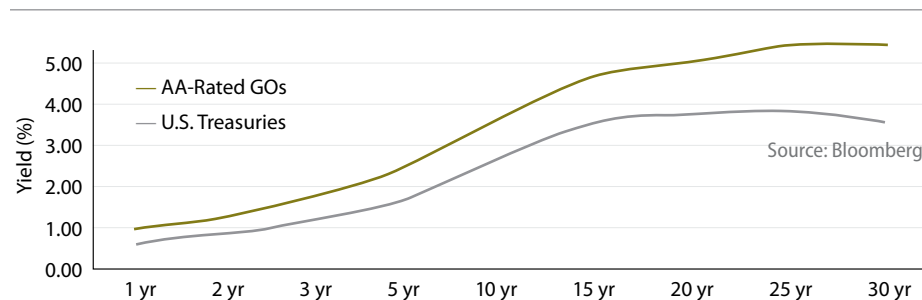
# Longer-Maturity Municipal Bonds Still Offer Good Investment Value

## Investment Perspectives: Municipal Bonds

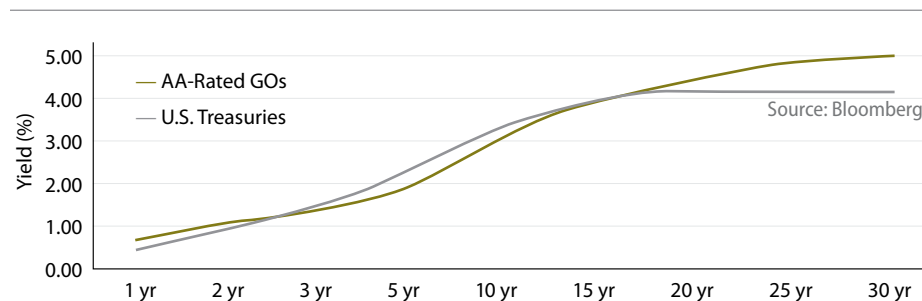
*Wells Fargo Funds Management, LLC—Fixed-Income Team*

The municipal bond market has rallied strongly year to date in 2009 (period that ended September 30, 2009), with strong performance broadly distributed across the municipal yield curves. But this does not mean the opportunities for capturing good investment value may be gone. At the end of the third quarter, intermediate and longer-maturity municipal bonds still offered historically high yields when compared with yields on equivalent U.S. Treasuries.<sup>1</sup> Investors who are heavily overweighted in short-term municipal bond strategies due to interest-rate concerns or general risk aversion may be missing out on an opportunity to add higher levels of income.

**Chart 1 | Yield Curves as of March 31, 2009**



**Chart 2 | Yield Curves as of September 30, 2009**



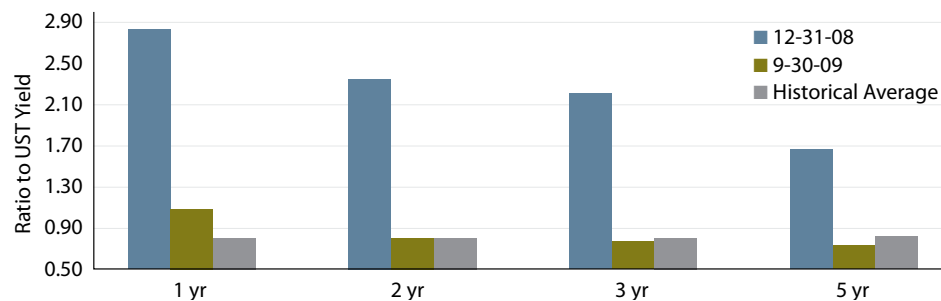
1. Note that securities issued by the U.S. government are guaranteed as to the timely payment of principal and interest.

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### Investors Flocked to Short-Term Municipal Bond Funds in 2009

Inflows into short-term municipal bond funds were particularly robust in 2009, as investors sought to capture the extraordinarily high relative yields available on short-term municipal debt. Liquidity risk was still a thematic concern in the first half of 2009 because the recovery from the 2008 credit crisis was in the initial stages. Thus, investors poured into short-term municipal bonds, using them as substitutes for other lower-yielding, short-term strategies, such as Treasury bills and money market funds, and to reallocate asset holdings from longer-duration risk to the shorter-duration, more liquid asset classes.

Chart 3 | Short-Term AAA-Rated GO Bond Ratios



Past performance is no guarantee of future results.

Source: Bloomberg

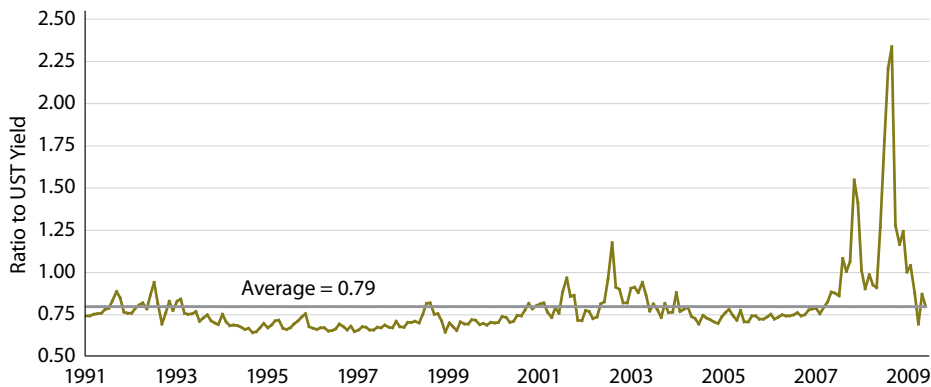
The one-year AAA-rated general obligation (GO) municipal bond yield remained historically elevated through the first half of 2009. On December 31, 2008, the one-year GO note yielded 97 basis points versus the one-year Treasury note yield of 34 basis points, resulting in a ratio of 2.85 (Chart 3). However, as 2009 progressed, the one-year GO yield dropped by more than half to finish the third quarter at 41 basis points of yield versus the one-year Treasury yield of 39 basis points, dropping the ratio to 1.05. Other short-term bonds saw a similar retreat, dropping ratios to near or even below their 20-year averages.

### The Rally Drove Short-Term Ratios Back to Their Historic Averages

As the broad municipal bond rally deepened in the third quarter of 2009, many of those generous ratios began to come down to their historic averages. By the end of the third quarter, short-term municipal bond yields were about half the levels from the start of 2009. The 30-day Securities and Exchange Commission (SEC) yield of the Lipper Short Municipal Debt Funds Average declined from 3.07% on December 31, 2008, to 1.67% on September 30, 2009. As can be seen in Chart 4 on the following page, the AAA-rated two-year municipal bond ratio retreated to its historic average.

*Investors poured into short-term municipal bonds in 2009, using them as substitutes for other lower-yielding, short-term strategies, such as Treasury bills and money market funds, and to reallocate asset holdings from longer-duration risk to the shorter-duration, more liquid asset classes.*

Chart 4 | Two-Year AAA-Rated Ratios Declined to Historic Average



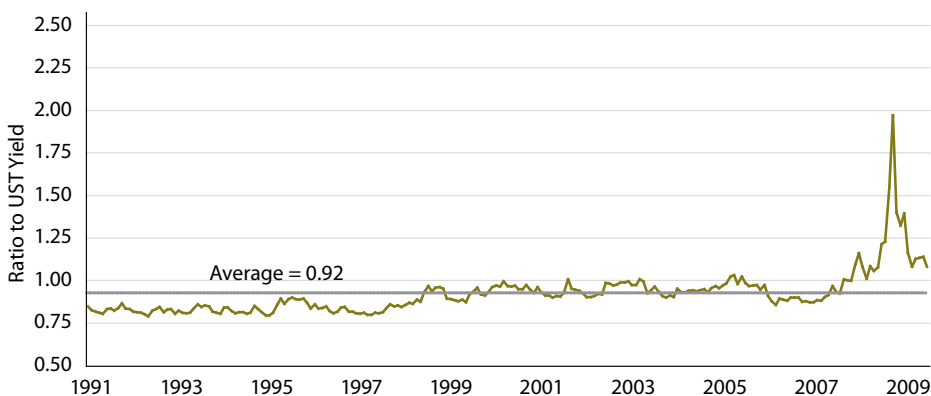
Past performance is no guarantee of future results.

Source: Bloomberg

### Intermediate and Longer-Maturity Ratios Declined but Remained Historically Elevated

While short-term ratios retreated to their historic averages and tested record lows in specific areas of the market, intermediate and longer-maturity ratios persisted above their historic averages. Ratios remained elevated from the ten-year note to the 30-year bond across the AAA-rated curve. The ratio for ten-year AAA-rated GOs at the end of the third quarter was 0.89, which is above the long-term average of 0.85. The 30-year AAA-rated ratio finished the third quarter at 1.07 (Chart 5), well above its average of 0.92, and still higher than any level measured before last year's credit crisis. The 30-year ratio was never higher than 1.03 prior to the credit crunch of 2008. Thus, even after a very strong rally, yields on longer maturities are still unusually attractive versus yields on comparable Treasury bonds.

Chart 5 | 30-Year AAA-Rated Ratios Remained Above Historic Average



Past performance is no guarantee of future results.

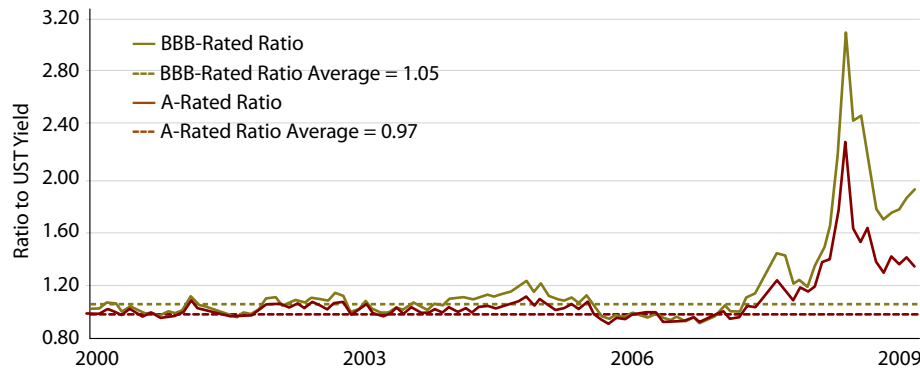
Source: Bloomberg

*While short-term ratios retreated to their historic averages and tested record lows in specific areas of the market, intermediate and longer-maturity ratios persisted above their historic averages.*

### Lower-Quality Municipal Bonds May Hold Even Greater Relative Value

Opportunities for historically high relative yields were even more abundant in the lower-quality credit tiers of the municipal bond market. Chart 6 shows the ratios of A-rated and BBB-rated GOs compared with their historic averages. The 30-year A-rated ratio finished the third quarter at 1.33, well above its average of 0.97. The 30-year BBB-rated ratio finished at 1.90, significantly higher than its average of 1.05.

Chart 6 | A-Rated and BBB-Rated 30-Year Ratios Remained Elevated

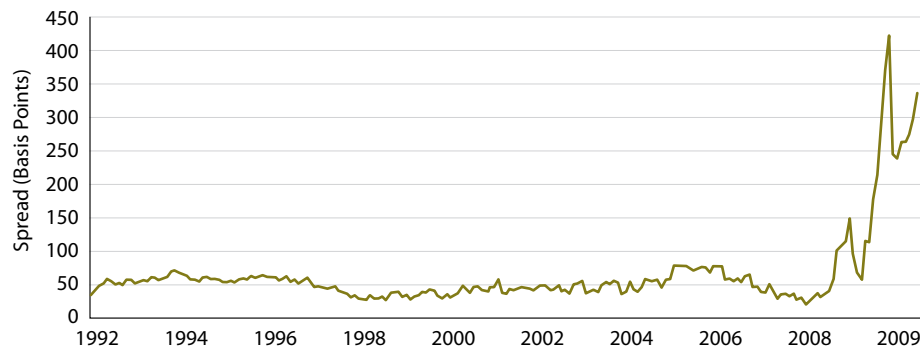


Past performance is no guarantee of future results.

Source: Bloomberg

Chart 7 shows the yield spread between the 30-year BBB-rated GO and the 30-year AAA-rated GO. Since late 2008, these quality spreads have been far greater than the long-term averages. Investors willing to go into longer-maturity, lower-quality credit tiers may find historically generous levels of relative yield compensation.

Chart 7 | Spread Between 30-Year BBB-Rated and 30-Year AAA-Rated GOs at Historic Peaks



Past performance is no guarantee of future results.

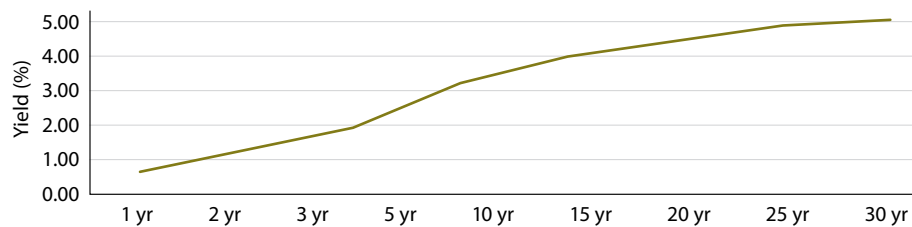
Source: Bloomberg

*Investors willing to go into longer-maturity, lower-quality credit tiers may find historically generous levels of relative yield compensation.*

## Long-Term Yields Are at Record Spreads Over Short-Term Yields

Despite the fact that this year's municipal bond rally was broadly allocated across the maturity spectrum, the front end of the curve is now significantly lower in yield than the long end of the curve. In fact, it is the steepest level of yield spread between 30-year bonds and one-year notes on record (data available from March 1991). Chart 8 shows the municipal yield curve. Chart 9 shows the historic steepness from the longest AA-rated maturity to the one-year maturity. The spread is around 450 basis points, offering investors historically generous yield increases when moving from short-term to the longer-term maturities.

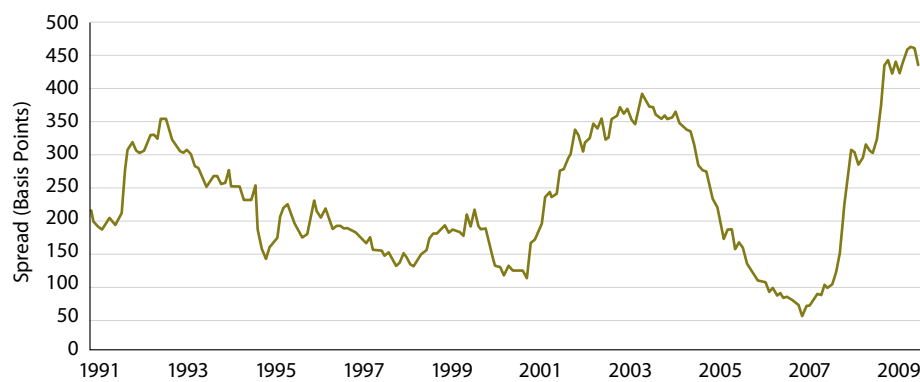
Chart 8 | Historically Steep AA-Rated Municipal Bond Curve as of 9-30-09



Past performance is no guarantee of future results.

Source: Bloomberg

Chart 9 | Historical Spread Between 30-Year AA-Rated and 1-Year AA-Rated Municipal Bonds



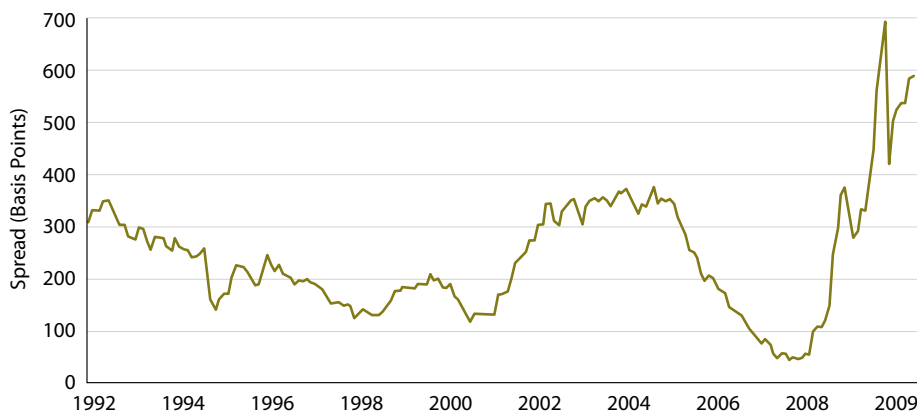
Past performance is no guarantee of future results.

Source: Bloomberg

This steepness in spread between long maturities and short maturities is even more pronounced in lower-quality credit tiers. Chart 10 on the following page shows the relationship between 30-year BBB-rated securities and one-year BBB-rated securities.

*The front end of the curve is now significantly lower in yield than the long end of the curve. In fact, it is the steepest level of yield spread between 30-year bonds and one-year notes on record.*

**Chart 10 | Historical Spread Between 30-Year BBB-Rated and 1-Year BBB-Rated Municipal Bonds**



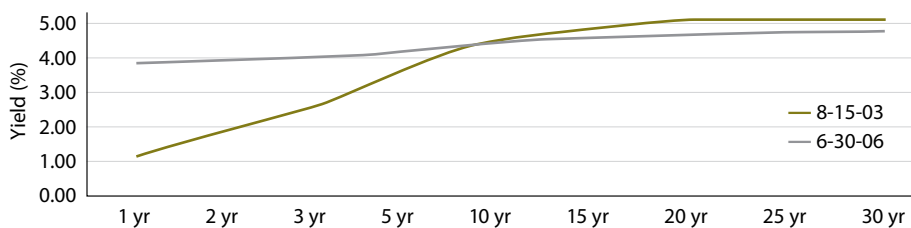
Past performance is no guarantee of future results.

Source: Bloomberg

### Assessing Interest-Rate Risk in a Steep Yield Curve

Certainly, longer maturities inherently carry more interest-rate risk, and we will likely see increasing interest rates at some point ahead. But this does not mean intermediate and long-term municipal bonds will necessarily underperform in a rising-rate environment. A very steep yield curve has provided some price protection in past rising-rate cycles. In 2003, the municipal yield curve was very steep, as it is now. It proceeded to flatten as interest rates rose through the summer of 2006. The federal funds target rate rose from 1% to 5% over that period; however, the long end of the municipal yield curve remained mostly unchanged and actually rallied modestly from around 5% to around 4.75%. Chart 11 shows the significant flattening of the municipal yield curve during the 2003–2006 rising-interest-rate period.

**Chart 11 | During the Rising Rate Environment the Municipal Bond Curve Flattened**



Past performance is no guarantee of future results.

Source: Bloomberg

*A very steep yield curve has provided some price protection in past rising-rate cycles.*

As interest rates increased during the 2003–2006 period, the one-year AA-rated GO yield rose from around 1% to almost 4%; however, the AA-rated ten-year yield stayed around 4.25%, and the AA-rated 30-year yield remained near 5%. Consequently, intermediate and long-term municipal bond strategies performed well. The Lipper General Municipal Debt Funds Average had an income return of 11.2% over that period, despite a 2.7% decline in net asset value (NAV). This netted investors who reinvested their income a cumulative return of 9.14% over the period. The Lipper Short Municipal Debt Funds Average had an income return of 6.53% despite a 2.7% decline in NAV, netting a cumulative return of 3.73% with reinvested income. Please note that past performance of the averages does not guarantee future results.

### **Concluding Observations**

Although the municipal bond markets have rallied strongly year to date, intermediate and longer-maturity segments of the markets still offer higher-than-usual yields relative to the U.S. Treasury market. Additionally, there is a wide dispersion in yields across the longer-maturity credit-quality tiers. **Thus, relatively attractive yields are still available to investors who are willing to shift into the intermediate and longer-maturity spaces of the municipal bond markets, and particularly into some of the mid-quality and lower-quality credit tiers. In our view, portfolio managers with active, fundamental approaches to measuring relative value in these segments of the market may continue to find historically generous opportunities to add yield from longer-duration assets and the wide dispersion across the credit tiers.** Investors who are still heavily overweighted in short-term municipal bond strategies due to liquidity concerns and risk aversion may be missing out on the opportunities to add higher levels of income. In our view, investors with municipal bond portfolios—particularly those with longer investment horizons—should consider an allocation to intermediate and longer-maturity bonds.

*In our view, portfolio managers with active, fundamental approaches to measuring relative value in these segments of the market should continue to find historically generous opportunities to add yield from longer-duration assets and the wide dispersion across the credit tiers.*

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