

MUNICIPAL BOND MARKET NOTE

JANNEY FIXED INCOME STRATEGY

October 19, 2012



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The Threat to the Tax-Exemption

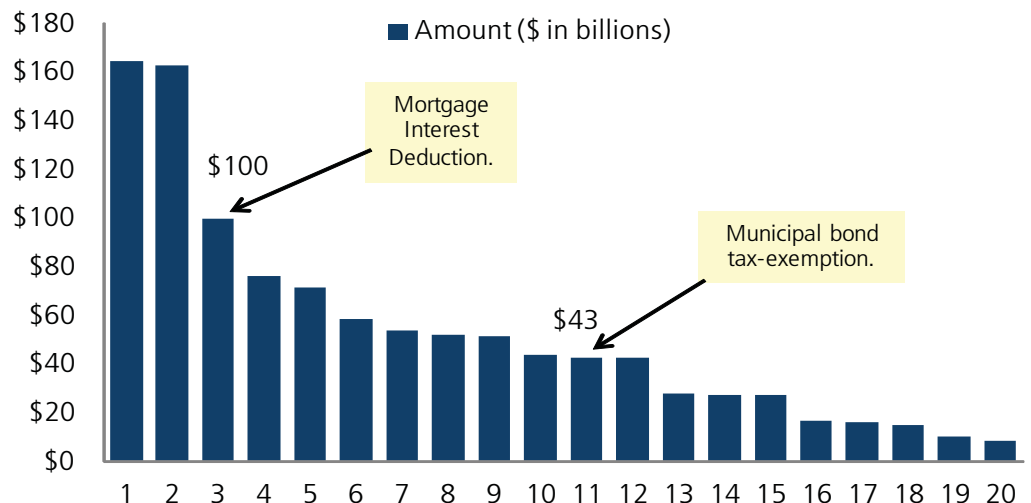
It Exists and it is Rising

- The municipal bond tax-exemption is facing the most hostile threat to its existence since the 1986 Tax-Act.
- The factors merging to create this threat include deficit reduction, tax reform, and progressive arguments of fairness.
- Any significant change in the tax-exemption would be a major policy shift with the unintended consequences of impeding state and local government investment.
- Without the tax-exemption, issuers – especially smaller issuers – could be locked out of the debt market and others would pay higher debt service costs. States, cities and towns would have to pass on their higher costs to taxpayers and users or forgo further infrastructure investment.
- It is still too soon to have a clear read on what will become of the municipal tax-exemption. We do not recommend any specific investor action at this time due to the uncertainty, but we do advise investors to continue to monitor the situation. We will continue to provide updates as new facts present themselves or as the political situation evolves.

THE TAX-EXEMPTION THREAT

Over the years there have been a variety of attempts and initiatives to limit or eliminate the exemption of municipal bond interest from federal income tax, with little success. The Tax Reform Act of 1986 subjected the previously exempt interest on certain private activity bonds to Alternative Minimum Tax (AMT) treatment, a slight erosion of the tax benefit. A 1983 law requires the inclusion of tax exempt interest when determining the threshold for taxation of social security benefits. In 1986 Bob Packwood, then chairman of the Senate Finance Committee and Republican Senator from Oregon, proposed elimination of the tax exemption, putting the municipal market into a tailspin for a day or so, before calmer heads prevailed and the proposal was rejected by the entire committee. More recently the December 2010 report by the Presidential Commission on Fiscal Responsibility and Reform (Simpson–Bowles), as part of a comprehensive tax reform proposal, included elimination of the tax exemption of interest from future municipal issues. Last year, an Obama administration plan

20 Largest Individual Tax-Expenditures, FY2014



Source: Congressional Research Service and Janney FIS. See page 4 of this Janney report for more detail.

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Over the years there have been a variety of attempts and initiatives to limit or eliminate the exemption of municipal bond interest from federal income tax, with little success.

In the current gridlocked, contentious environment that is Washington, DC, the threat to tax exemption has never been stronger.

Approaches to modification range from the complete elimination to partial reduction.

sought to limit the tax exempt benefit to that earned by 28% bracket investors, effectively taxing a portion of the tax exempt interest received by top bracket taxpayers. Perhaps the most disturbing element of the President's proposal was its retroactive nature, since it would apply to outstanding as well as future issues.

RATIONALE

In the current gridlocked, contentious environment that is Washington, DC, the threat to tax exemption has never been stronger. There are three rationales being used to justify change.

Deficit Reduction

Few in Washington disagree with the need for reductions in the federal deficit, which has exceeded \$1 trillion in each of the past four years and is likely to approach that amount in the current fiscal year which ends September 30, 2013. The strident Beltway arguments are not about if deficits should be reduced, but rather are focused on how and how quickly to lower the annual budget gap. Municipal tax exemption is estimated to total about \$48 billion in foregone taxes for FY2013, which is a small amount in the context of a \$3.8 trillion budget.

Tax Reform

Although often intertwined in discussions about deficit reduction, tax reform in its purest form primarily focuses on simplifying the voluminous federal tax code. The argument is that a less complex, more transparent tax code would improve economic output through increased efficiency. The December 2010 Simpson-Bowles report proposed elimination of many tax deductions and expenditures, including tax exemption, but it also lowered personal income tax rates with the top bracket falling to 23% to 28% (under various scenarios) compared to the current 35% (scheduled to rise to 39.6% on January 1, 2013).

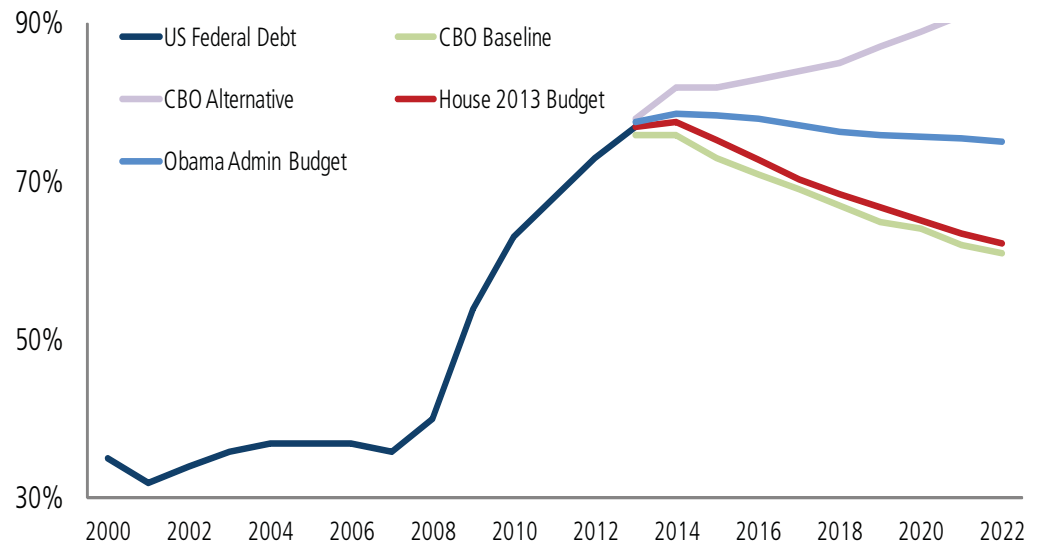
Fairness

The fairness argument is that since higher income taxpayers benefit most from the municipal tax exemption, eliminating it would generate a more level playing field. This argument partially underlies Obama administration proposals to limit the exemption benefit to that of a 28% bracket taxpayer, effectively imposing a tax on a portion of the municipal interest earned by investors in the top federal bracket.

APPROACHES

Approaches to modification of the tax exemption range from the complete elimination of its use for new bond issues (Simpson-Bowles); to partial reduction through narrowing the types of issuers that would qualify; to limitation of the benefit in some form similar to the administration proposal that

U.S. Federal Government Debt to GDP Trajectory Under Select Scenarios



Source: Congressional Budget Office; OMB FY13 Mid-Session Review Aug 2012; House 2013 Budget and Janney FIS.

A partial reduction could come about by applying the tax exemption only to core essential purpose municipal issuers.

Given the myriad of potential options noted, it is difficult to handicap the likelihood or market impact of various plans.

We believe the threat for change, and perhaps significant change, is the greatest since the 1986 Tax Act and the threat is gaining momentum.

applies income tax on a portion of the interest earned by top bracket investors. A partial reduction could come about by applying the tax exemption only to core essential purpose municipal issuers, perhaps cutting off tax free market access to nonprofit senior living, hospital and higher education borrowers or by amount of issuance (as in the bank qualified designation currently), which would retain tax exempt support for smaller issuers only. The option of limiting the taxable benefit to that of the 28% tax bracket investor is particularly problematic since it is retroactive in nature, applying to both past and future municipal bond issues, unlike the Simpson Bowles elimination, which applied only to future issues.

MARKET IMPACT

Given the myriad of potential options noted, it is difficult to handicap the likelihood or market impact of various plans. For example, elimination of tax exemption for future issues, as proposed in Simpson-Bowles, would create a scarcity factor since new issues would be taxable, while more than \$3 trillion of outstanding municipal bonds would remain tax free, with amounts available diminishing over time as bonds mature. An offsetting consideration is reduction of the economic benefit of tax free interest to high bracket investors if at the same time top bracket tax rates were dropped.

Uncertainty generated by the discussion has already had an impact on the market and is likely partially responsible for elevated municipal to Treasury ratios, which have hovered above 100% for most of the past 5 months. Investors may gain more comfort if the tax free yield on a municipal bond investment is equal to or above the yield of a like quality and maturity taxable bond, as exemplified by ratios above 100%.

10 Year M/T Ratio Above 100% in Recent Months



Source: Municipal Market Advisors, Bloomberg and Janney FIS.

ALL TAX EXPENDITURES ARE UNDER ATTACK

The current status of the threat to the municipal bond tax-exemption tax expenditure is caught in the political quagmire somewhere between potential deficit reduction and within the topic of comprehensive U.S. tax reform. We believe the threat for change, and perhaps significant change, is the greatest since the 1986 Tax Act and the threat is gaining momentum. The \$1 trillion of tax-expenditures (out of a \$3.8 trillion U.S. budget) will remain ripe for continued attacks as the U.S. debt to GDP ratio remains elevated and Congress remains divided over spending plans.

A variety of approaches include iterations that would keep, replace, eliminate or limit the tax exemption "tax-expenditure," as noted above. Tax expenditures are a category of federal spending in the form of incentives or exemptions created by tax-code regulations. While direct federal spending uses taxpayer dollars or debt to pay for programs, tax expenditures indirectly pay for government initia-

Tax-expenditures support government policies by providing a taxpayer benefit and hopefully achieve specific strategic goals.

There are approximately 200 separate tax expenditures, which total about \$1 trillion. The top 20 make up about 90% of the \$1 trillion.

The Simpson-Bowles Commission recommended eliminating the majority of tax-expenditures, including the tax exemption.

initiatives. Tax-expenditures support government policies by providing a taxpayer benefit and hopefully achieve specific strategic goals. The indirect spending incentivizes taxpayers to buy a home, save for retirement, fund a college education, or even buy a tax-exempt municipal bond, for example. There are approximately 200 separate tax expenditures, which total about \$1 trillion. The top 20 make up about 90% of the \$1 trillion.

The 20 Largest Individual Tax-Expenditures, FY2014

Rank	Tax-Expenditure/Provision	Amount (\$ in billions)	Share of All Tax Expenditures (%)	Cumulative Share (%)
1	Exclusion of Employer Health Insurance	164.2	13.8	13.8
2	Exclusion of Employer Pensions	162.7	13.7	27.5
3	Mortgage Interest Deduction	99.8	8.4	35.9
4	Exclusion of Medicare	76.2	6.4	42.3
5	Capital Gains Rates	71.4	6.0	48.3
6	Earned Income Credit	58.4	4.9	53.2
7	Deduction of Income Taxes	54	4.5	57.7
8	Gains: Exclusion at Death/Gift Carryover	51.9	4.4	62.1
9	Deduction of Charitable Contributions	51.6	4.3	66.4
10	Employer Benefits Under Cafeteria Plans	43.8	3.7	70.1
11	Tax-exempt/Tax Credit Bonds	42.7	3.6	73.7
12	Exclusion of Social Security Benefits	42.6	3.6	77.3
13	Exclusion of Inside Buildup, Insurance	27.7	2.3	79.6
14	Exclusion of Capital Gains on Housing	27.2	2.3	81.9
15	Deduction of Property taxes	27.1	2.3	84.2
16	Deduction of Medical Expenditures	16.6	1.4	85.6
17	Individual Retirement Accounts	16	1.3	86.9
18	Child Credit	15.1	1.3	88.2
19	Accelerated Depreciation	10.3	0.9	89.1
20	Exclusion of Foreign Earned Income	8.2	0.7	89.8

Source: Congressional Research Service and Janney FIS.

Almost all tax expenditures are coming under attack, either as an entirety or as individual line-items. The attacks have been sourced to lawmakers from both sides of the political aisle and various observers. Some of the recent attacks include:

- **"Everything is on the table,"** Senator Max Baucus (D-MT), chairman of the U.S. Senate Finance Committee warned state and local governments during an April 2012 committee hearing. Senator Baucus also highlighted the fairness factor we noted earlier when he said, "For every dollar we spend on infrastructure through a tax-exempt bond, 20 cents goes to tax breaks for higher-income taxpayers;"
- **Deficit Reduction Committee call for elimination:** Simpson-Bowles Commission recommended eliminating the majority of tax-expenditures;
- **President Obama** has proposed limiting the tax-exemption benefit for investors to 28%, retroactively;
- **Economist call for a new progressive movement:** Even the Economist magazine recently noted that a method of lowering the income gap in the U.S. could come from the elimination of tax deductions. The Economist did not mention the tax-exemption specifically but did highlight the more commonly known, mortgage interest deduction.

An important point that seems to be lost during most of the discussions surrounding the commentary about this topic is that any significant change to the tax-exemption tax expenditure would represent a significant shift from current policy.

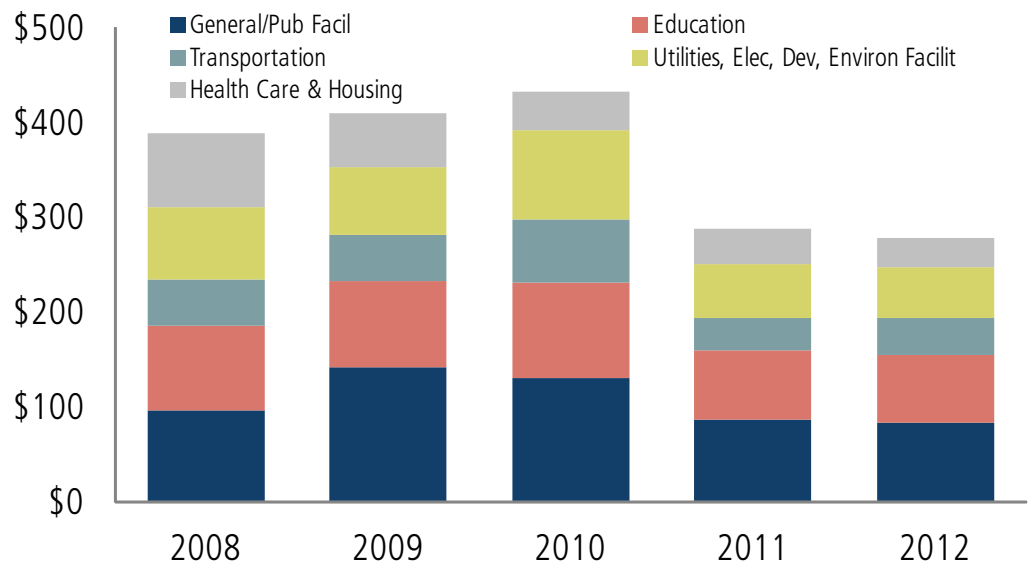
"America spends a lot on its schools, but that funding comes largely from state and local governments," The Economist, October 13, 2012, p.12 of special report.

"Local and state governments comprise three quarters of U.S. infrastructure spending and debt financing ...nearly four million miles of roadways, 500,000 bridges, 1,000 mass transit systems, 16,000 airports, 25,000 miles of inter-coastal waterways, 70,000 dams, 900,000 miles of pipe in water systems, and 15,000 waste water treatment plants," per data from the National League of Cities.

A Significant Policy Shift Away from an Effective Financing Mechanism

An important point that seems to be lost during most of the discussions surrounding the commentary about this topic is that any significant change to the tax-exemption tax expenditure would represent a significant shift from current policy. This point is especially true as it relates to the way the U.S. has funded infrastructure, especially education. Another important point is that many federal policymakers oftentimes do not understand what municipal debt usually finances. Unlike the federal government, which utilizes debt to fund day to day operations and spending, municipal debt typically does not. Much of the debt sold by municipal issuers is an investment in the future.

Municipal Debt Finances Many Critical Functions (par amount debt issued)



Source: Thomson Reuters and Janney FIS (\$ in billions.) Please note that totals include refundings.

Future U.S. Infrastructure Requirements- The Need is Great

The U.S. has been famously known for aggressive infrastructure investment going back to the 19th century. Canal systems in the early to mid-1800s, railroads in the late 1800s and interstate highways in the 1950s are all examples of the United States effort to invest in infrastructure to fuel economic growth. However, current infrastructure systems in the U.S. have not been maintained and upgraded at optimal levels. In fact, the American Society of Civil Engineers estimates that \$2.2 trillion is needed to upgrade America's infrastructure over a 5-year period. Many state and local governments will attempt to postpone these upgrades and expansions back as they continue to recover from the 2008 Recession. Upgrades and expansion will be even more difficult if they are more expensive to finance, the result if the tax-exemption is eliminated.

TAXPAYERS & USERS AT THE STATE AND LOCAL LEVELS WOULD PAY MORE

There are several, mostly political, arguments against the tax-exemption. And most do not offer a financing alternative that would allow state, local and other municipal government organizations to effectively access the capital markets. If the exemption is eliminated, smaller issuers, such as towns and smaller school districts, could see meaningful challenges through higher borrowing costs and diminished market access. Larger issuers such as states, toll roads and wholesale electric borrowers, would likely retain market access, although at higher interest rates. The success of the taxable Build America Bond program demonstrated demand for taxable municipal bonds of larger issuers. On the other hand, a \$10 million borrower (the majority of municipal issuers borrow smaller amounts) could have difficulty attracting investors. The mainstay of municipal bond investors has been individuals who either directly or through mutual funds hold more than 70% of outstanding municipal bonds. If this important retail sector reduced allocations to municipal bonds due to the disappearance of tax

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U.S. infrastructure received the grade of a "D" from the American Society of Civil Engineers.

A \$5.5 trillion investment is needed for U.S. infrastructure over a 5 year period.

Report Card for America's (and PA's) Infrastructure A

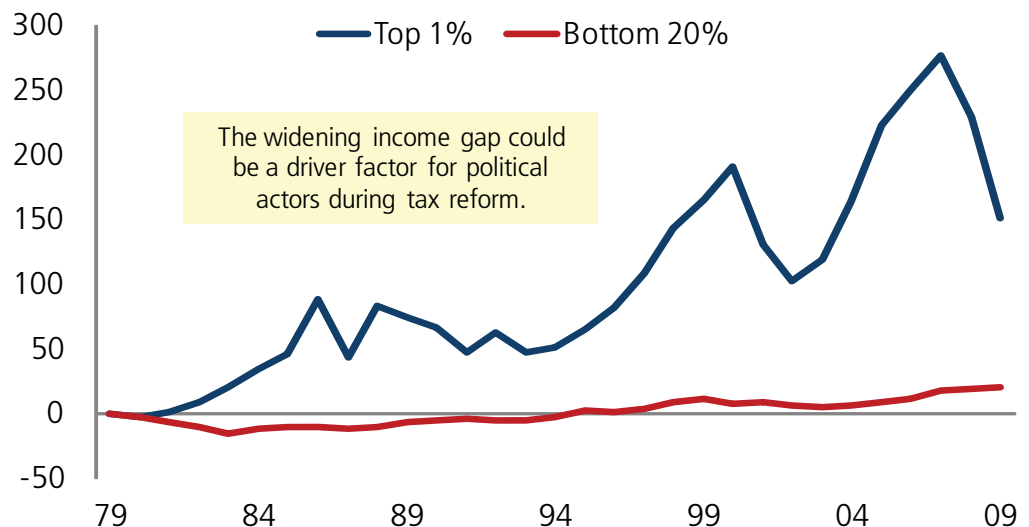
Infrastructure Type	United States	Pennsylvania	Notes
Aviation	D	None	Outdated U.S. systems, more delays
Bridges	C	C	44% of PA are deficient or obsolete
Dams	D	C-	39% PA dams deficient
Drinking Water	D-	D+	PA require \$15 billion of 20 years
Energy	D+	None	US needs to 2030 could cost \$1.5 trillion
Hazard Waste	D	None	188 US cities' brownfields waiting clean-up
Inland Waterways	D-	D+	Avg age US locks 60 yrs (useful life 50 yrs)
Levees	D-	C-	Avg age PA levees: 43 years
Public Parks & Rec	C-	B-	PA was Nat Gold Member winner
Rail	C-	B	Smaller railroads need more help than large
Roads	D-	D-	38% of PA's roads are fair or poor
Schools	D	B-	65% of PA schools excellent or good
Solid Waste	C+	B-	PA landfills- 16 years remaining capacity
Transit	D	D-	Public transit usage has increased
Wastewater	D-	D+	PA must invest \$23 billion next 20 years
Total G.P.A	D	C-	Tremendous US and PA challenges
Estimated Investment	\$5.5 trillion	N/A	Required investment over 5 years

Source: American Society of Civil Engineers and Janney FIS.

exemption, alternative investors such as insurance companies and pension funds could be hesitant to dive into a market known for lack of timely and robust disclosure including release of financial information.

We noted earlier that fairness is a driving rationale for why policymakers are considering the elimination of the tax exemption but this burden could then fall on middle class and other taxpayers. The elimination of the tax exemption would cause states, counties, cities and school districts to pay more in financing costs, if they could access the market at all. These issuers would have to pass on

Fairness is an Issue for Policymakers- U.S. Avg. Real Income (% change since 1979)



Source: Congressional Budget Office and Janney FIS.

States, counties, cities and school districts would have to pass on higher financing costs to taxpayers and users.

"State and local governments, 'don't have the resources' to pay for lobbyists," Viveca Novak from the Center for Responsive Politics per the Bond Buyer.

There also seems to be growing support for President Obama's 28% retroactive limitation.

their higher costs to taxpayers and users as a result. At a time when the federal government continues to cut funding to state governments and most state governments have significantly cut subsidies to local government, the limitation or elimination of access to the capital markets is the last thing that municipal issuers need.

SUPPORT FOR THE TAX EXEMPTION FROM MUNICIPAL ISSUERS

For some time we have expected that the most powerful arguments for tax-exemption would come from the issuers themselves. And while we are aware that some outreach has occurred from issuer organizations there does not seem to be a large scale organized effort to educate federal lawmakers. This is partially because there is not a significant amount of lobbying resources available to state and local governments. Issuers have had their hands full managing thin budgets in uncertain times while maneuvering through today's volatile political environment. We expected a more organized effort by issuers and the organizations that represent them to make their opinions heard. The silence and lack of engagement could be interpreted by federal lawmakers as a lack of support for the tax-exemption by state, local, and other municipal issuers. Without support from the users lawmakers may find it politically palatable to eliminate the tax expenditure, no matter how small it is compared to overall spending. Representatives from Janney attended a lunch at the beginning of October where a member of Congress discussed the fiscal cliff and the threat to tax-exemption, among other topics. The Congressman made it clear that this topic [tax-exemption] is still not decided and that issuers should make their voices heard.

The Anthony Commission's 1989 Report

There is a historical precedent of state and local government issuers supporting tax-exempt financing. For example, in the wake of the 1986 Tax Act, the Anthony Commission on Public Finance presented a report titled "Preserving the Federal-State-Local Partnership: The Role of Tax-Exempt Financing." The Anthony Commission and its effort was sparked by Wooten Epes, former President of the Arkansas Development Finance Authority who brought to the attention of then Arkansas Governor Bill Clinton that further changes to the tax-code would drastically affect municipal bond issuers' costs of funds. Governor Clinton enlisted Congressman Beryl Anthony Jr. to head a group, of individuals mostly from state and local governments, to make a case from the state and local government side. The Commission's report argued that, "The ability of state and local governments to finance the projects needed by their citizens is more critical than ever to economic growth and the health and welfare of our citizens." It was true then and it is a valid argument now too.

CONCLUSION

Several rationales exist that lead us to believe that the threat to the tax-exemption is the greatest since the 1986 Tax Act. From a policy perspective the elimination or any significant limitation to the tax-exemption would be a significant shift that would raise costs for issuers, which would eventually be passed onto taxpayers in higher tax rates or increased user fees. While it remains possible that politics might trump effective policy in the near term, it is still too soon to have a clear read on what will become of the municipal tax-exemption. We continue to see it included with other items during macro-level tax reform discussions without regard to its benefits, frustratingly. Senator Max Baucus (D-MT) took a shot across the policy's bow early in 2012 when he noted that everything (including the tax-exemption) was on the table as a possible cut. There also seems to be growing support for President Obama's 28% retroactive limitation. We do not recommend municipal investors take specific actions or reposition holdings based on current information, but this remains a very important topic to monitor. We will continue to provide updates as new facts present themselves or different situations evolve.

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Positive: Janney FIS believes there are apparent factors which point towards improving issuer or sector credit quality which may result in potential credit ratings upgrades

Stable: Janney FIS believes there are factors which point towards stable issuer or sector credit quality which are unlikely to result in either potential credit ratings upgrades or downgrades.

Cautious: Janney FIS believes there are factors which introduce the potential for declines in issuer or sector credit quality that may result in potential credit ratings downgrades.

Negative: Janney FIS believes there are factors which point towards weakening in issuer credit quality that will likely result in credit ratings downgrades.

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