

# A New Reality

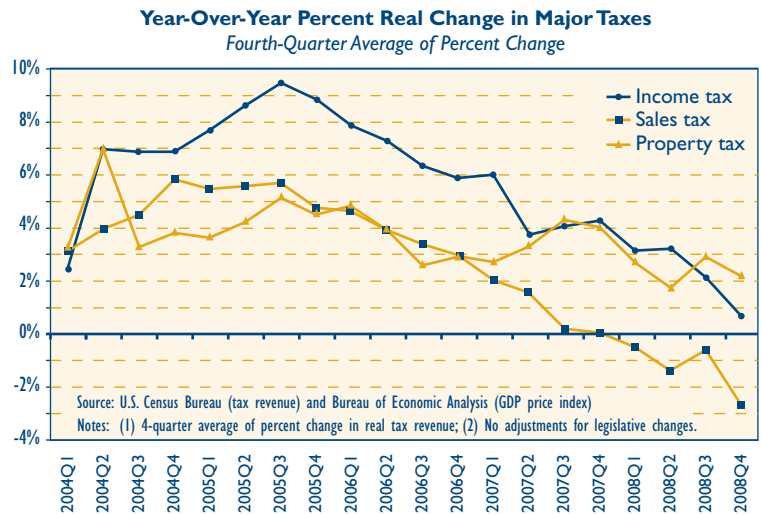
by **George Strickland**,  
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The present U.S. recession has already lasted longer than the previous two recessions. Unemployment has spiked to 8.5%, a 3.7% increase from a year ago, and many economists expect it to continue rising until it hits 10% or more. Nationally, home prices have fallen 25% on average from peak levels hit in July 2006. The recession started in the housing industry, but has since spread to the financial services, auto, retail, tourism, and energy sectors, among others. It was also fairly well contained geographically; affecting parts of California, Nevada, Arizona, Florida, and Michigan initially, but now has reached into virtually every state.

According to the Nelson Rockefeller Institute of Government, state tax revenues fell by 3.6% in the fourth quarter of 2008 compared to the previous year. The revenue shortfalls were widespread, hitting 35 of 47 states reporting to the Institute. Unlike the last downturn, sales tax revenues have been severely affected (down 5.9%) and have been responsible for the bulk of the decline to date (see graph above). State personal income tax receipts have fallen only 0.4% through the end of 2008, but can be expected to fall more precipitously over the next few quarters, particularly in light of recently reported job losses. Many economists expect the current recession

to end in the second half of 2009. While we believe that is possible, state tax revenues tend to be a lagging indicator, so any significant recovery in tax revenues will probably not show up until 2010 or later.

Most states are currently producing or revising budgets for the 2009-10 fiscal year that begins July 1st. Standard and Poor's estimates that collective budget gaps (before corrective measures) faced by the 50 states exceed \$100 billion. This is clearly an enormous challenge for state lawmakers. The projected deficits vary widely from state to state as do proposed solutions. However, we see some reasons for optimism. Investment grade municipal bonds have an impressive long-term track record. Standard and Poor's recently updated their study showing 10-year cumulative default rates that averaged 0.13%. We expect defaults to be somewhat more frequent going forward, but there are counterbalancing factors that should limit any rise in the default rate. Many state and local governments set aside large reserve balances when times were good, so they can draw upon those resources today. Others are rebalancing their budgets frequently and are cutting spending aggressively. Some governments are doing both while raising taxes and fees, and all are making use of the federal largess in the \$787 billion American Recovery and Reinvestment Act. As we scrutinize municipal finances, we see that many



issuers are standing up to these challenging times. There are a few that may not, and we will strive to continue avoiding their bonds in order to protect our portfolios.

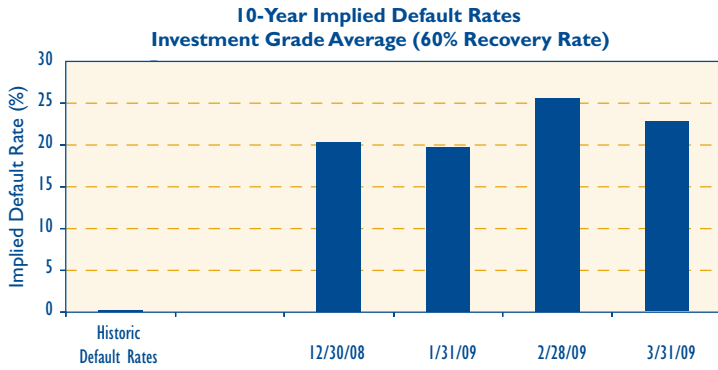
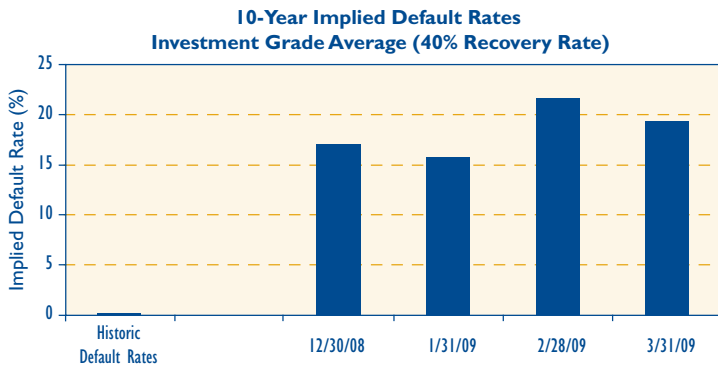
In the meantime, quality spreads for lower-tier investment grade municipal bonds have surged to unheard of levels. As you can see from the charts on the next page, we calculate that, at today's spreads, implied default rates for municipal bonds are many multiples of historic post-war actual default rates. While we do expect actual default rates to rise, we also believe that fear has seized the municipal market and caused it to overreact.

Investors have been shunning risk of all types and that is certainly true in the municipal bond market. However, there are other reasons that municipal quality spreads are at unprecedented levels. Large monoline bond insurers such as MBIA, AMBAC and FGIC were in the business of

arbitraging bond spreads. If a bond's spread to the AAA yield curve got too wide, they would typically step in and charge the issuer a premium for an insurance policy that got them a AAA rating. Bonds that received a AAA rating through insurance didn't quite get an issuer the same interest rate as a "natural" AAA bond such as the state of Maryland, but it got them very close. In this way, the bond insurers were the policemen of the municipal spread markets. Instead of writing speeding tickets, they wrote insurance policies that got issuers back in line with AAA rates. Now that investors' confidence in the bond insurers has been justifiably shattered, insured bonds typically trade at very wide spreads based upon market views of the underlying obligor. In effect, there are no policemen any more.

The market, which was becoming more generic and homogenous in nature, is now fractured and harder to analyze. Many traders

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Source: Data from Merrill Lynch 3-15 Municipal Bond Index, calculations by Thornburg

used to glance at a bond, see the MBIA insurance, and work up a quick bid. Many of those traders are now out of business. Traders and portfolio managers today have to look into covenants, security provisions, margins and balance sheets before they can decide what a bond is worth. These are skills that we, at Thornburg Investment Management, have never gotten out of the habit of using.

The consequences of faulty or incomplete analysis are more severe today. The market is adapting to the new reality, but while it does, fear and opportunity are at exaggerated levels. Liquidity is harder to find, and any bond that

is not straightforward and easy to analyze is trading at a large yield premium to widely recognized bonds. The market is greatly favoring bonds pre-refunded in Treasury securities and large general obligation issuers over high and medium quality issuers of tax-backed and revenue bonds. In other words, it is a bond picker's paradise. For the price of a little research and market knowledge, great value can be extracted. ■

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Investments in the Funds carry risks, including possible loss of principal. Bond funds have the same interest rate, inflation, and credit risks that are associated with the underlying bonds. The principal value of bonds will fluctuate relative to changes in interest rates, decreasing when interest rates rise. Unlike bonds, bond funds have ongoing fees and expenses. Investments in the Funds are not FDIC insured, nor are they deposits of or guaranteed by a bank or any other entity.

**General Obligation (GO) Bonds** – A municipal bond secured by the pledge of the issuer's full faith, credit, and taxing power rather than the revenue from a given project.

**Pre-Refunded Bond** – A type of municipal bond that has been escrowed or collateralized either by direct obligations guaranteed by the U.S. government, or by other types of securities. The escrow account is structured so that these refunded bonds are to be called at the first possible call date. Such bonds, if escrowed with securities guaranteed by the U.S. government, have little if any credit risk.

**Quality Spread** – The difference between the yields of securities with different quality ratings.

**Revenue Bond** – A bond on which the debt service is payable solely from the revenue generated from the operation of the project being financed or a category of facilities, or from other non-tax sources.

**Tax-Backed Bonds** – A broad category of bonds that are secured by taxes levied by the obligor.

**U.S. Treasury Securities** – U.S. Treasury securities, such as bills, notes and bonds, are negotiable debt obligations of the U.S. government. These debt obligations are backed by the "full faith and credit" of the government and issued at various schedules and maturities. Income from Treasury securities is exempt from state and local, but not federal, taxes.

The views expressed by the Portfolio Managers reflect their professional opinions and are subject to change.

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