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CIFA Conference

Muni Strategy

State of the Muni Market

MORGAN STANLEY RESEARCH
North America

Municipal Strategy

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Information as of October 30, 2013, unless otherwise indicated.

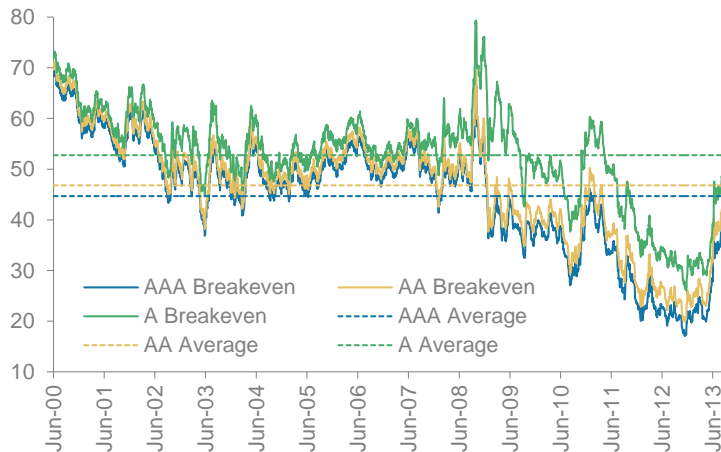
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Key Driver | Growing Confidence in Economy, Higher Rates

- **Underlying trends: Economy shows signs of emerging from twilight to daylight**
- **Policy: Fed surprises with decision to delay taper**
- **Rates: Forecasts for steady UST rates near term, higher long term**

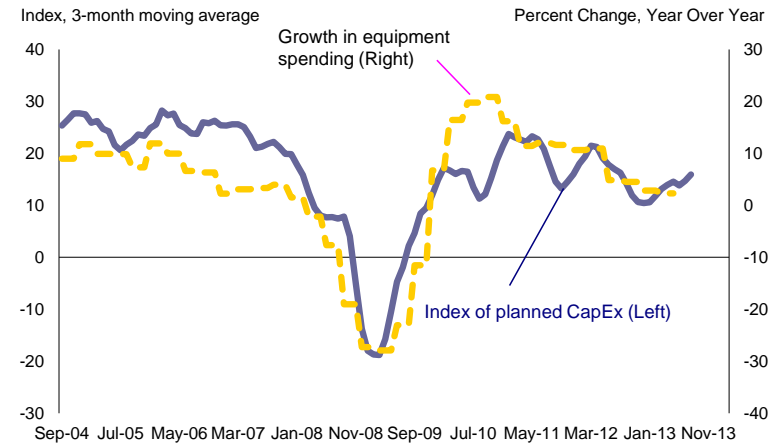
...But the Cushion Against Negative Returns From Rising Rates Has Increased



Source: Morgan Stanley Research, MMD

Note: Assumes 12-month forward bond price to calculate breakeven levels for 10-year AAA, AA, and A MMD since 1/1/2000.

Capex Planning Augurs Capital Investment Growth



Source: Richmond, Philadelphia, New York, Kansas and Dallas Federal Reserve Banks, Bureau of Economic Analysis, Morgan Stanley Research

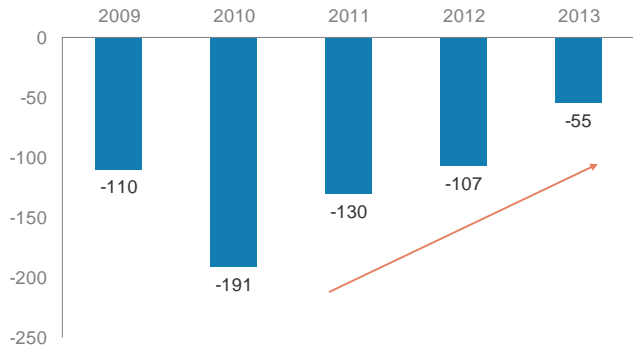
US Economics and Rates Forecast

	2Q13a	3Q13	4Q13	1Q14	2Q14	3Q14
10Y UST Bull Case	2.49	2.39	2.25	2.33	2.45	2.61
10Y UST Base Case	2.49	2.74	2.79	2.93	3.16	3.36
10Y UST Bear Case	2.49	3.22	3.46	3.58	3.70	3.86
Real GDP	2.50	2.10	2.70	2.80	2.90	2.80
CPI	0.00	2.90	1.90	0.30	1.90	1.70
PPI	-1.10	3.50	1.00	-1.80	-0.80	2.80

Source: Morgan Stanley Research

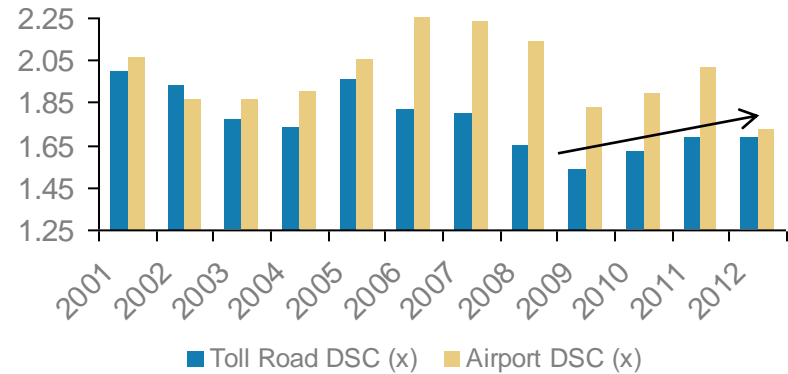
Key Driver | Credit Fundamentals: Broad Improvement Continues

States: 50 State Budget Gap Is Improving



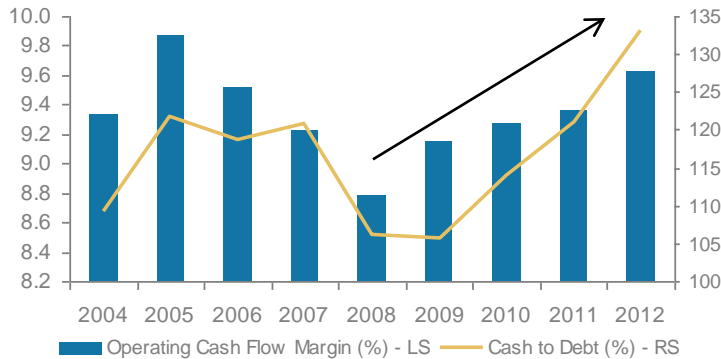
Source: Morgan Stanley Research, Center on Budget and Policy Priorities
Note: Bars represent aggregate budget gaps for all states. The yellow portion represents the portion of budget gaps filled by ARRA funds

Transportation



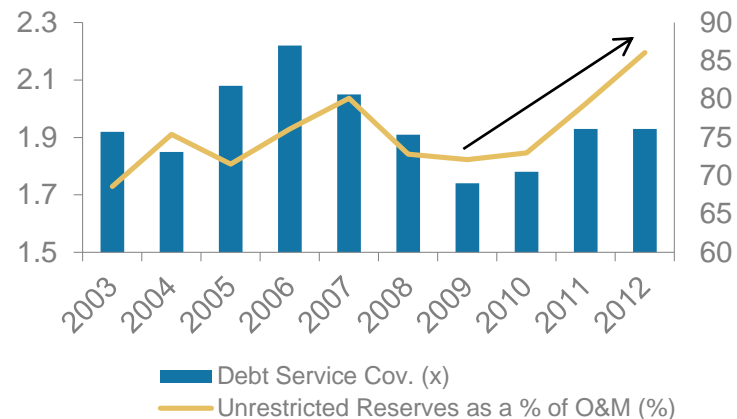
Source: Morgan Stanley Research, Moody's Medians

Hospitals



Source: Morgan Stanley Research, Moody's Medians

Essential Services (Water and Sewer)



Source: Morgan Stanley Research, Moody's Medians

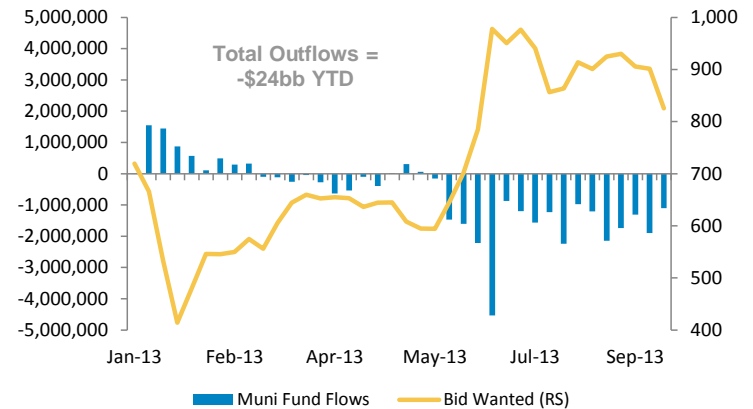
Key Driver | As the Demand Cycle Turns... (1 of 2)

Over the long term, we expect rising rates and headline credit risk will continue to challenge market liquidity, but supportive factors should drive near-term demand normalization. We believe we are on step 3 of a 4-step process to a short-term peak in the traditional muni investor demand cycle.

1 Selling Pressure Picks Up After Sustained Outflows:

- As investors fled funds in favor of individual bonds, liquidity suffered and bid wanted lists spiked
- Since May, higher rates and price deterioration sparked outflows, higher bid lists, and higher muni risk premiums
 - Headline credit risks in Detroit and Puerto Rico likely also assisted in extending the trend, in spite of our view that muni credit fundamentals are broadly improving (see [Muni Strategy Brief: Munis & the Motor City](#), July 18, 2013)

Selling Pressure Picks Up With Outflows

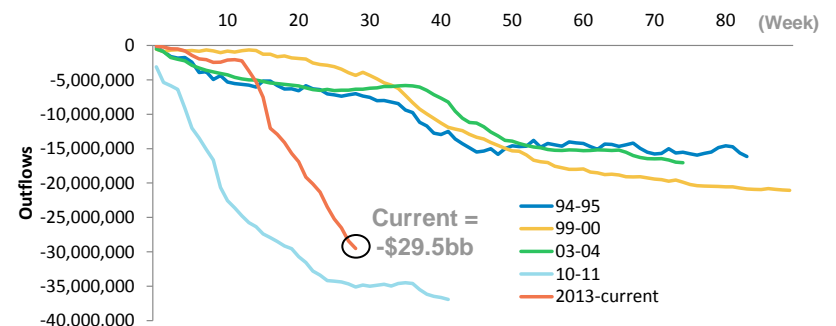


Source: Morgan Stanley Research, Lipper, Bloomberg
Note: Assumes 30-day rolling average of muni bid wanted

2 Outflows Begat More Outflows – Muni Fund Redemptions Near Record High, But Near Average as a Percentage of AUM:

- The absolute dollar amount of cumulative muni fund outflows since 3/6/13 (-\$29.5bb) already exceeds absolute totals from earlier periods (94/95, 99/00, 03/04)
- However, given the growth in muni mutual fund AUM, current cumulative fund outflows as a percentage of AUM are at or below levels seen historically

Muni Fund Outflows Approach Absolute Highest Levels Compared to Historical Liquidity-Challenged Periods

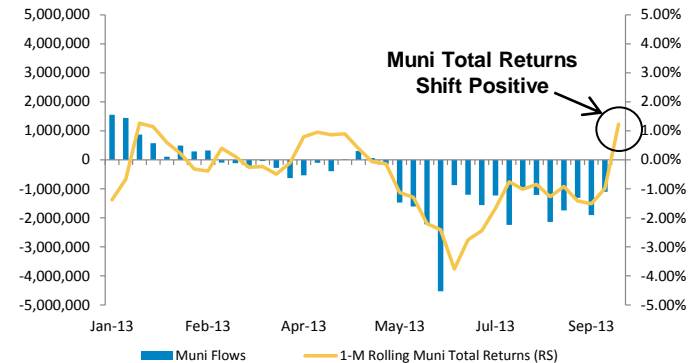


Source: Morgan Stanley Research, Lipper
Note: Current outflows assumes total since 3/6/2013

Key Driver | **As the Demand Cycle Turns... (2 of 2)**

- 3 YOU ARE HERE – Positive Returns May Encourage Inflows:** Muni bond fund flows tend to chase returns, and 1-month rolling total returns recently turned positive, and have now been positive for 6 consecutive days
- Positive flows are not a foregone conclusion given ongoing headline risks in widely held Puerto Rico, which could further extend the outflow dynamic
 - **However, it is likely that some systemic demand sensitivity around PR is resolved** given its recent price deterioration and evidence of broader systemic fundamental improvement

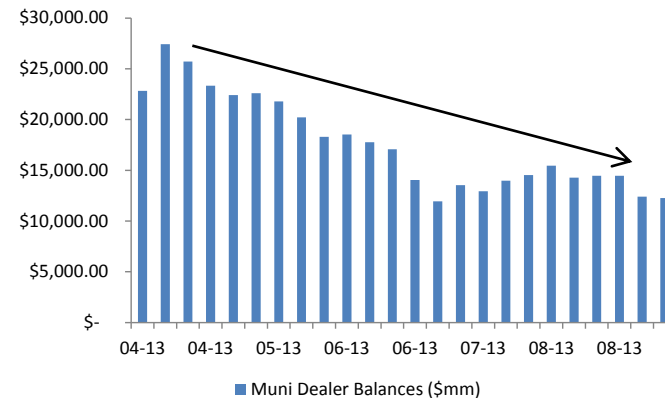
Returns Are Up, Will Flows Follow?



Source: Morgan Stanley Research, Lipper, Bloomberg
Note: Adjusts flows by 1 week to reflect lagged relationship to returns

- 4 Low Dealer Balances Support Further Liquidity Improvement:** Muni dealer balances are lighter compared to before the selloff. Thus, any pickup in balances following inflows may also contribute to breaking the cycle of outflows, and support a return to a normalization of two-way flows

Dealer Balances Are Lighter Following May '13 Selloff



Source: Morgan Stanley Research, Federal Reserve Bank of New York

Risk-Reward | **Downside Risks: De Minimis & Extension Risk Rise Meaningfully w/ Rates**

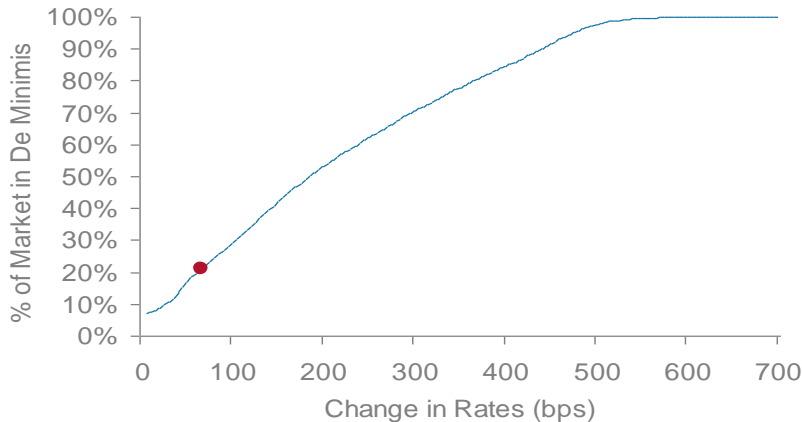
Why It's a Risk: With the recent sell-off in the bond market and interest rates expected to rise further, we posit "de minimis" is a topic worth careful consideration

De Minimis Risk Is on the Rise: We have realized ~27% of the base case 200bps de minimis threshold rate cushion since March 2013, suggesting de minimis risk has increased

Liquidity Price Penalty: We found that bonds in "de minimis" trade at a penalty in excess of the tax-adjusted value.

A Rate Increase of ~60bps May Signal a Systemic Threat

Percentage of Muni Market in De Minimis Given Incremental Interest Rate Changes



Source: Morgan Stanley Research, S&P Municipal Market Index.

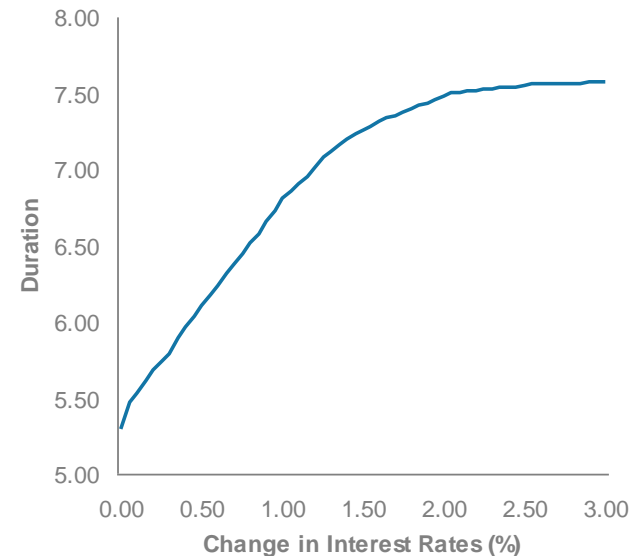
Note: Change in rates shows a bond's current price to its de minimis boundary price, and determined the increase in interest rates that would cause a bond to trade at de minimis. Ignores spread compression.

Why It's a Risk: 73% of munis carry calls, and much of the callable market is trading at a premium, suggesting the market is pricing in the likelihood that most bonds will be called.

Extension Risk Is on the Rise: As rates rise, many of these bonds will "extend" in duration, making the market more rates sensitive. We find that the blended duration of the market for index-eligible bonds increases meaningfully over the next 100-150 bps of yield increase, before leveling off.

Munis Should Become More Rates-Sensitive As Yields Rise

Duration Change of Index Based on Yield Changes



Source: Morgan Stanley Research, Bloomberg

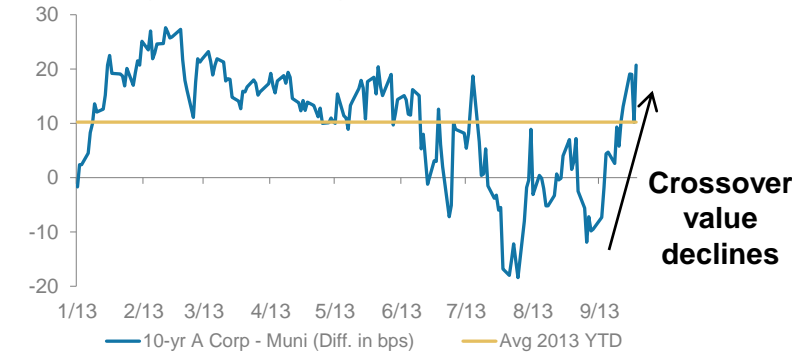
Note: The sensitivity analysis measures the blended muni index duration based on assumed increases in interest rates from levels on July 24, 2013

Key Driver | Relative Value Scorecard: Opportunities Linger

Crossover value is not nearly as compelling as it was this summer (1), but value remains, particularly in the higher grade, non-government sectors and longer on the curve (2). Munis remain very attractive to other fixed income assets on a tax-adjusted basis (3), and the Muni/Div yield is near wides since 2012 (4)

1- 10-yr A Spd Between Corp and Muni

Near Long-Term Averages



Source: Morgan Stanley Research, Bloomberg, Yield Book

2- Spread Between Corp and Muni

Boxes Highlighted in Yellow Are Relative Value Opportunities

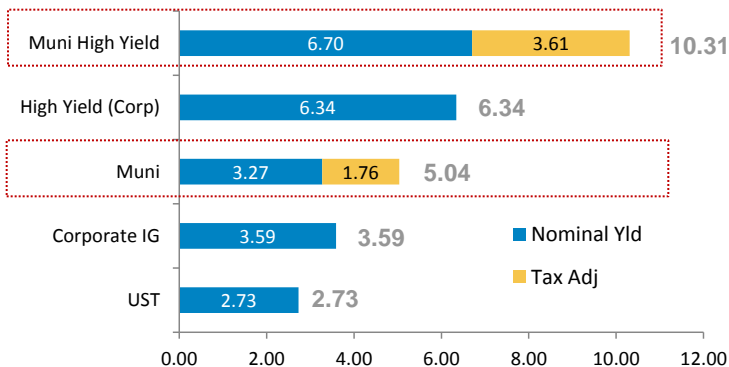
		Difference (Corporate - Muni Yield) in bps							
		AAA*		AA*		A		BBB	
Maturity		Curr.	Avg	Curr.	Avg	Curr.	Avg	Curr.	Avg
2		28	35	23	26	20	9	13	-17
5		60	69	45	52	34	31	56	30
10		83	67	61	44	21	10	30	5
30		47	78	24	54	15	39	29	33

Source: Morgan Stanley Research, Yield Book, Bloomberg

Note: 30-year comparison may overstate difference between corporate and municipal bonds as the municipal bond includes a 10-year par call and the corporate bond does not
*AAA and AA columns compare "AAA" and "AA" munis to "AAA/AA" corporate bonds

3- Munis Versus Other Fixed Income Assets

Attractive After Tax Adjustment



Source: Morgan Stanley Research, Bloomberg, Yield Book

4- Muni Yield vs. Dividend Yield Near Wides

Potential Source of Retail Demand



Source: Morgan Stanley Research, Bloomberg

Strategy | A Short-Term Beta Opportunity to Focus on Long-Term Alpha

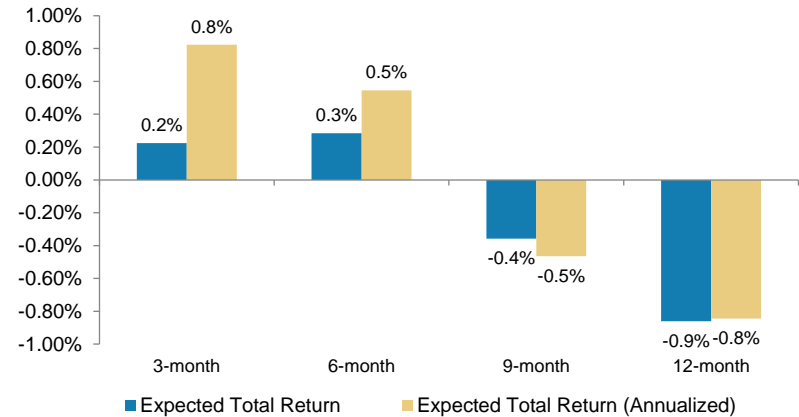
Near-term total return pickup offers portfolio restructuring opportunity: Given the relatively flat path for 4Q13 rates and our expectation for stable credit spreads, annualized muni total returns for 4Q13 look attractive relative to YTD performance and relative to our forecasts for periods over the next 12 months (see top right). This offers the opportunity to restructure undesirable muni positions in a pocket of market strength.

- The 3-month annualized total return of 0.8% is less than the long-term average of 5%¹, but a notable improvement from the negative return results in 2013
- Our expectation for 10-yr UST rates to rise to 3.36% by 3Q14 undermines future total return potential (at current spread and ratio levels)

Long-term excess return projections have improved, providing a rationale for putting capital to work. Given our expectation for munis to outperform as Treasury rates rise, excess returns look attractive beyond 4Q13 despite an erosion in total return prospects (see bottom right). This suggests that capital put to work in Q4 will help generate alpha vs. benchmarks over the long term.

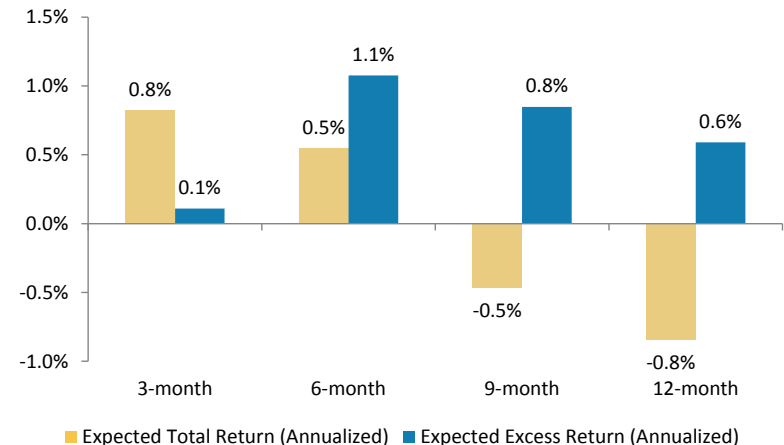
- Note: As rates rise, we assume the Muni/Tsy ratio compresses based on the historical inverse correlation between rates and ratios, implying munis over an excess return opportunity

4Q Total Returns (Annualized) Look Relatively Attractive Compared to the 12-month Outlook...



Source: Morgan Stanley Research, Bloomberg, Yield Book

... However, Excess Returns Look More Attractive Going Forward

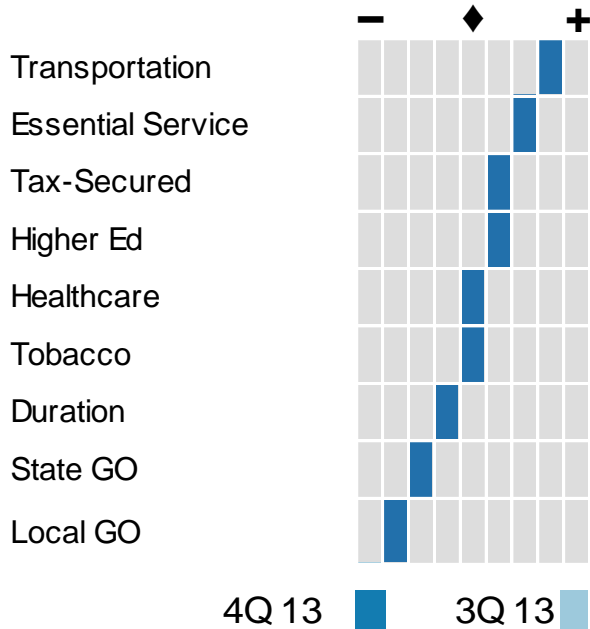


Source: Morgan Stanley Research, Bloomberg, Yield Book

¹ Assumes average since 2006

Strategy | **An Opportunity to De-Risk and Rebalance with an Up in Quality Bias**

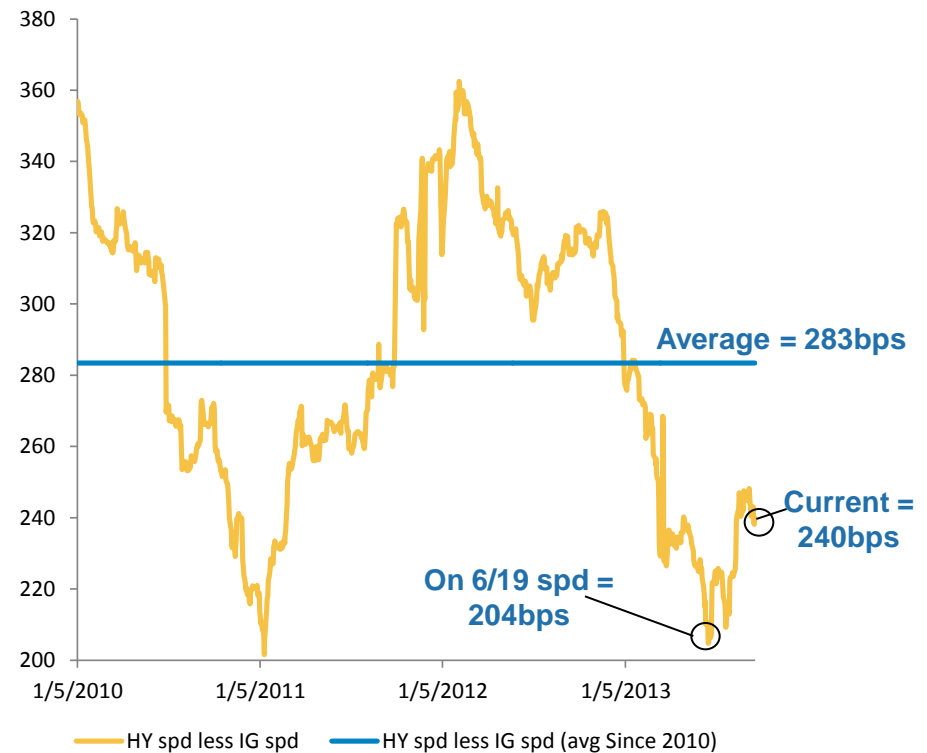
Relative Sector Preferences



Source: Morgan Stanley Research.

HY excess spread to IG remains well below average

High Yield Spread to MMD Less Investment Grade Spread to MMD



Source: Morgan Stanley Research, Bloomberg
 Note: data from 2010 – present. Data compares the spread on the HY index to the 20-year MMD to the spread on the IG index yield to 10-yr MMD

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