HEDGEYE
RISK MANAGEMENT

Mayhem In Muni Land

Framing Up The Muni Bond Debate And How To Play It

February 10, 2011

THIS PRESENTATION WAS PREPARED BY:
THE HEDGEYE RISK MANAGEMENT MACRO TEAM

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THE GLOVES ARE OFF IN THE MUNI DEBATE

"This will amount to hundreds of billions of dollars worth of defaults."

- Meredith Whitney, December 19th, 2010

"Ultimately, municipal bankruptcies will be at a lower level. I don't subscribe to the theory that there will be lots of them."

- Bill Gross, January 12th, 2011

"There have been six or seven municipal bankruptcies already. I think unfortunately you will see more."

- Jamie Dimon, Janaury 13th, 2011

HEDGEYE'S VIEW:

We are Bears on Bonds.

While we don't necessarily foresee a Muni Bond contagion, they are our least favorite bond class.

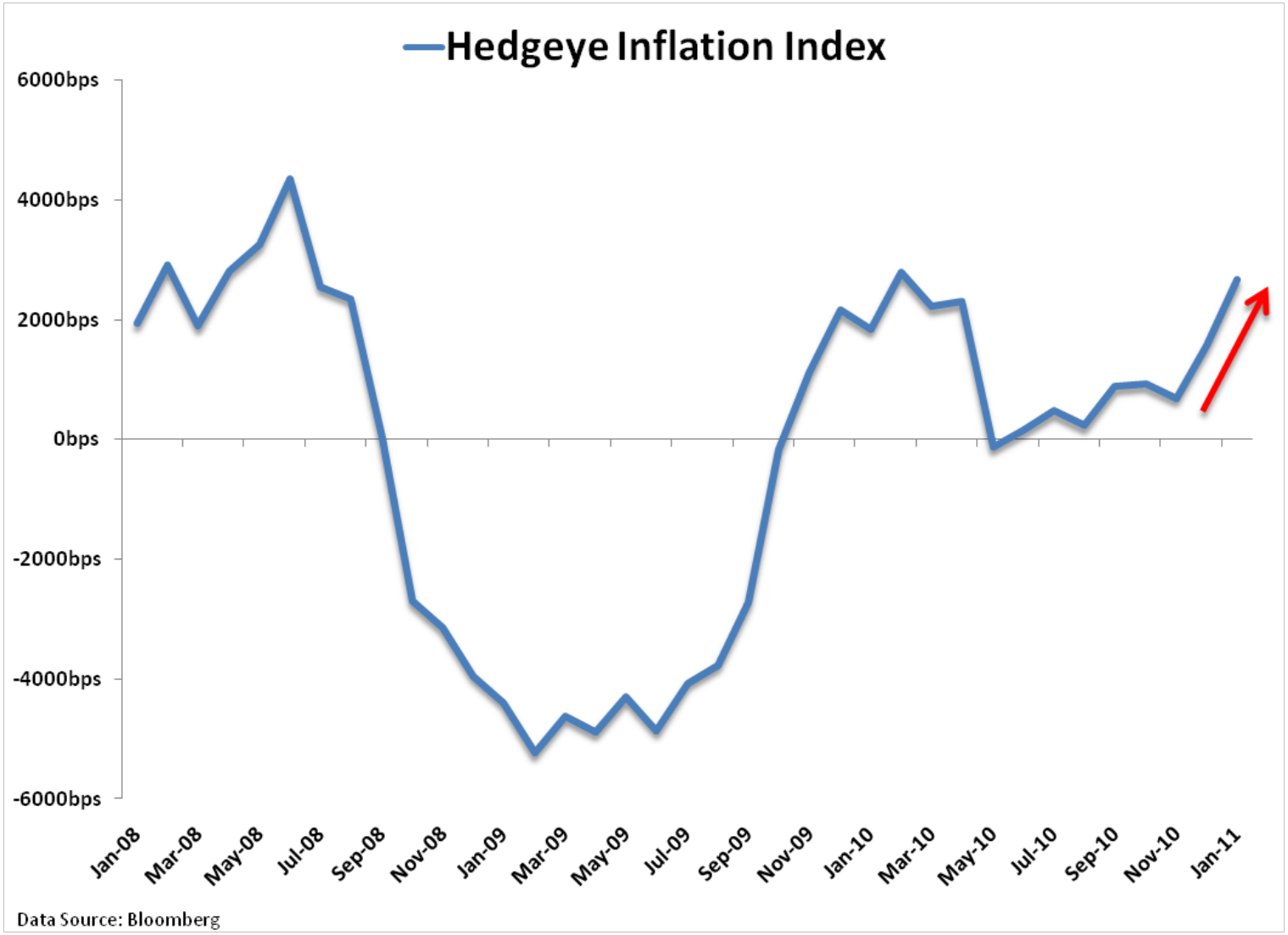
WE ARE BEARISH ON BONDS FOR 3 CORE REASONS

1. **Inflation is accelerating globally**

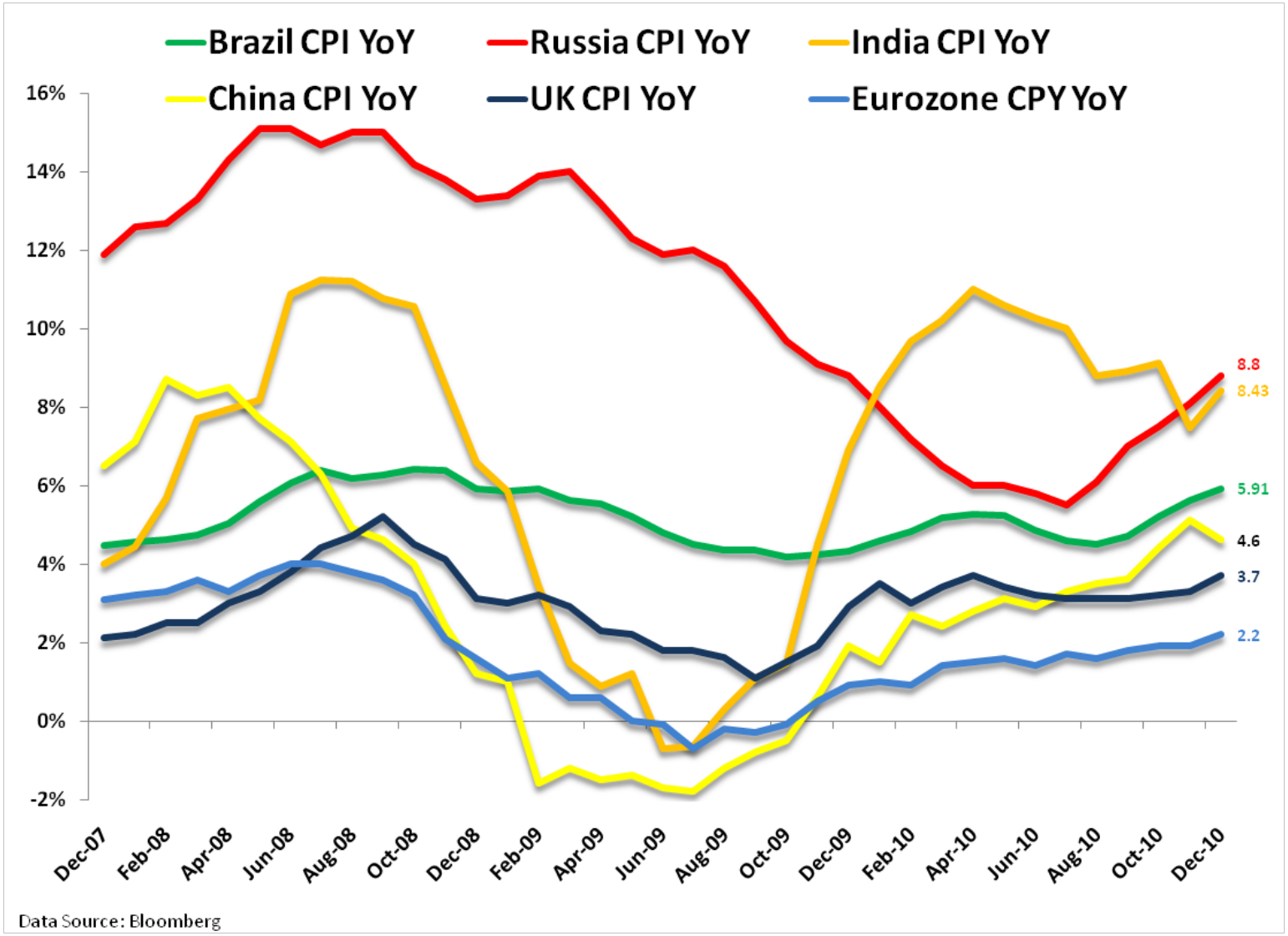
2. **Interest rates are breaking out quantitatively**

3. **Supply is increasing**

ACTUAL INFLATION IS ACCELERATING . . .



. . . SO IS REPORTED INFLATION GLOBALLY



EVEN IF THE GOV'T HASN'T NOTICED, INFLATION IS PRESENT DOMESTICALLY AS WELL

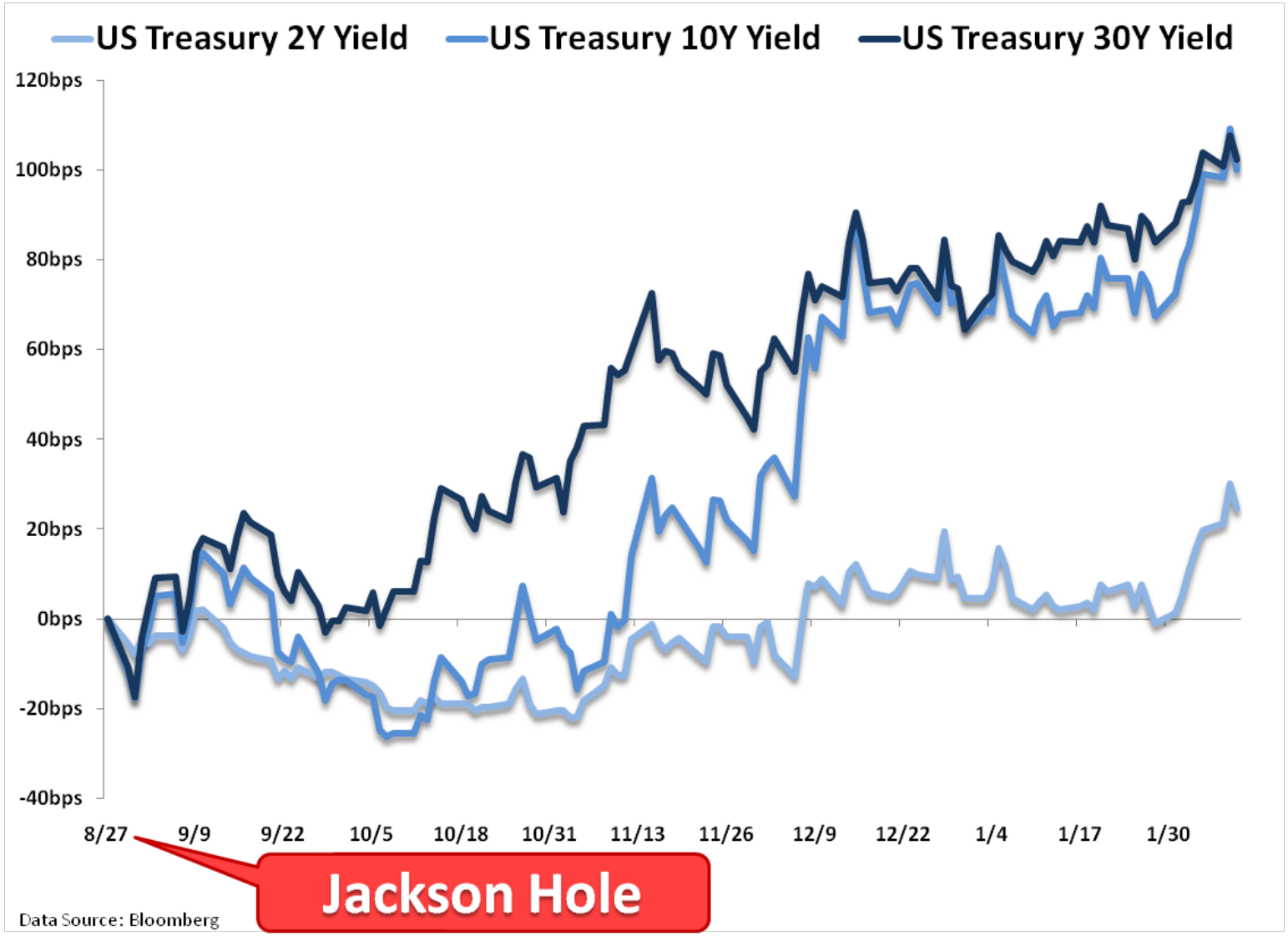
"Inflation as measured by the estimated change in SYSCO's product costs was 4.5% during the second quarter, even higher than the 3.3% reported during the first quarter of this year, and a significant swing from the 3.5% deflation reported last year. As Bill mentioned, dairy, meat, and seafood were again the categories that saw extreme levels of inflation with each being in the 11 to 12% range during the quarter."

Sysco Earnings Call – February 7th, 2011

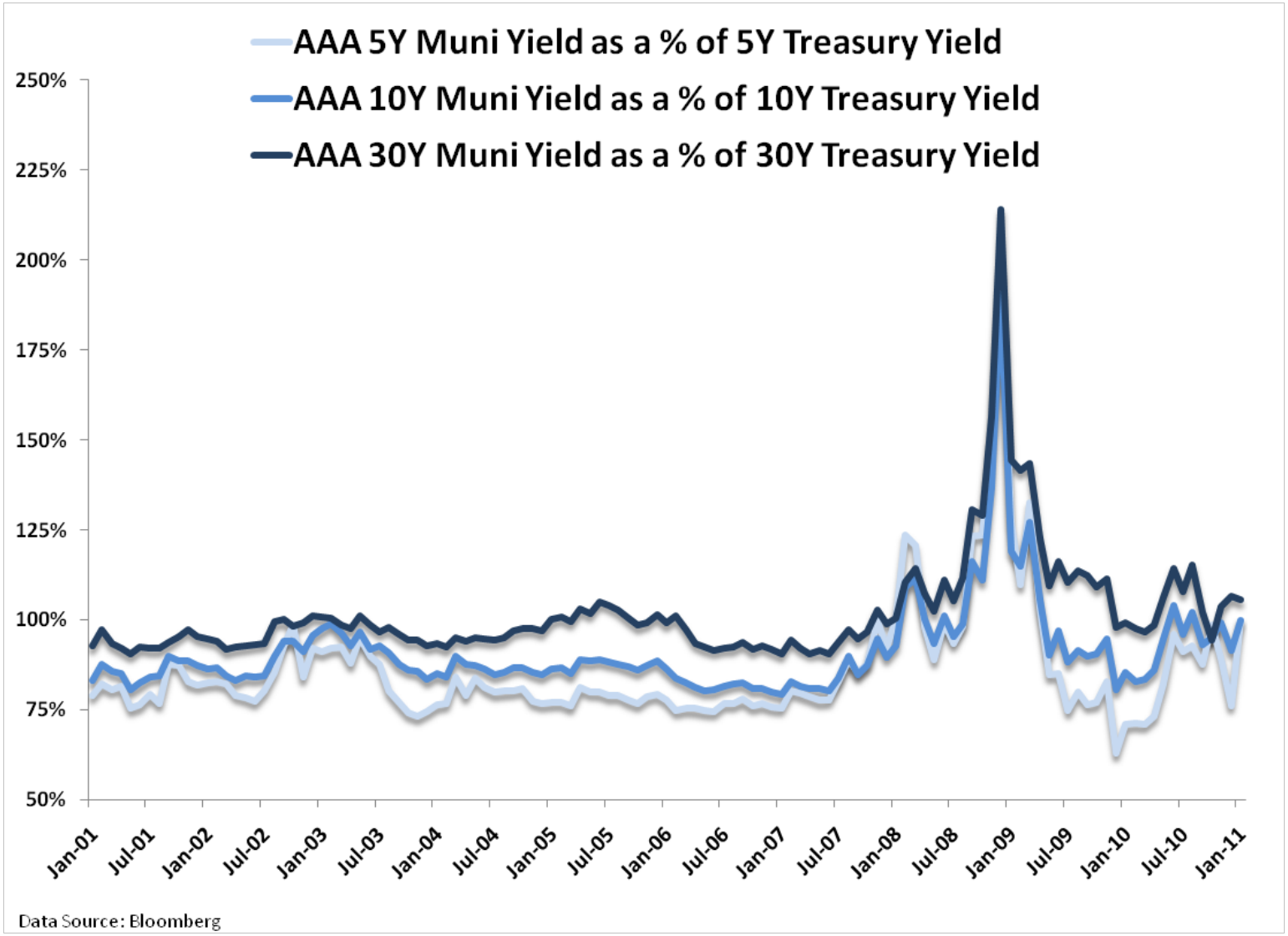
"Prices Paid accelerated from 72.5 in December 2010 to 81.5 in January 2011. This is up 353% since December 2008 and back to levels last seen in the summer of 2008 when oil was testing $150 per barrel."

Hedgeye Macro Research Note – February 3rd, 2011

NOT SURPRISINGLY, TREASURY YIELDS ARE BREAKING OUT TO THE UPSIDE



MUNIS TRACK TREASURIES VERY CLOSELY



IN THE MEANTIME, SUPPLY FOR BOTH TREASURIES AND MUNIS IS SET TO INCREASE DRAMATICALLY

Federal Budget Deficit Estimates in US$ Trillions

Year	Hedgeye	New CBO	Old CBO	% change
2011	$1.20	$1.48	$1.06	39.6%
2012	$1.00	$1.10	$0.67	65.4%
2013	$0.90	$0.70	$0.53	34.1%
Total	$3.10	$3.28	$2.25	46.0%

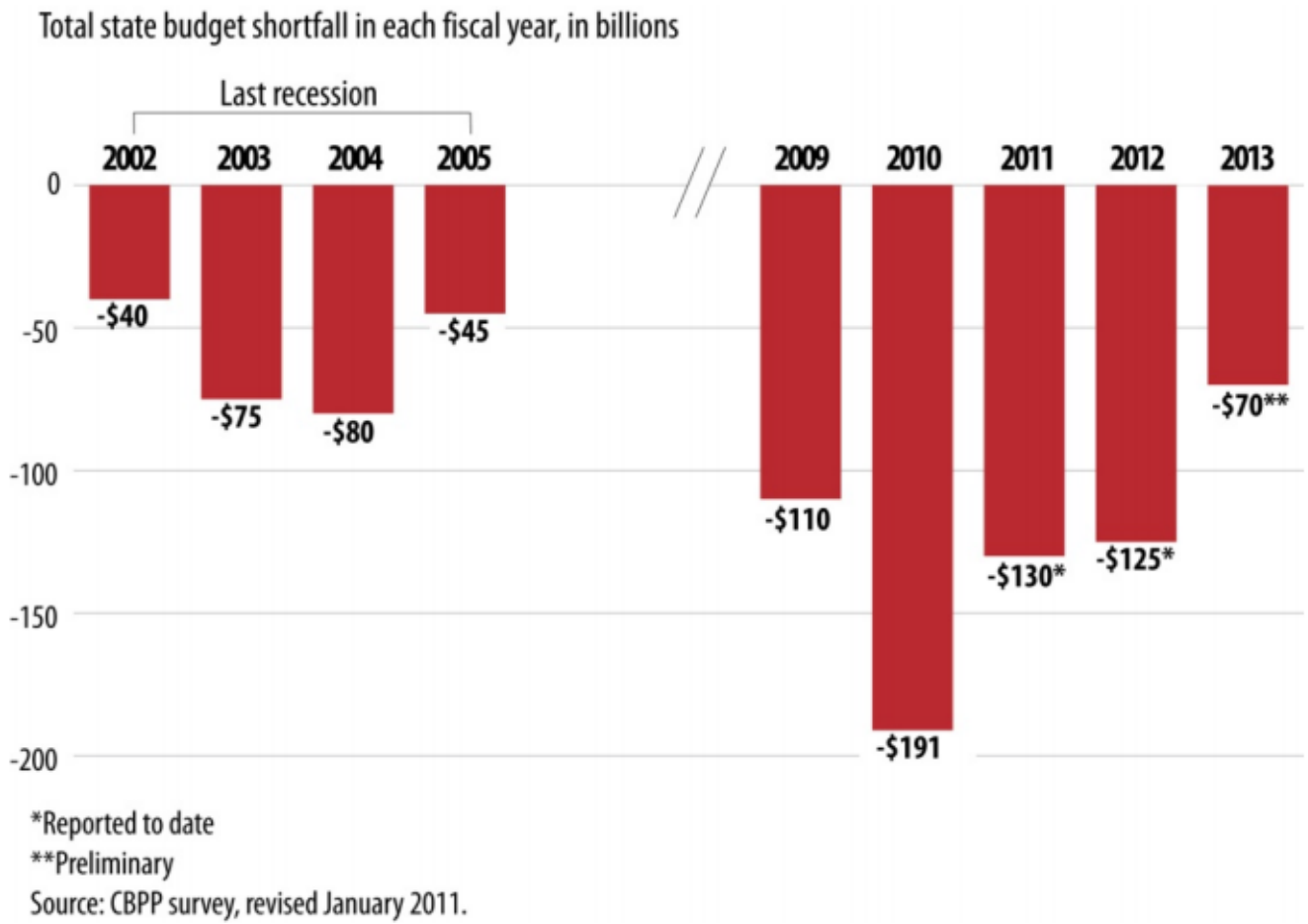
Meanwhile on the State level, budget deficits are set to hit a record $134BN in FY2012, which begins on July 1, 2011 for all but four States.

THE MUNI BOND DEBATE IS FOCUSED ON A NUMBER OF CORE ISSUES

1. **Austerity measures will / won't improve dire fiscal situations**
2. **States will / won't declare bankruptcy**
3. **The Federal gov't will / won't bail out States and other large issuers**
4. **History does / does not show a limited history of bankruptcies**
5. **There will / won't be a large number of defaults in 2011**
6. **Retail investors are a leading / lagging indicator**

CURRENT STATE BUDGET SHORTFALLS ARE AS LARGE AS THEY HAVE EVER BEEN . . .

Largest State Budget Shortfalls On Record

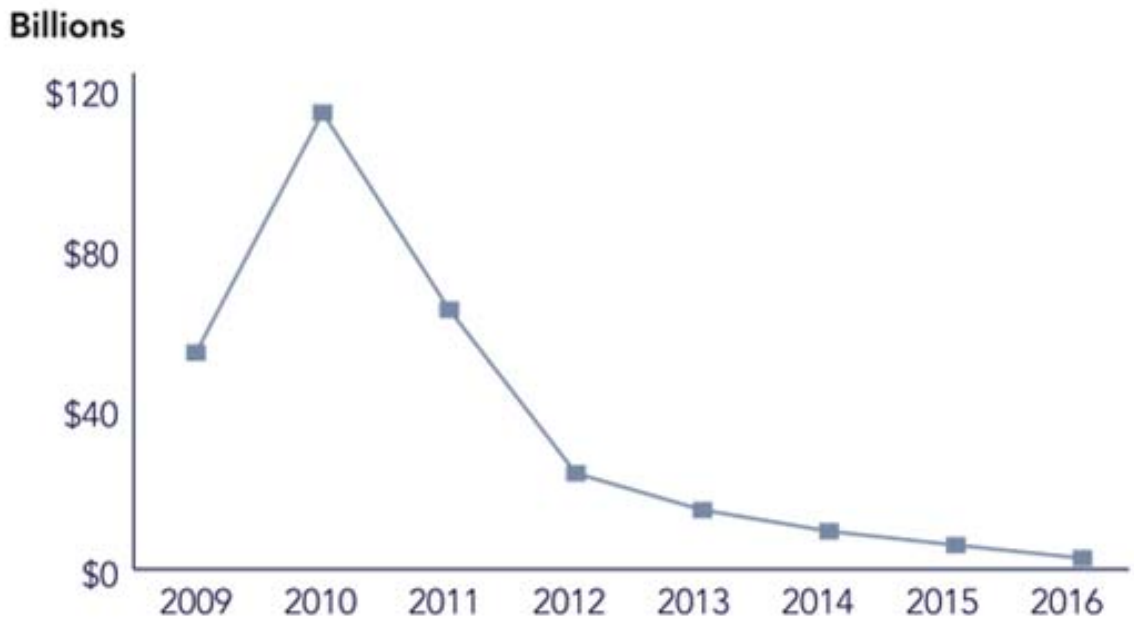


Source: Center on Budget and Policy Priorities

. . . WHILE FEDERAL SUPPORT FOR STATE BUDGETS ROLLS OFF A CLIFF STARTING IN JULY

The federal stimulus "cliff"

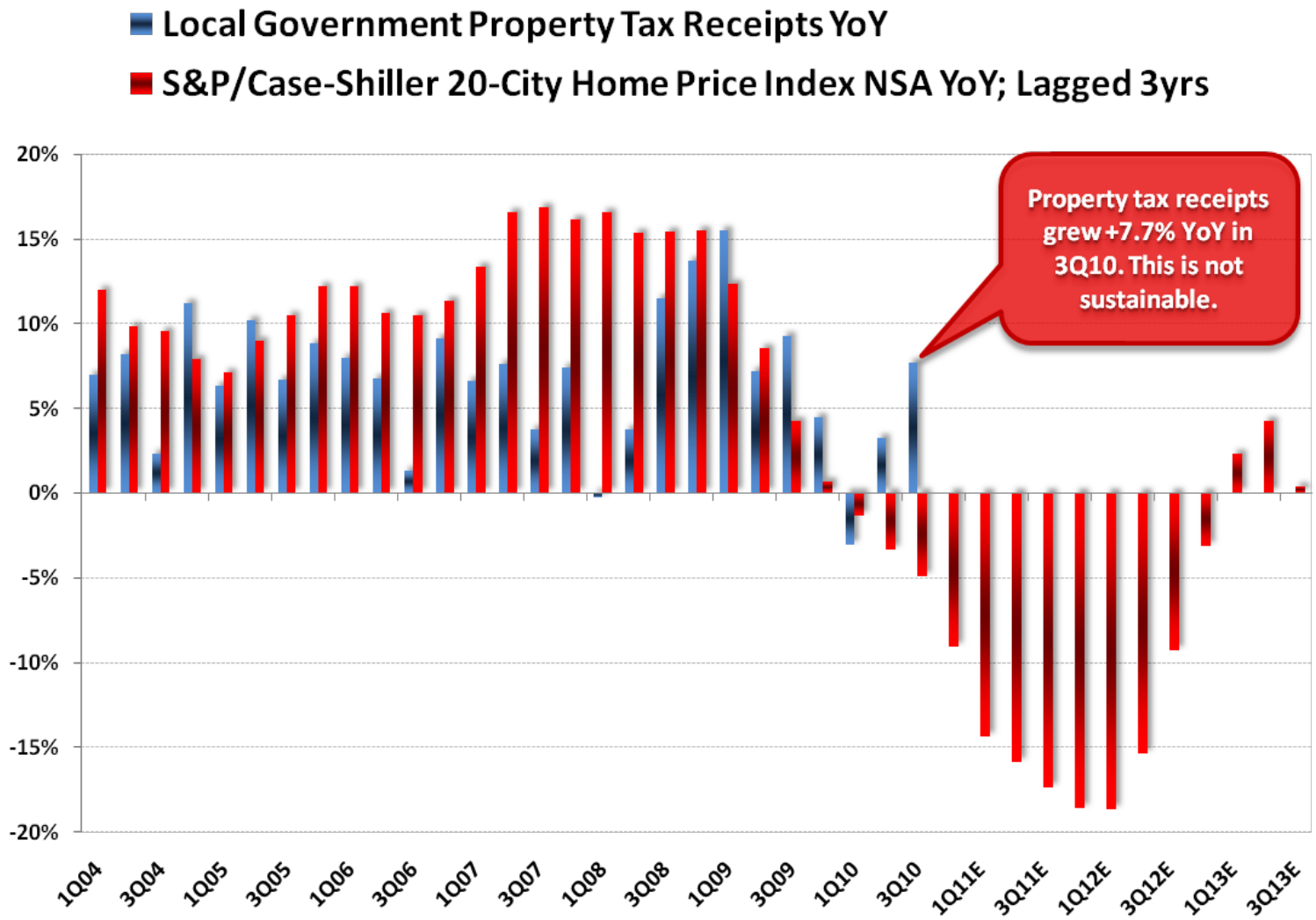
As of December 10, 2010, states and localities had received $186 billion in stimulus funds. Over the past two years, states relied heavily on the federal aid to balance their budgets, but those dollars decline dramatically in the 2012 fiscal year, which in most states begins July 1.



Stateline.org

Source: U.S. Government Accountability Office

TO COMPOUND MATTERS, PROPERTY TAX RECEIPTS CAN NO LONGER BE COUNTED ON TO BUOY MUNICIPALITIES BECAUSE . . .



Data Source: US Census Bureau; Bloomberg

. . . THE 3-5 YEAR OUTLOOK FOR PROPERTY TAX RECEIPTS IS DECIDEDLY BEARISH

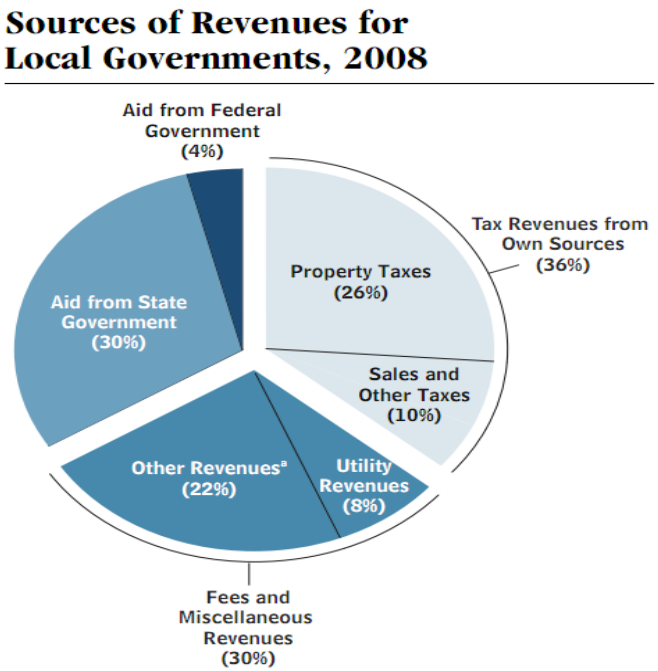
State & Local Government Tax Receipts Correlation w/ Select Economic Data	R	R^2
Income Taxes vs. US Personal Income	0.85	0.72
Income Taxes vs. GDP	0.87	0.75
Sales Taxes vs. PCE	0.97	0.94
Sales Taxes vs. Retail Sales ex-Auto	0.99	0.97
Sales Taxes vs. GDP	0.99	0.98
Property Taxes vs. S&P/Case Shiller Home Price Index (20 City) NSA, Lagged 3YR	0.98	0.96

Property Tax Forecast CY10/'07 Case-Shiller		% Change from Current Levels	YoY Change
$	409,707.54	-6.4%	-4.5%
Property Tax Forecast CY11/'08 Case-Shiller		% Change from Current Levels	YoY Change
$	368,436.30	-15.8%	-10.1%
Property Tax Forecast CY12/'09 Case-Shiller		% Change from Current Levels	YoY Change
$	362,862.34	-17.1%	-1.5%
Property Tax Forecast CY13/'10 Case-Shiller		% Change from Current Levels	YoY Change
$	360,417.00	-17.7%	-0.7%
Property Tax Forecast CY14/'11 Case-Shiller*		% Change from Current Levels	YoY Change
$	334,552.05	-23.6%	-7.2%

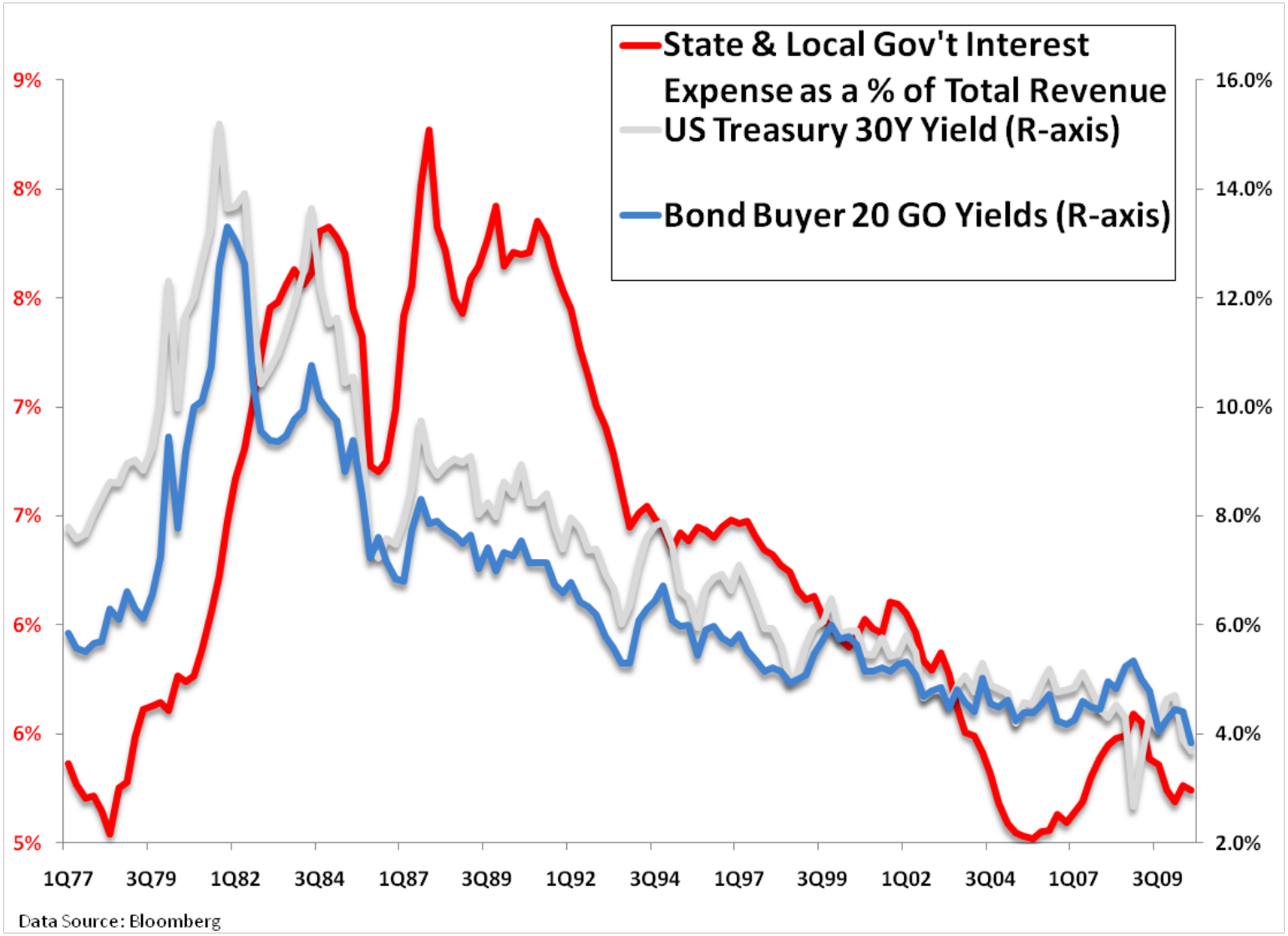
*2011 Case-Shiller Uses Hedgeye Estimate of a (15%) Decline in Housing Prices in 2011

HEDGEYE RISK MANAGEMENT

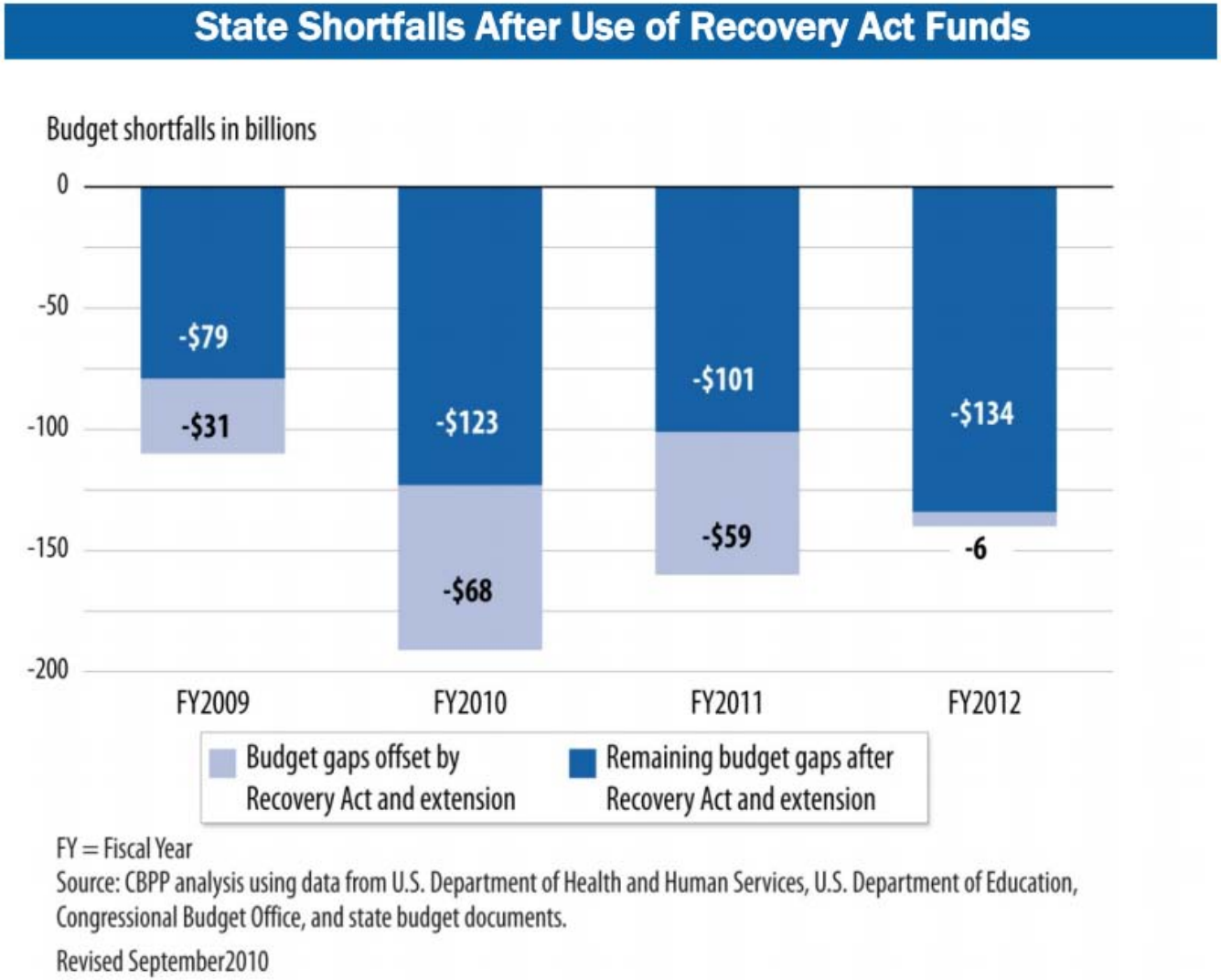
As ~26% of local gov't budgets and their most defensive revenue source, the finances of many municipalities will be incrementally stressed when these receipts begin to roll over alongside waning federal and State funding.



RISING INTEREST RATES WILL PROVIDE AN ADDITIONAL HEADWIND TO STATE AND LOCAL BUDGETS

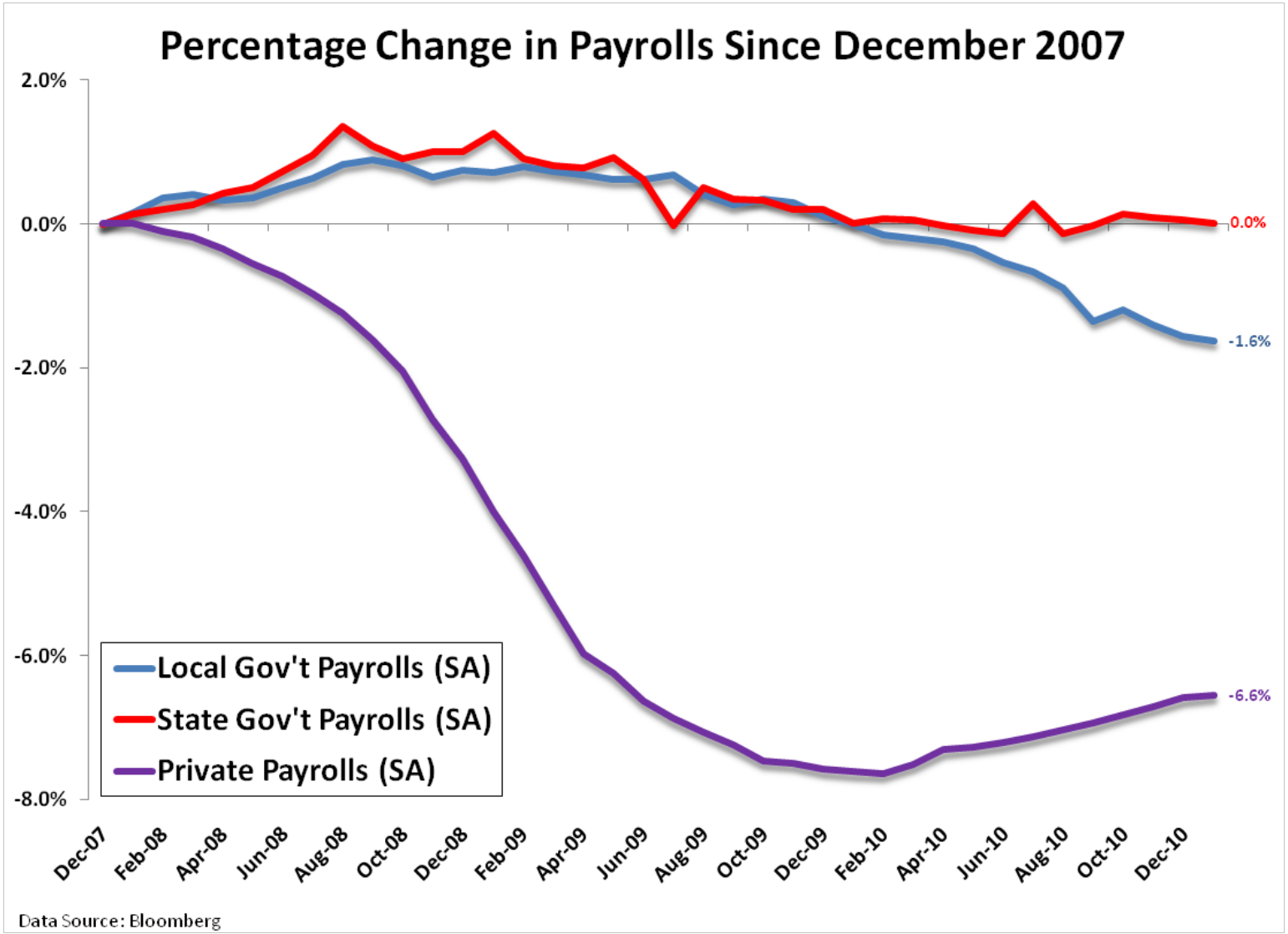


FEDERAL STIMULUS SUPPORT HAS SHIELDED GOVERNORS FROM MAKING REALLY TOUGH CHOICES

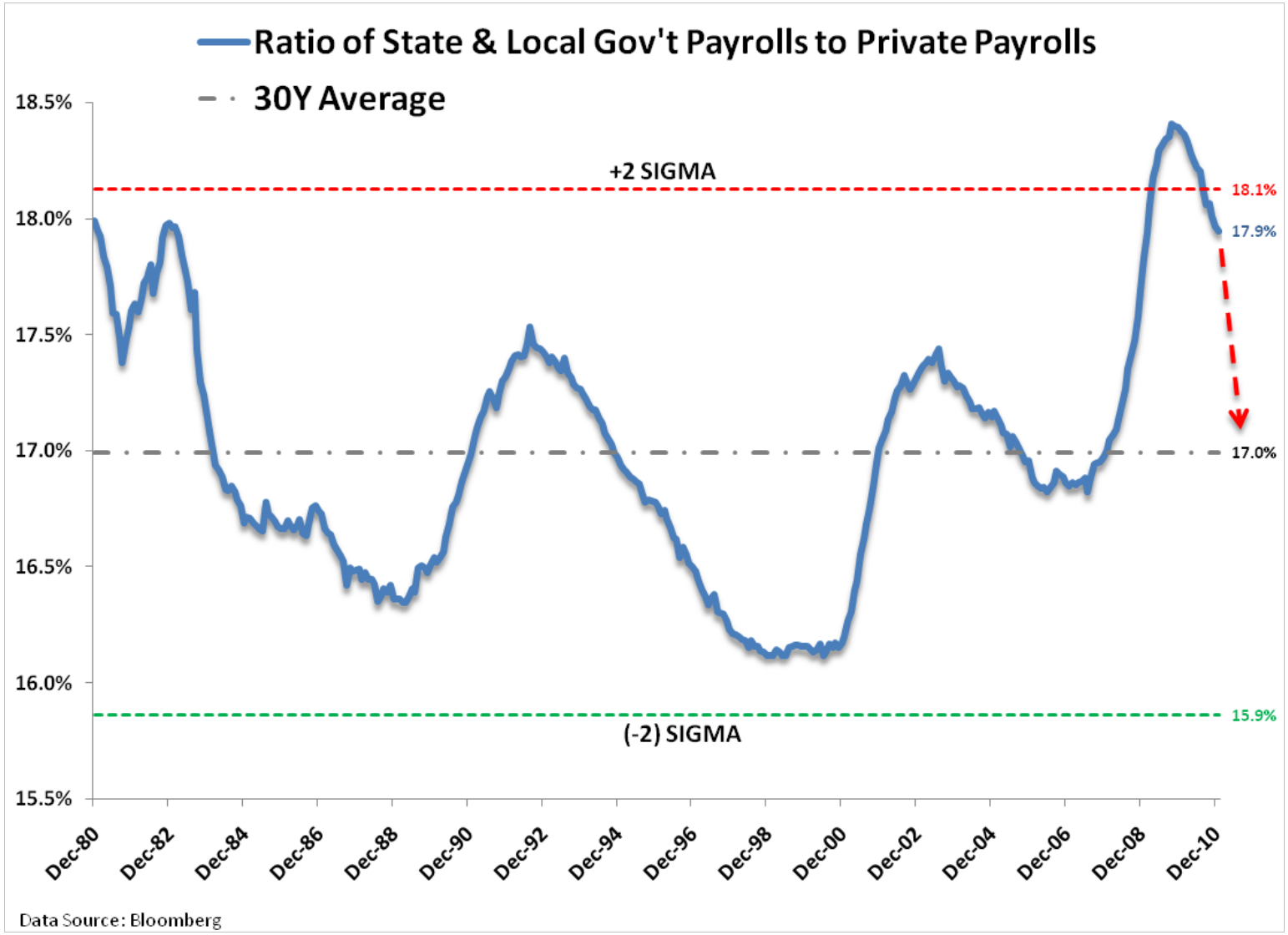


Source: Center on Budget and Policy Priorities

THUS, STATE & LOCAL GOV'T EMPLOYMENT HAS OUTPERFORMED THE PRIVATE SECTOR . . .



. . . BUT NOW DEEP CUTS ARE NEEDED IN THE FACE OF WANING STIMULUS



THERE IS EVIDENCE OF STATE'S WILLINGNESS TO IMPLEMENT AUSTERITY MEASURES . . .

New Jersey - Gov. Chris Christie (R.): *"Any tax cuts would have to be matched by spending cuts. We are not the federal government… Our Medicaid spending is growing out of control. We have to figure out a way to be more efficient and effective."*

New York - new Democratic Gov. Andrew M. Cuomo is expected to call for a one-year salary freeze for state workers, a move that would save $200 million to $400 million and challenge labor's traditional clout in Albany.

California - new Democratic Governor Jerry Brown is promising to review the benefits received by government workers in his State, which faces a $20-25 billion budget shortfall in FY12.

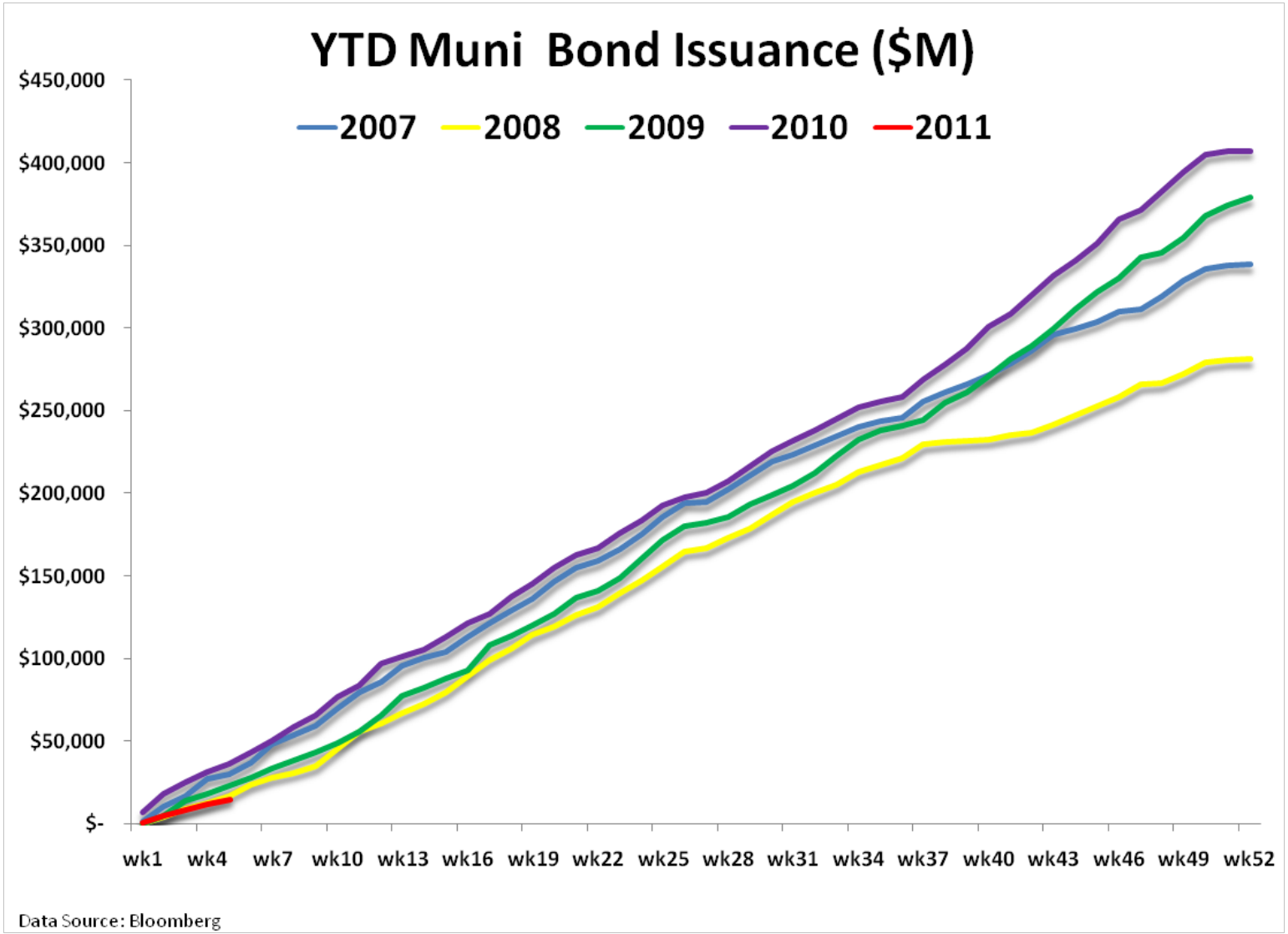
. . . BUT THE PUSHBACK FROM UNIONS WILL, AT BEST, DELAY TRUE FISCAL REFORM

Gerald McEntee, President of the American Federation of State, County, and Municipal Employees (January 19, 2011):
"The stakes have never been higher… We'll be running ground operations, hitting the airwaves and taking on the forces allied against us"

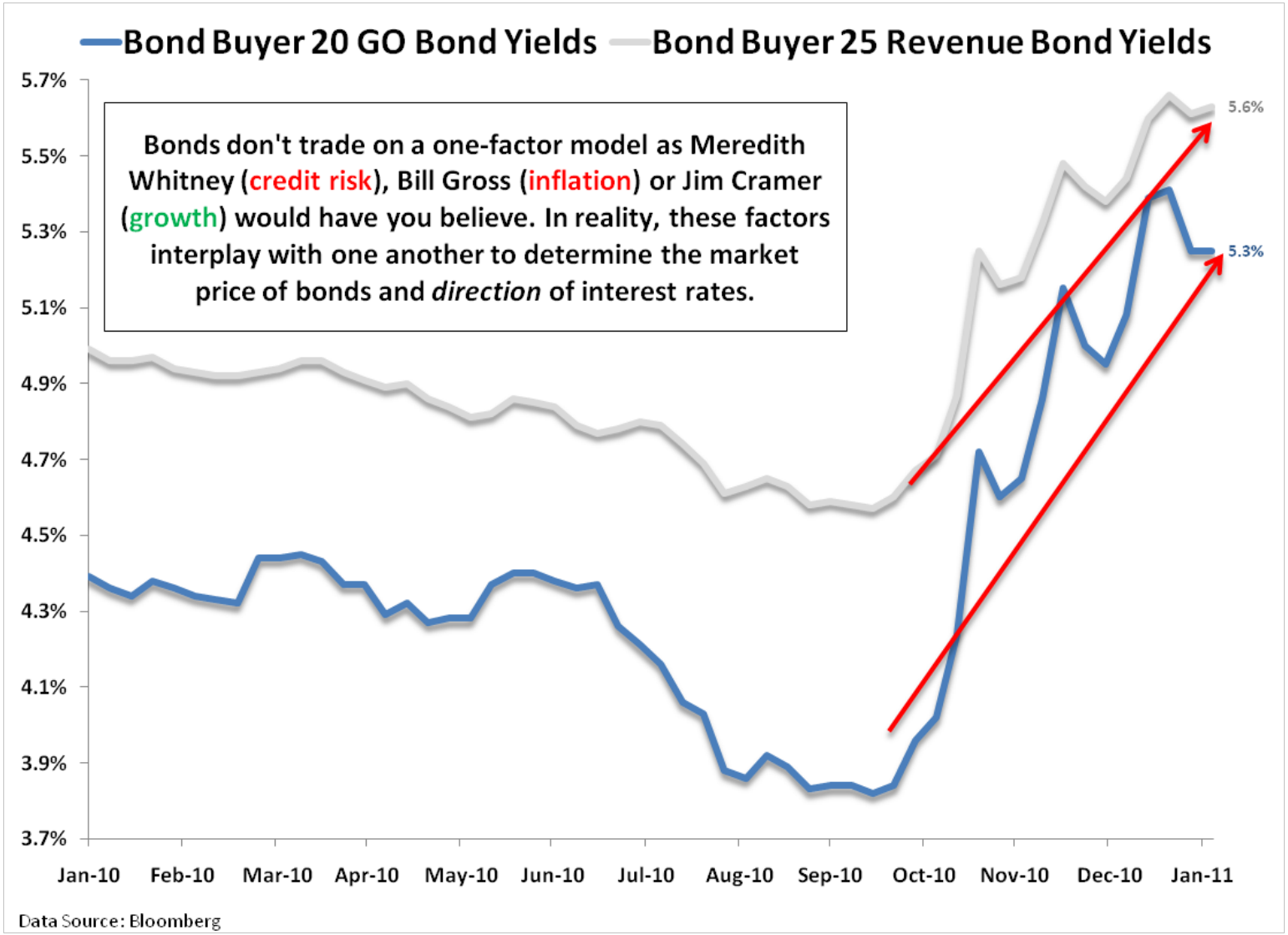
Randy Weingarten, president of the 1.5 million-member American Federation of Teachers (January, 2011):
"Christie's vilification of teachers and their unions is a cloak for all of the cuts that have been or about to be visited upon public education."

Public workers in CO, SD, and MN are already suing their State governments in protest of proposals to reduce pension and union benefits. Thus far, 18 Governors plan to reduce pension benefits in their FY12 budgets. Their proposals will be met with much resistance in the coming months.

MUNI BOND SUPPLY GROWTH WILL ACCELERATE MEANINGFULLY IN 2H11 AND BEYOND . . .



. . . IN AN ELEVATED INTEREST RATE ENVIRONMENT . . .



What happens to US interest rates when the Fed is no longer monetizing $600B in Treasury Debt? QE3?

. . . IN PART DRIVEN BY THE "FLOWS"

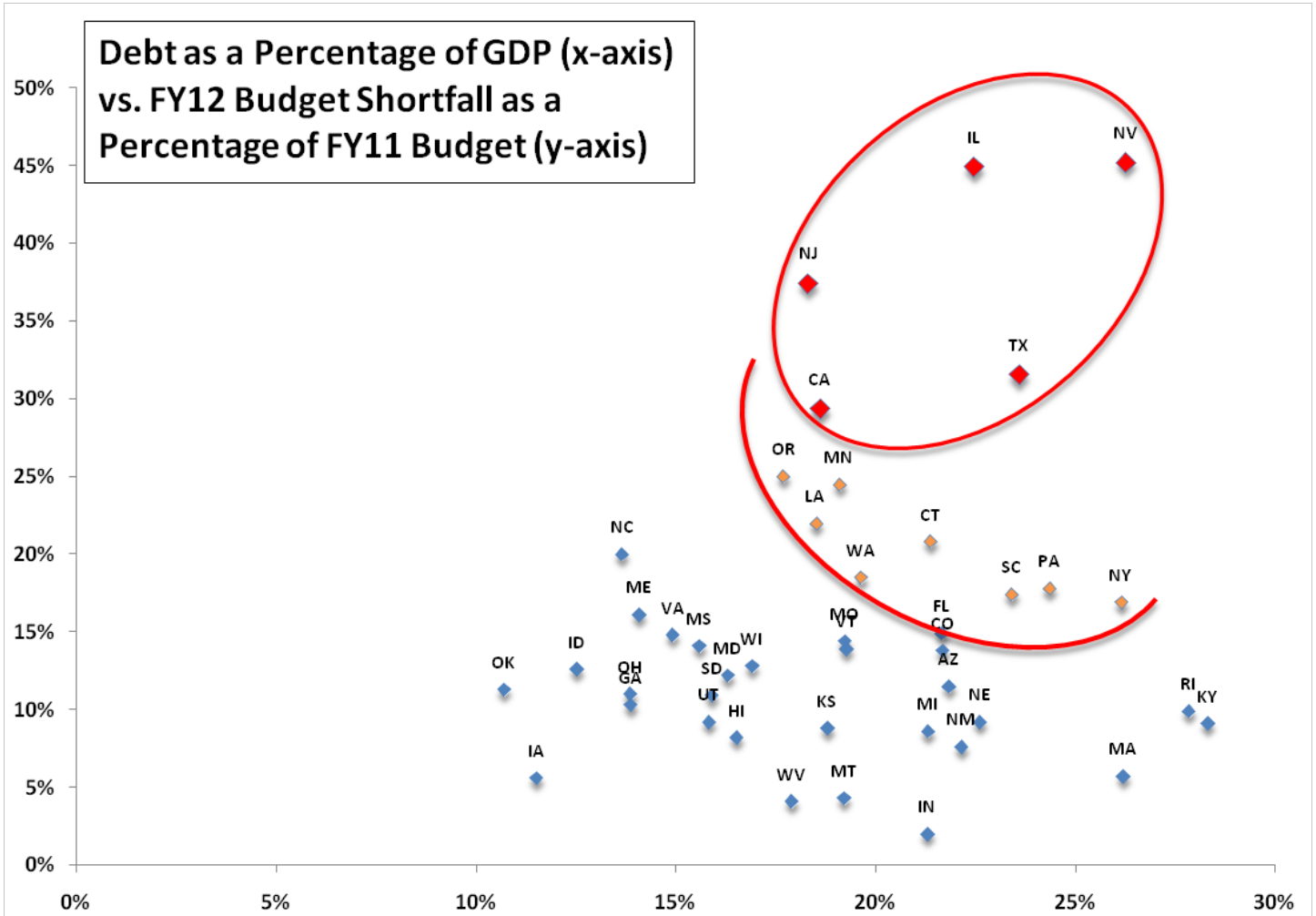
- **For the week ended February 2nd, 2011, Muni bond funds saw net outflows for a 13th consecutive week**

- **The latest weekly outflow ($1.17B) brings the cumulative total to $34.68B since retail investors started fleeing the sector in early November (roughly 35% of the inflows we saw from January '09 – October '10)**

- **Two things happened in early November: *Quantitative Guessing Part II* was announced and Republicans dominated the mid-term elections**

THERE IS ANOTHER SIDE TO THE QG2 TRADE AND THE BUSH TAX CUT COMPROMISE:
BONDS GET SMOKED AND INVESTORS NEED LESS TAX SHELTER ON THE MARGIN

THERE ARE CERTAIN STATES THAT WILL ADD MEANINGFUL SUPPLY AT HIGHER RATES & WILL SEE THE DEFALUT RISK OF THEIR MUNICIPALITIES INCREASE DRAMTICALLY



Data Source: Center on Budget and Policy Priorities; AL, AR, DC, DE, ND, NH, TN, and WY have yet to report FY12 budget estimates.

THOSE THAT HAVE THE MOST TO LOSE DENY THE POSSIBILITY OF STATE BANKRUPTCIES . . .

"It's a cynical proposal, intended to incite a panic in response to a phony crisis. Killer bees, space aliens, and now it's the invasion of the bankrupt states."

- Bill Lockyer, California Treasurer, January 24th, 2011

"Mr. Lockyer, a Democrat, said he thought this "ludicrous" idea had been cooked up by politically ambitious Republicans. "Their allies," he said, naming them as big insurance companies, banks and hedge funds, would torpedo the idea, because "even the faint odor of bankruptcy hurts the values of the bonds that they hold."

- New York Times, January 24th, 2011

. . . BUT THE IDEA IS BEING MORE WIDELY DISCUSSED THAN EVER BEFORE

- **The main pushback on bankruptcy for states is based on constitutionality it would interfere with state sovereignty, but legal experts suggest:**

  - **A law could be enacted that would not allow States to go bankrupt against their will**

  - **A law could be enacted that wouldn't usurp States**

  While Newt Gingrich is proposing a new Contract For America:

  > **"We're faced with the danger that the states are going to try to show up and say to Washington: You have to give us money. And I think we have to have an alternative that allows us to say no."**

IT IS ALSO HIGHLY UNLIKELY THAT THE FED OR FEDERAL GOV'T COMES TO THE RESCUE . . .

House Budget Committee Chairman Paul Ryan (R. WI) (1/6/11):
"We are not interested in a bailout… Should taxpayers in frugal states be bailing out taxpayers in profligate states? Should taxpayers in Indiana, who have paid their bills on time, who have done their job fiscally, be bailing out Californians, who haven't? No, that's a moral hazard we are not interested in creating… If we bailed out one state, then all of the debt of all of the states is not just implied, it's almost explicitly put on the books of the federal government."

House Majority Leader Eric Cantor (R. VA) (1/24/11):
"There will not be a federal bailout of the States… States have all the requisite tools to balance their budgets."

Federal Reserve Chairman Ben Bernanke (1/7/11):
"We have no expectation or intention to get involved in State and local finance... States should not expect loans from the Fed."

. . . OR THAT THEY CAN UNDER CURRENT LAW

- **In fact, the Fed only has the legal authority to purchase ~2% of the muni bond market**
    - **This is limited to muni debt with maturities of six months or less that is directly backed by a revenue source**
- **Further compounding the Fed's ineffectiveness is legislation introduced in the Dodd-Frank financial regulation, which prohibits the Fed from lending to insolvent borrowers or pursuing bailouts of individual borrowers**

TO BE FAIR, HISTORY SHOWS A LIMITED NUMBER OF MUNI BOND DEFAULTS . . .

- **In the period from 1970 – 2009, only four cities or counties defaulted on their General Obligation debt**
- **No State has defaulted since Arkansas did so back in 1933**

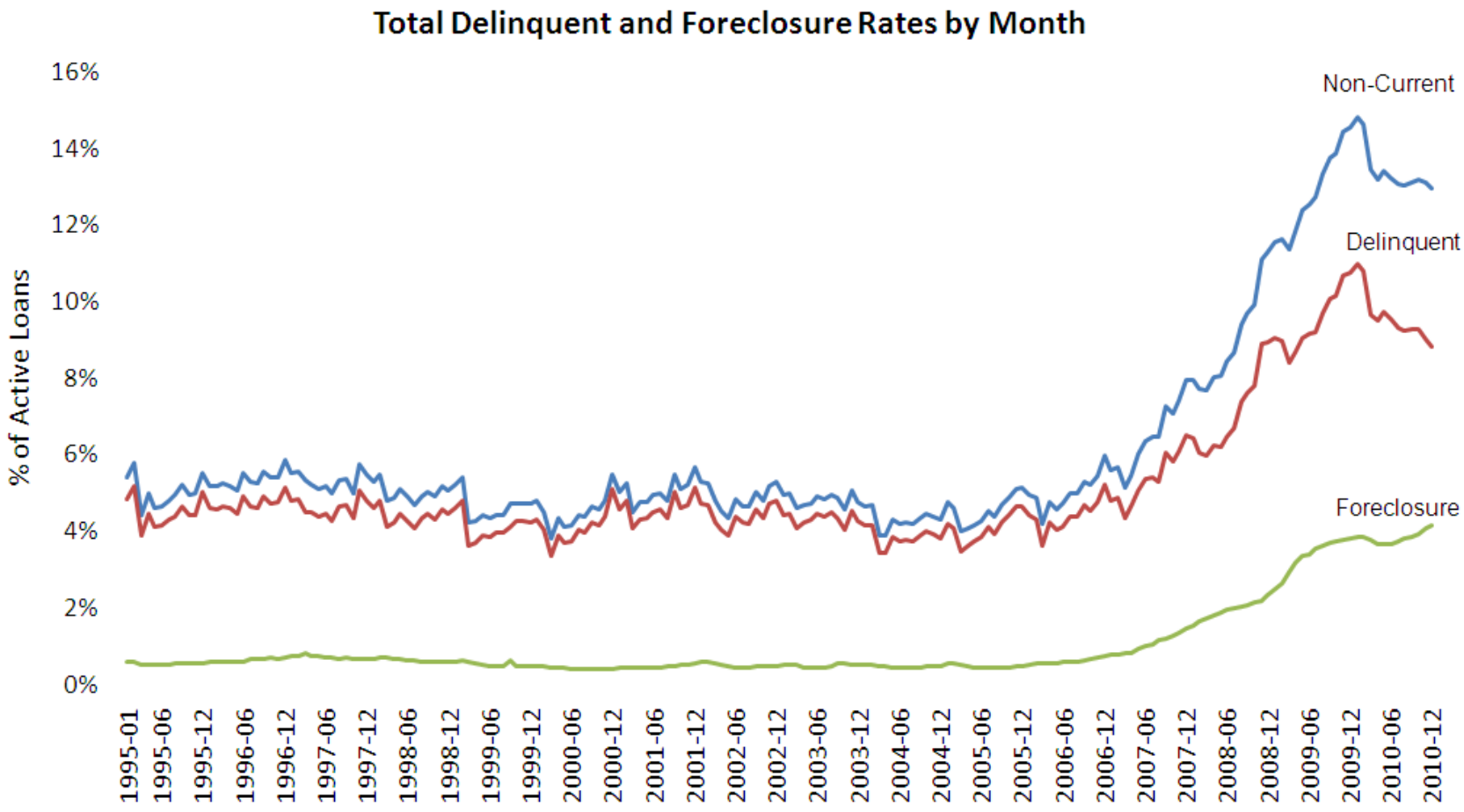
10 Year Cumulative Default Rates

Moody's (1970 - 2009)

	Municipalities	Corporates
Aaa	0.00%	0.50%
Aa	0.03%	0.54%
A	0.03%	2.05%
Baa	0.16%	4.85%
Ba	2.80%	19.96%
B	12.40%	44.38%
Caa	11.60%	71.38%

Source: US Department of the Treasury

. . . THOUGH THE SAME COULD HAVE BEEN SAID FOR RESIDENTIAL MORTGAGE-BACKED SECURITIES



Source: LPS Mortgage Monitor December 2010

THERE IS HISTORICAL PRECEDENT FOR WIDESPREAD MUNI BOND DEFAULTS

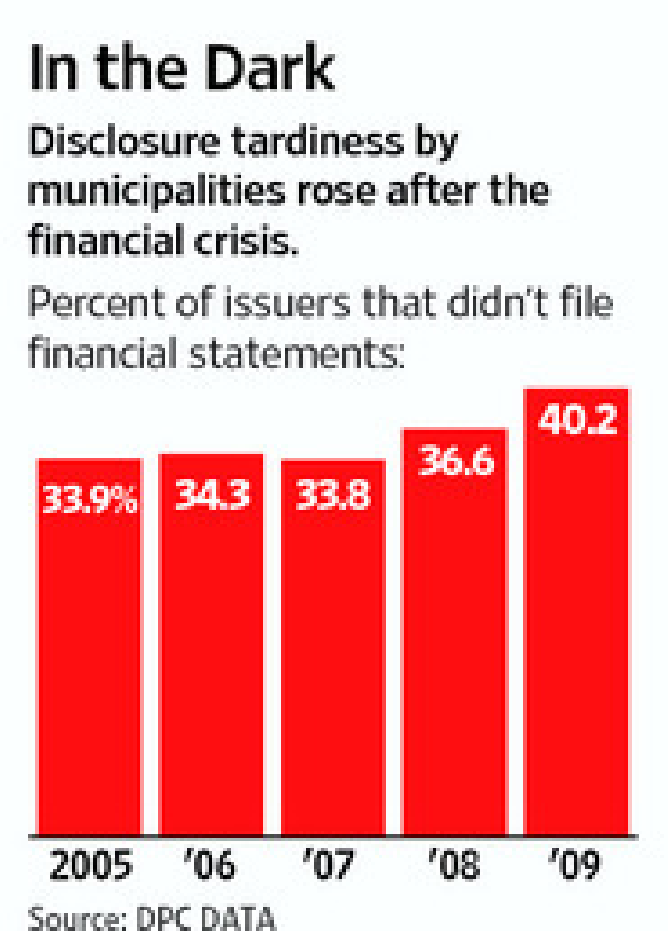
Type	Peak Defaults	Date
States	1 – 3	May 1, 1933
Counties	359	July 1, 1934
Cities and Towns	851	January 1, 1935
School Districts	882	August 1, 1935
Other Districts	229	September 1, 1935
Special Districts	1,173	May 1, 1938

Source: *"The Postwar Quality of Municipal Bonds"* by George Hempel

Avoid blind faith in the ratings agencies: Almost 80% of the total dollar value for all defaulting issues were rated Aaa in 1929 and 94.4% were rated Aa or better.

IN ANY EVENT, A LACK OF FINANCIAL TRANSPARENCY MAKES PREDICTING DEFAULTS DIFFICULT

- **56% of muni bond issuers did not file a financial statement in any given year between 2005 and 2009.**
- **Over 33% skipped filing in three or more of the past five years.**
- **In the latest filing year (2009), the percentage of non-filers jumped +360bps to 40.2%.**
- **An additional 30% filed "extraordinarily late" in 2009.**



AND RISING OPACITY HAS BEEN ASSOCIATED WITH A PICKUP IN DEFAULTS, THOUGH ON A SMALL SCALE

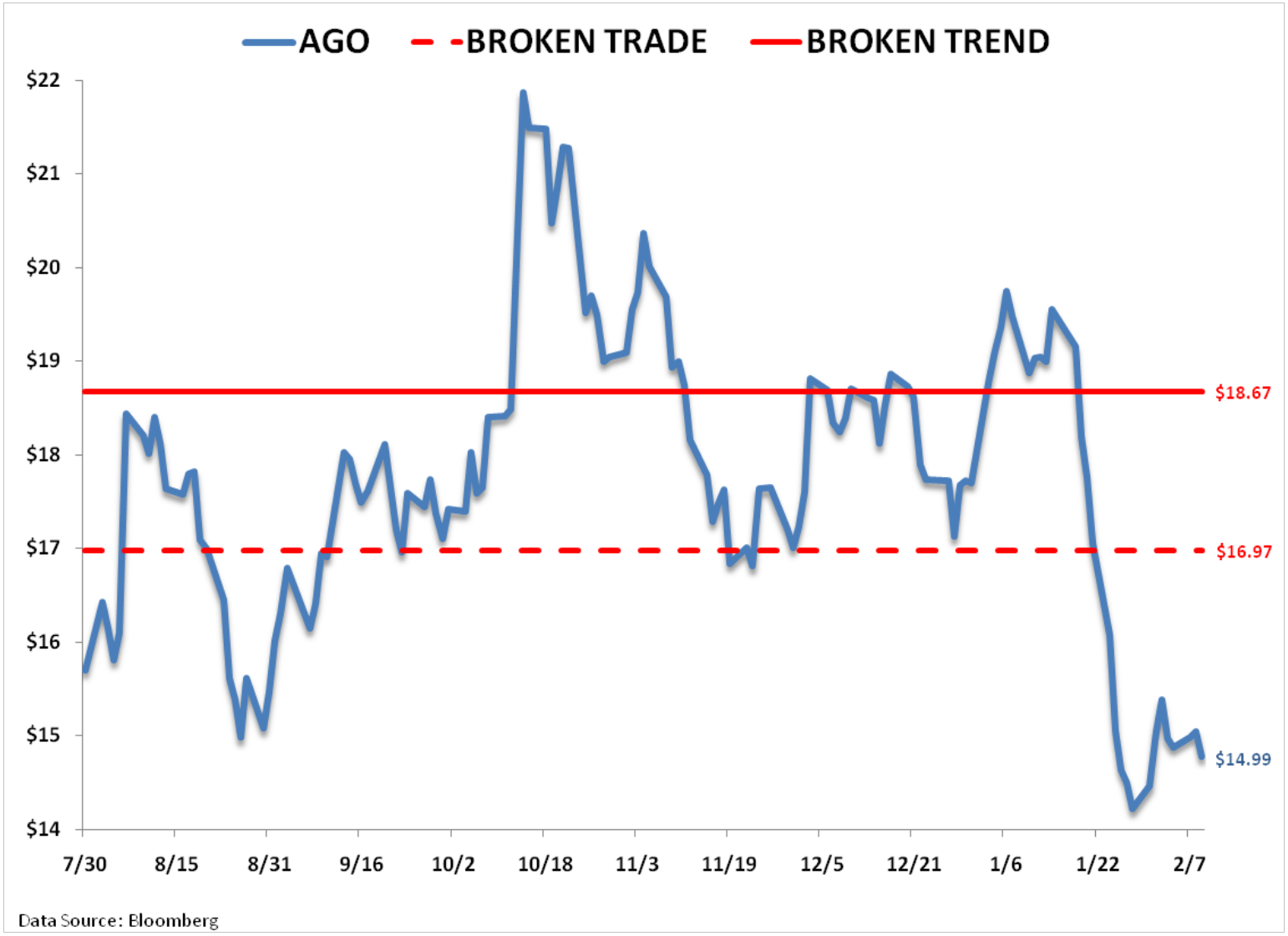
- **The State of New Jersey recently settled an SEC suit which claimed the State had failed to provide investors with an accurate picture of its large pension obligations.**

- **The Clay Gas & Utility District of Clay County, TN did not file a single disclosure for ten years until a default notice in November 2010.**

- **Maryland Health & Higher Education also avoided updating its financial statements for ten years until fall 2010, notifying investors in October that they would be offering $0.50 cents on the dollar in a restructuring plan.**

- **Chowchilla, CA defaulted on its bonds used to renovate its city hall in January without any filing or notice to investors. The default surprised even the city's assistant administrator, Wayne Padilla, who says the trustee stopped paying investors because the reserve fund was $500 short.**

WATCH AGO'S STOCK FOR AN ADDITIONAL REAL-TIME INDICATOR OF MUNI BOND DEFAULT RISK



CONCLUSION: MUNIS WILL BE REPRICED NEGATIVELY

1. **Interest rates are breaking out to the upside in global bond markets.**

2. **Pushback from unions and pensioners will make cutting State and local deficits, as well as the federal deficit, challenging – at a time when funding from the federal gov't for States and State funding for municipalities declines materially.**

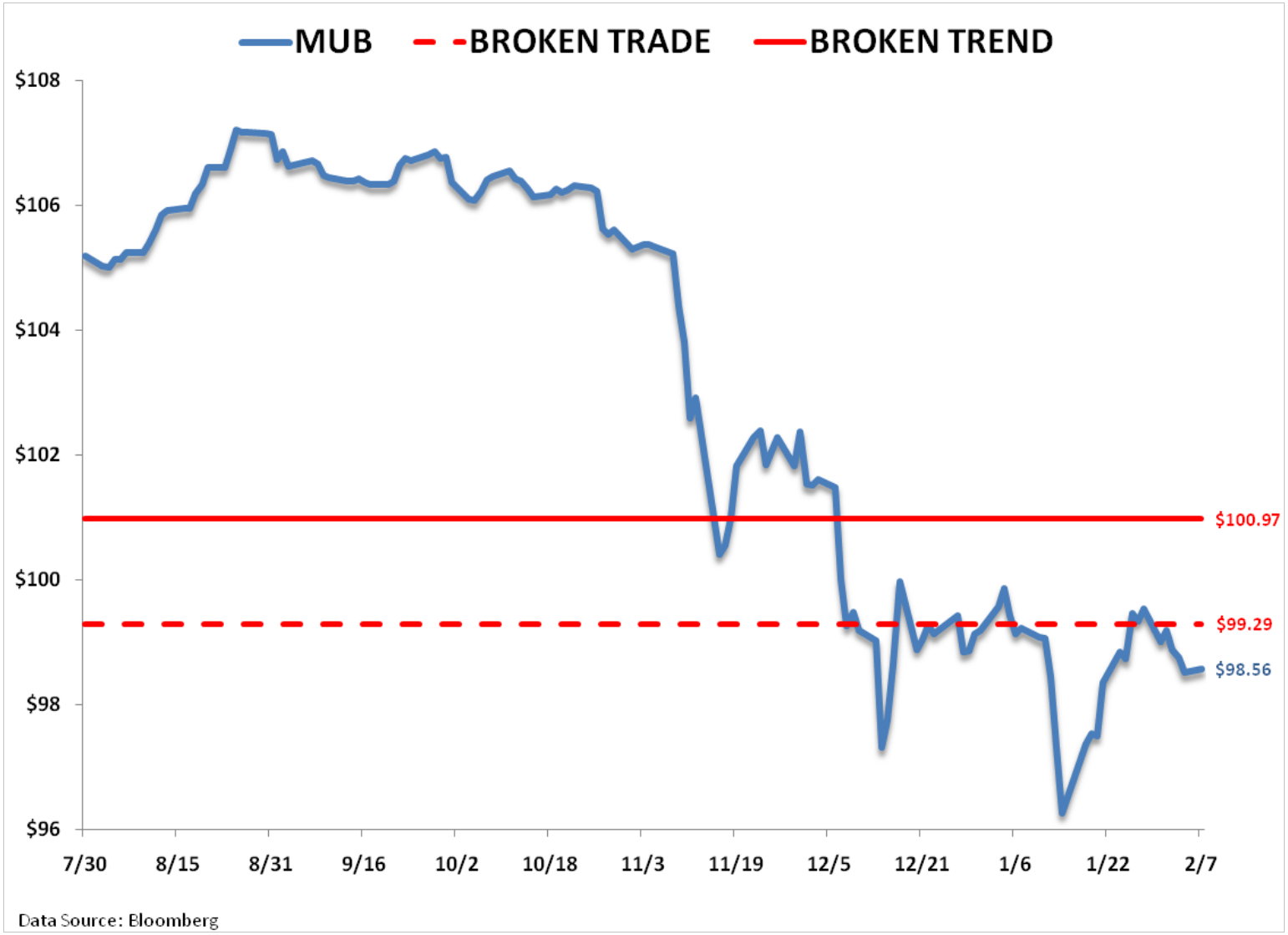
3. **As a result, supply is set to accelerate in both the US Treasury bond and US municipal bond market – at a time when demand for debt securities is decelerating (rising inflation, the end of QE2).**

4. **Bankruptcy is, at the very least, an overhang. Defaults don't need to occur for the price of a bond to go down.**

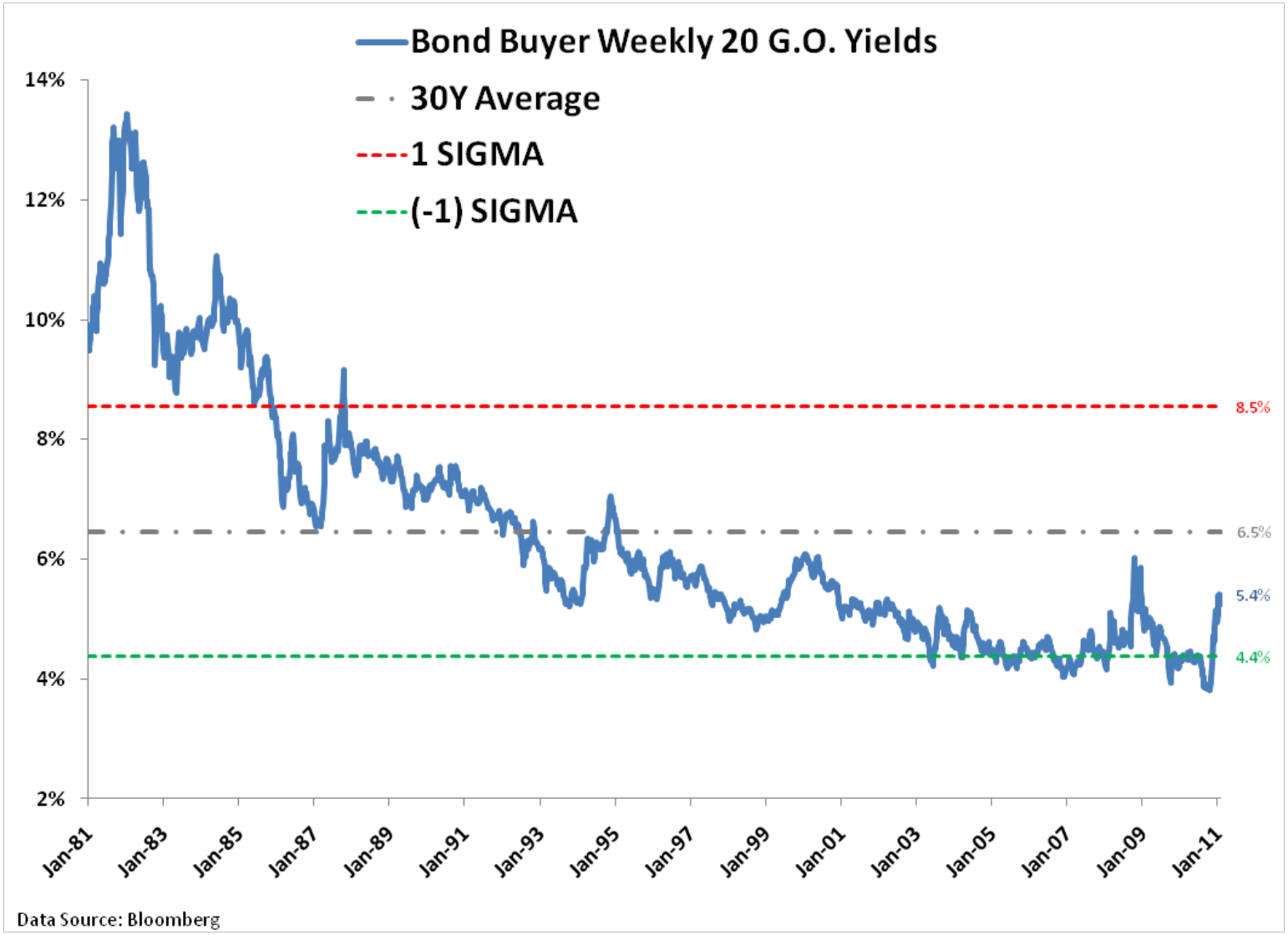
5. **Lack of transparency makes projecting defaults difficult, but also makes assessing creditworthiness difficult. Don't be fooled by credit ratings or lagging data points which create an illusion of "value".**

6. **Additional Federal support on the state level seems highly unlikely, so muni bonds need to accurately price in this marginal change in default risk.**

MUNIS WILL REMAIN BROKEN AND SHOULD BE UNDERWEIGHT, AT THE VERY LEAST



LONGER TERM, REVERSION TO THE MEAN SUGGESTS MORE LOWER-HIGHS IN MUNI BOND PRICES



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RISK MANAGEMENT

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