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Municipal Market 2010-2011

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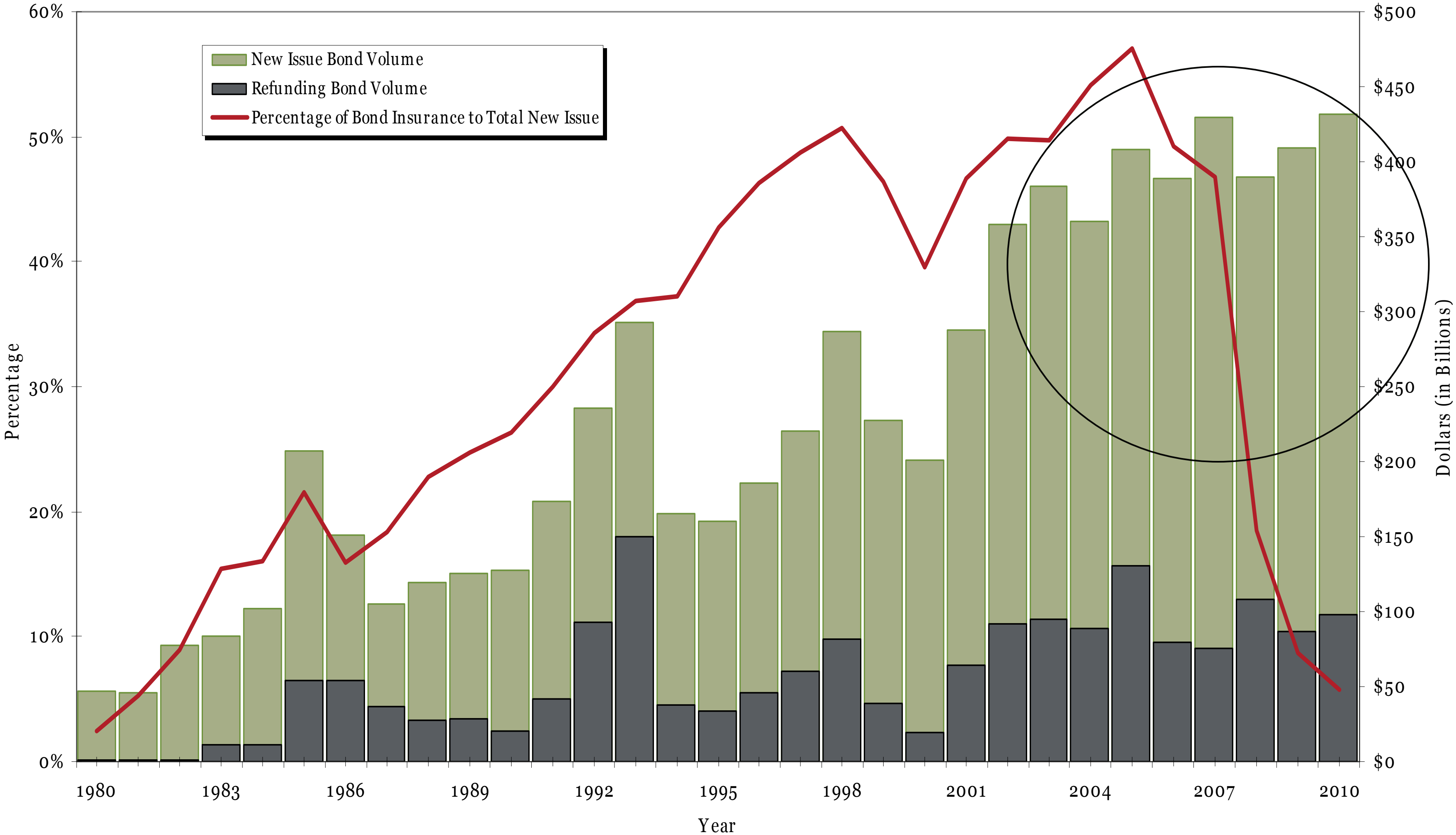
Key Factors Influencing the Recent and Current Municipal Market

- Loss of bond insurance
- Ending of federal supports
- The November election: a change in viewpoint
- Dire headlines promoting credit fears
- But also, optimism about the economy may be prompting asset reallocations from cash and tax exempts to equities

Loss of Bond Insurance

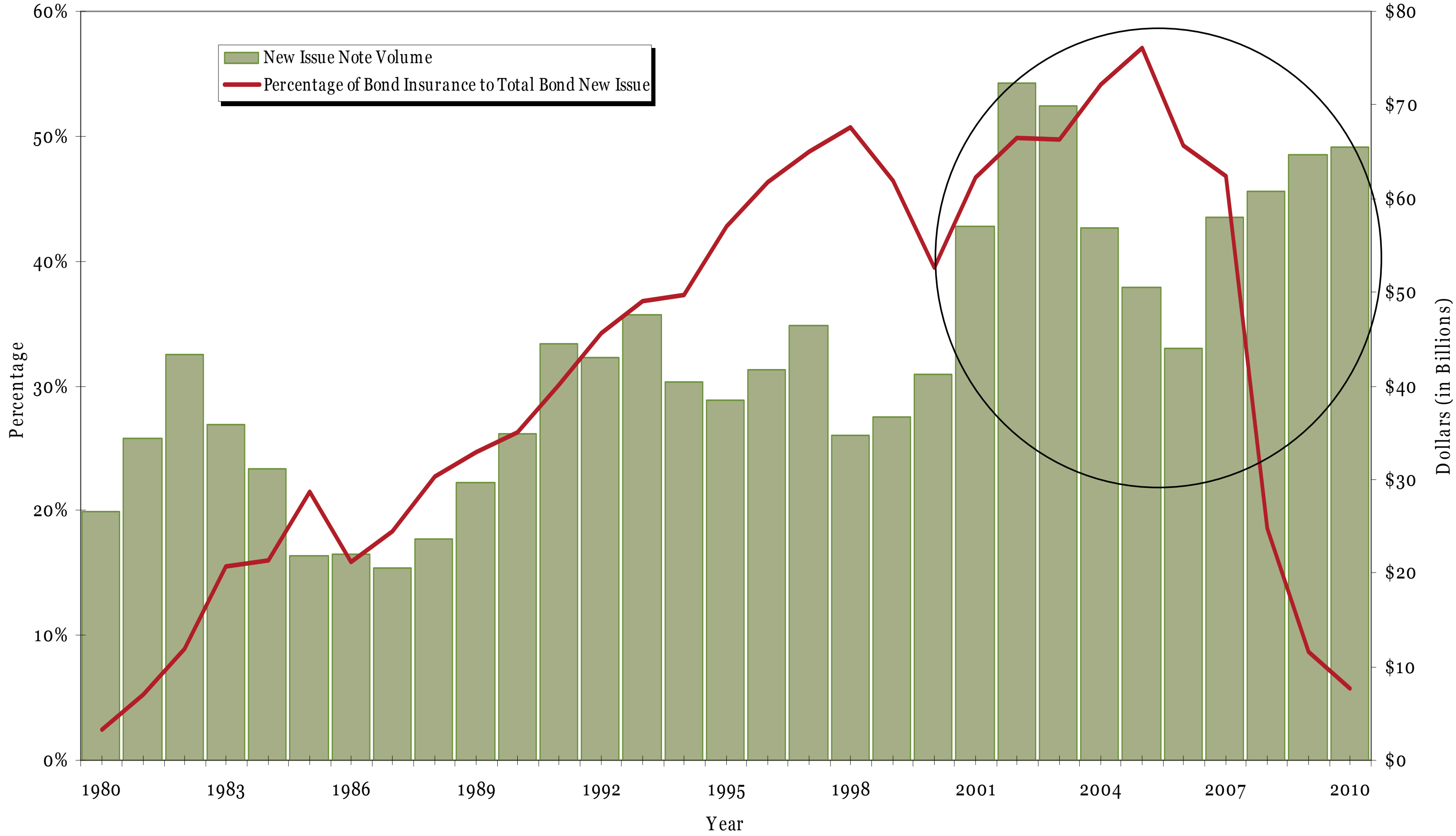
- Until a few years ago, municipal market investors did not worry much about credit.
- Bond insurance peaked at 57% of the new issue market in 2005 and provided a homogenizing effect.
- By definition, the loss of bond insurance makes the municipal market less homogeneous.
- An entire generation of investors, advisors, traders and analysts grew up in the presence of "AAA" credit protection.

Percentage of Bond Insurance to Total New Issue (1980-2010)



Source: Bond Buyer, Assured Guaranty, Thomson Reuters and Wells Fargo Securities, LLC analysis

Percentage of Bond Insurance and Total Short Term New Issue (1980-2010)



Source: Bond Buyer, Assured Guaranty, Thomson Reuters and Wells Fargo Securities, LLC analysis

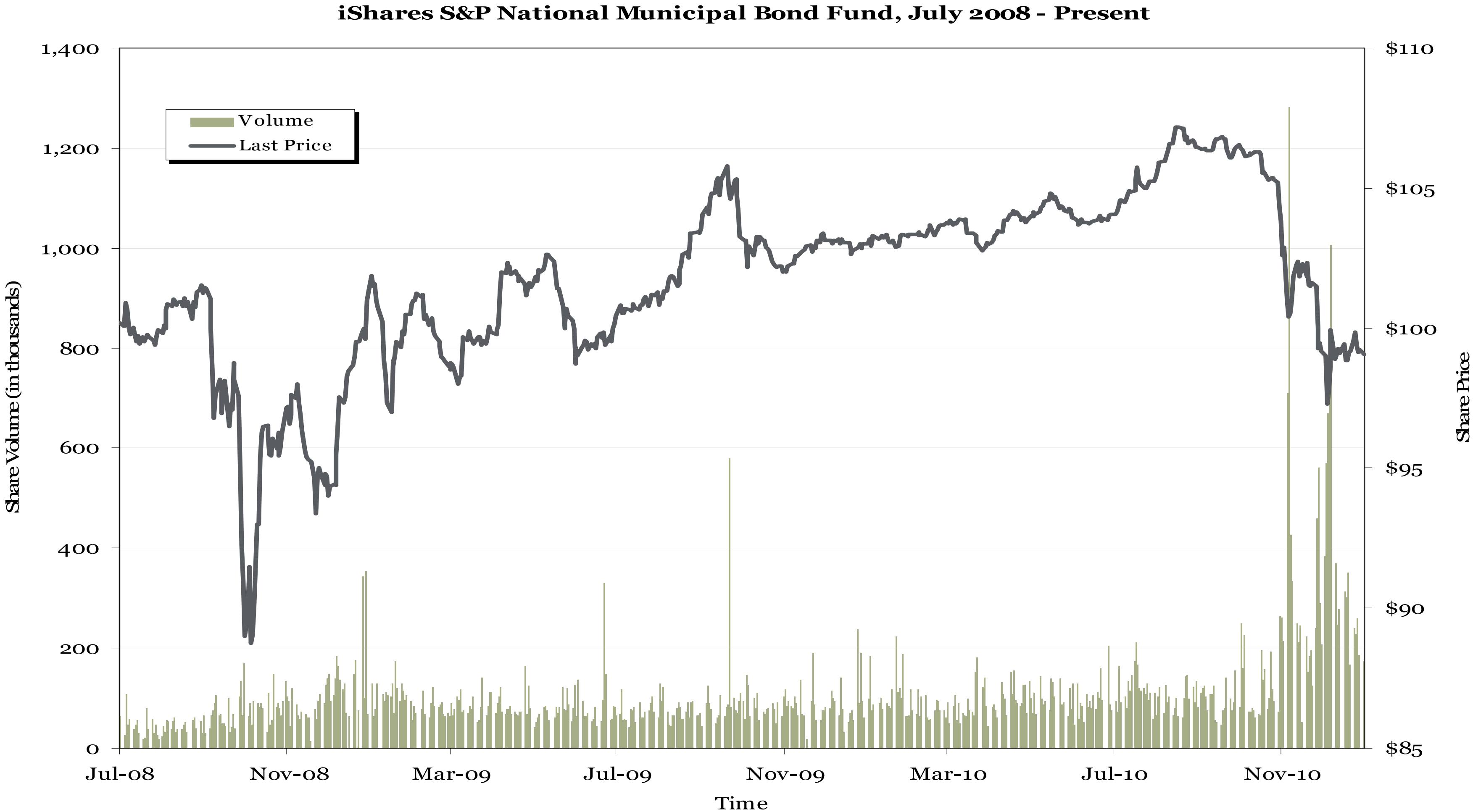
Ending of Federal Supports

- Since 9/11, there has been active federal involvement in financial markets in some fashion; these have each caused a variety of distortions.
- Build America Bonds terminated Dec. 31, 2010; the market is concerned that there will be a surge in tax-exempt volume.
- Enhanced federal Medicaid percentage rolls off June 30, 2011.
- Last August's jobs bill assistance also rolls off.
- Additional municipal market changes:
  - Lower bank-qualified ceiling (from $30 million to $10 million)
  - Loss of AMT exemption for certain private activity bonds

The November election: a change in viewpoint

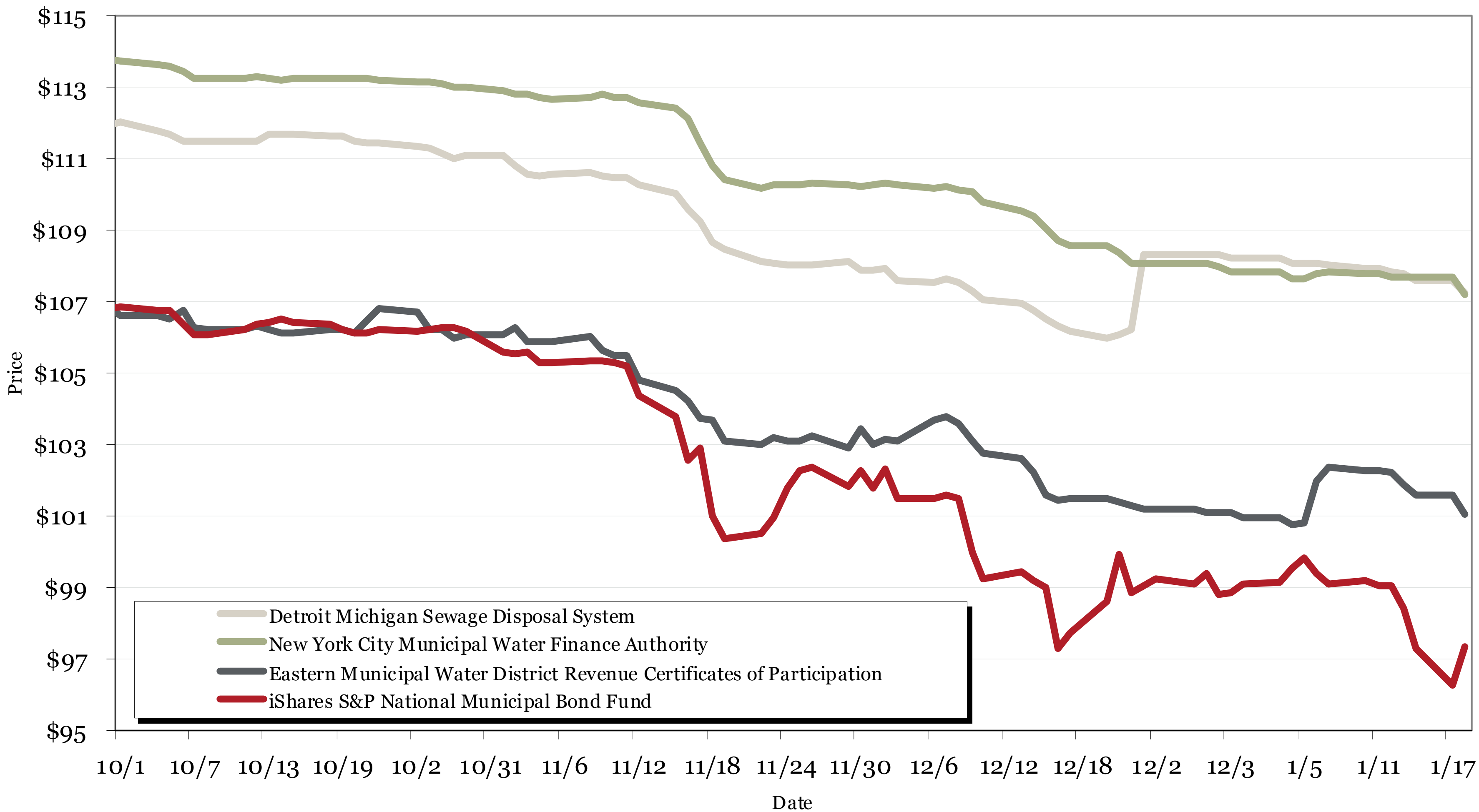
- Pre-election: Concern over “Big Government,” additional stimulus programs, higher taxes; premium bonds, driven by high demand for tax-exempt product and reduced supply, dominated the market until the beginning of November.
- Post-election: A big sigh; newly elected Republicans will likely hold the lid on spending and tax increases; evidenced by continuation of Bush tax cuts; less “value” to the tax exemption

IShares S&P National AMT-Free Municipal Bond Fund (MUB)
($1.838 billion market cap as of 1/21/11 – average maturity approx. 10.44 years)



Source: Bloomberg

Individual bonds perform better than funds in a sell-off – to be expected



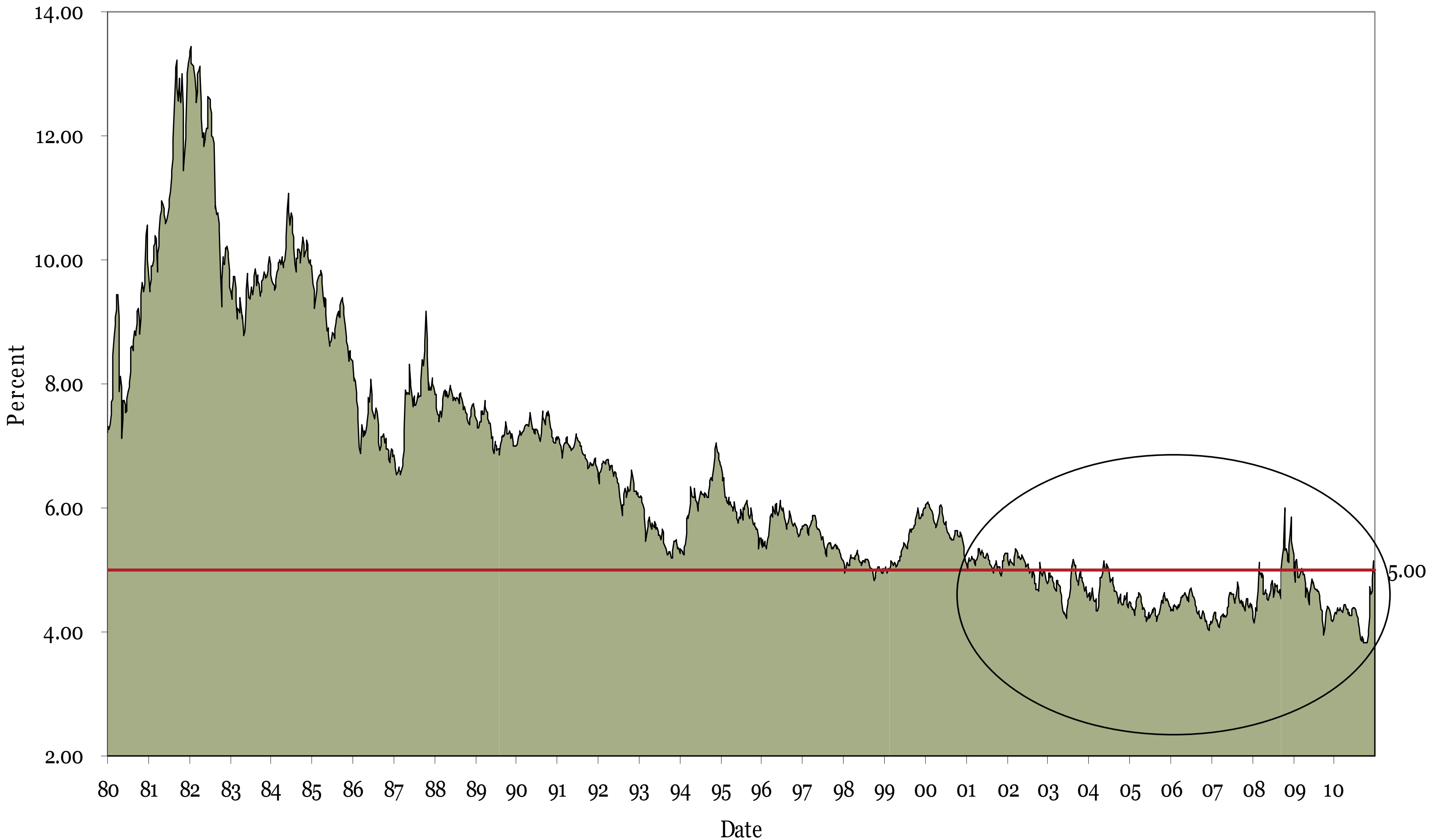
Note: Detroit CUSIP 251237V83 maturing 2021, MBIA insured from 1998 issue, remarketed to fixed rate; New York City Muni Water CUSIP 64970KE2 maturing 2022, series 2004-C; Eastern Muni water and sewer COPS CUSIP 276771GD8 maturing 2022 from series 2006-A also MBIA insured

Source: Bloomberg and Wells Fargo Securities, LLC

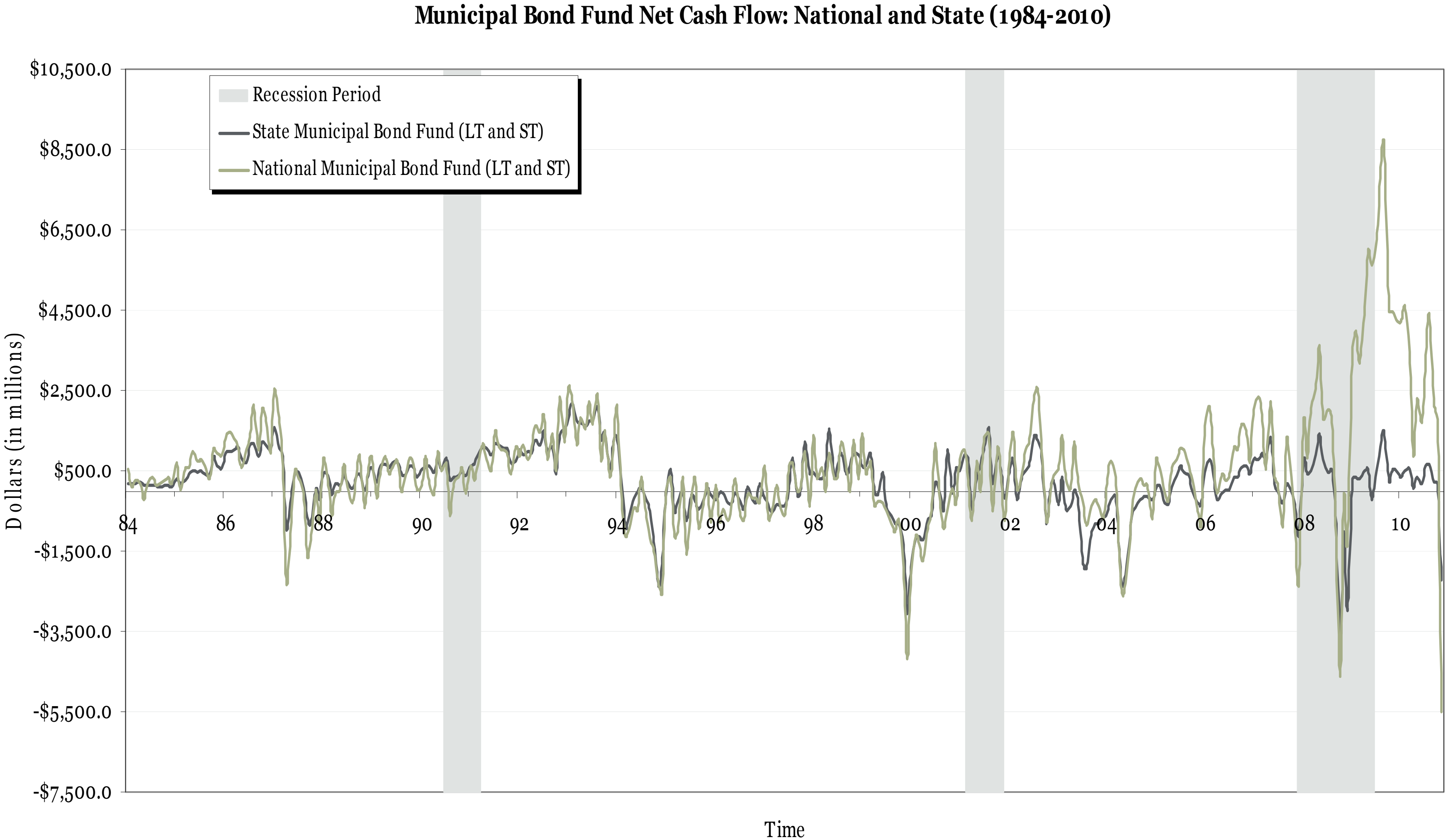
First-Quarter Expectations

- Q1 likely to be quiet in terms of volume
- Borrowers still digesting their BAB proceeds
- Rates have gone up
- In the context of tight fiscal conditions, heavy borrowing highly unlikely
- The municipal market survived with a 5% coupon many times in the pre-9/11 time period
- Lower volume, low bond insurance, less federal help = investors and market “going it alone” = more volatility and more room for headlines to dominate

Bond Buyer US Weekly Yields 20 GO Bond Index (1980-2010)

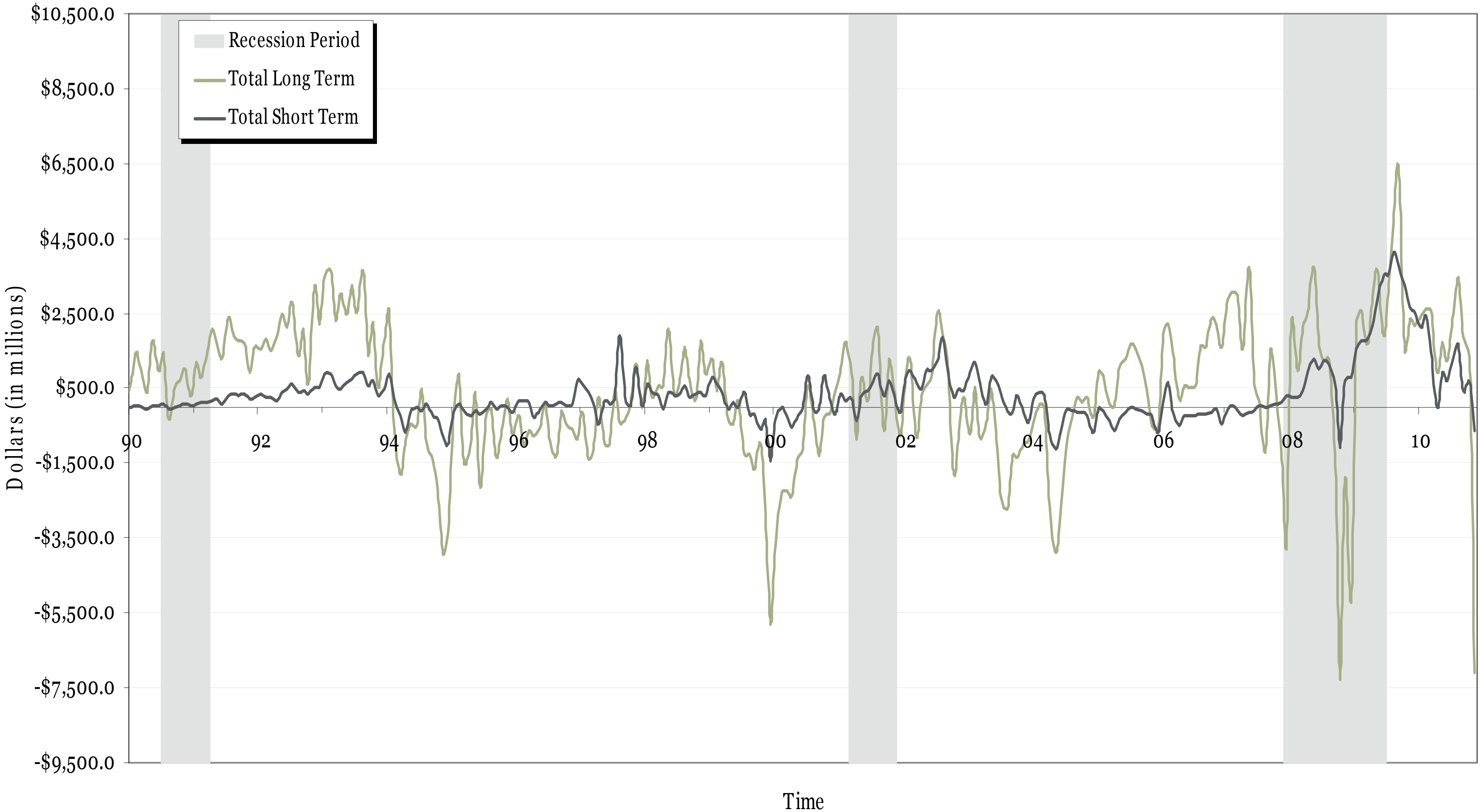


Source: Bloomberg



Source: Investment Company Institute

Municipal Bond Fund Net Cash Flow: Long Term and Short Term (1990-2010)



Source: Investment Company Institute and Wells Fargo Securities, LLC

Second-Quarter Expectations

- Q2 Credit Volatility Likely to Remain
  - Federal-enhanced Medicaid roll-off
  - Budget season in most state and local governments occurs in the spring, in time for a July 1 fiscal year
  - VRDO renewals
  - We expect a better directional signal about budgets, deficits and borrowing going into Q3.

Credit Concerns

- State deficits – Yes, in some places
  - New governors are just now making their proposals
    - Jerry Brown's California budget proposal being looked at by the legislature
    - Illinois plan to raise taxes (passed Jan. 12, 2011)
    - New Jersey, New York and others working through budgets
- This is not a debt service problem: According to Moody's, median debt service as a percentage of expenditures is 5%–7% for states, 8% for cities, 6% for counties and 8% for school districts. Median debt/personal income at the state level has remained steady at around 2.3%–2.5%.

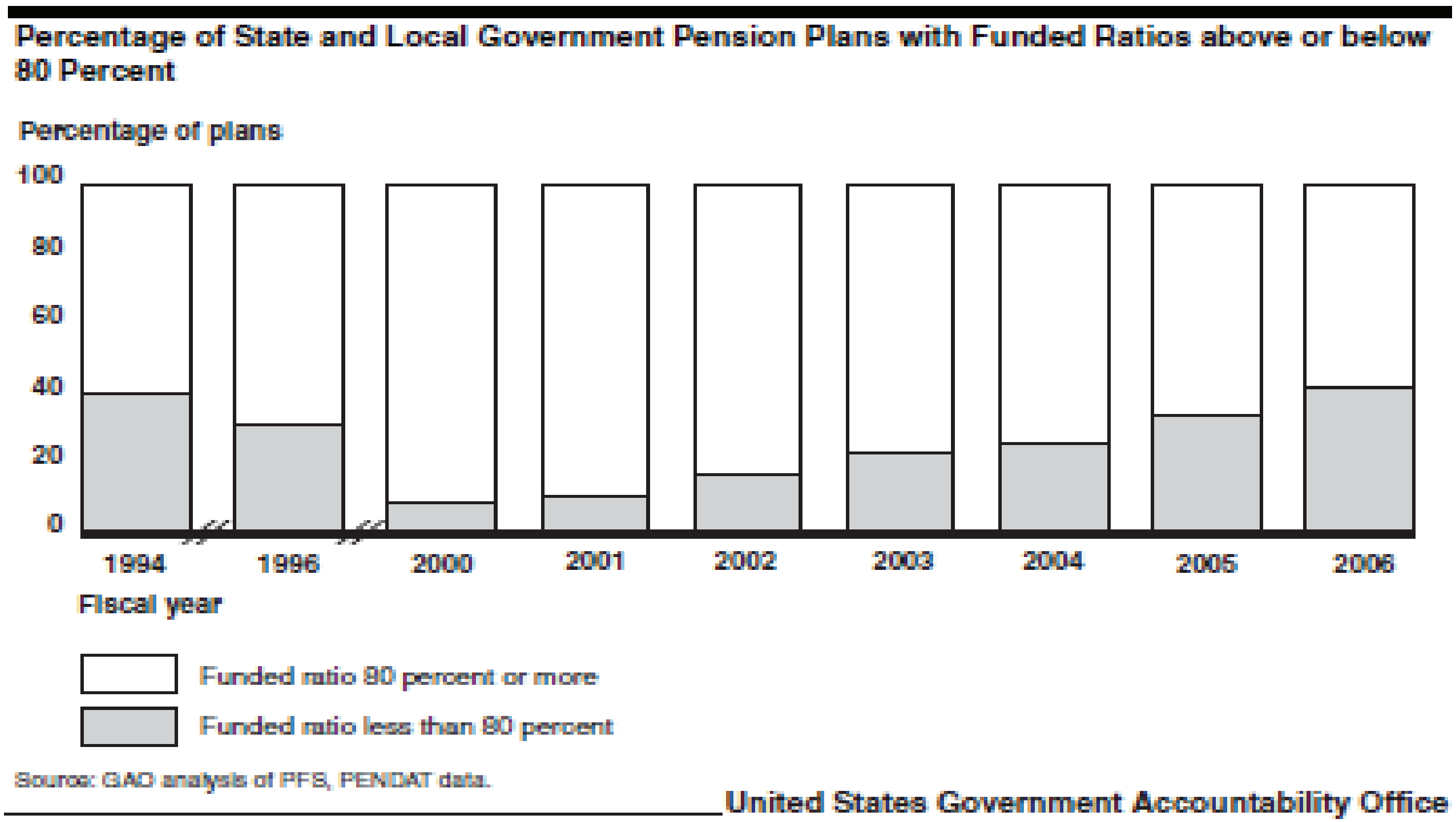
Credit Concerns: Public Pensions

- State and local pension systems held about $3.2 trillion in cash and investments as of 2008.
  - $2.6 trillion is in 218 state plans.
  - $526 billion is in 2,332 local systems.
- 70% of public sector employees participate in Social Security.
  - Originally excluded from Social Security Act of 1935
  - Amended act in 1950 allowed states to voluntarily provide coverage

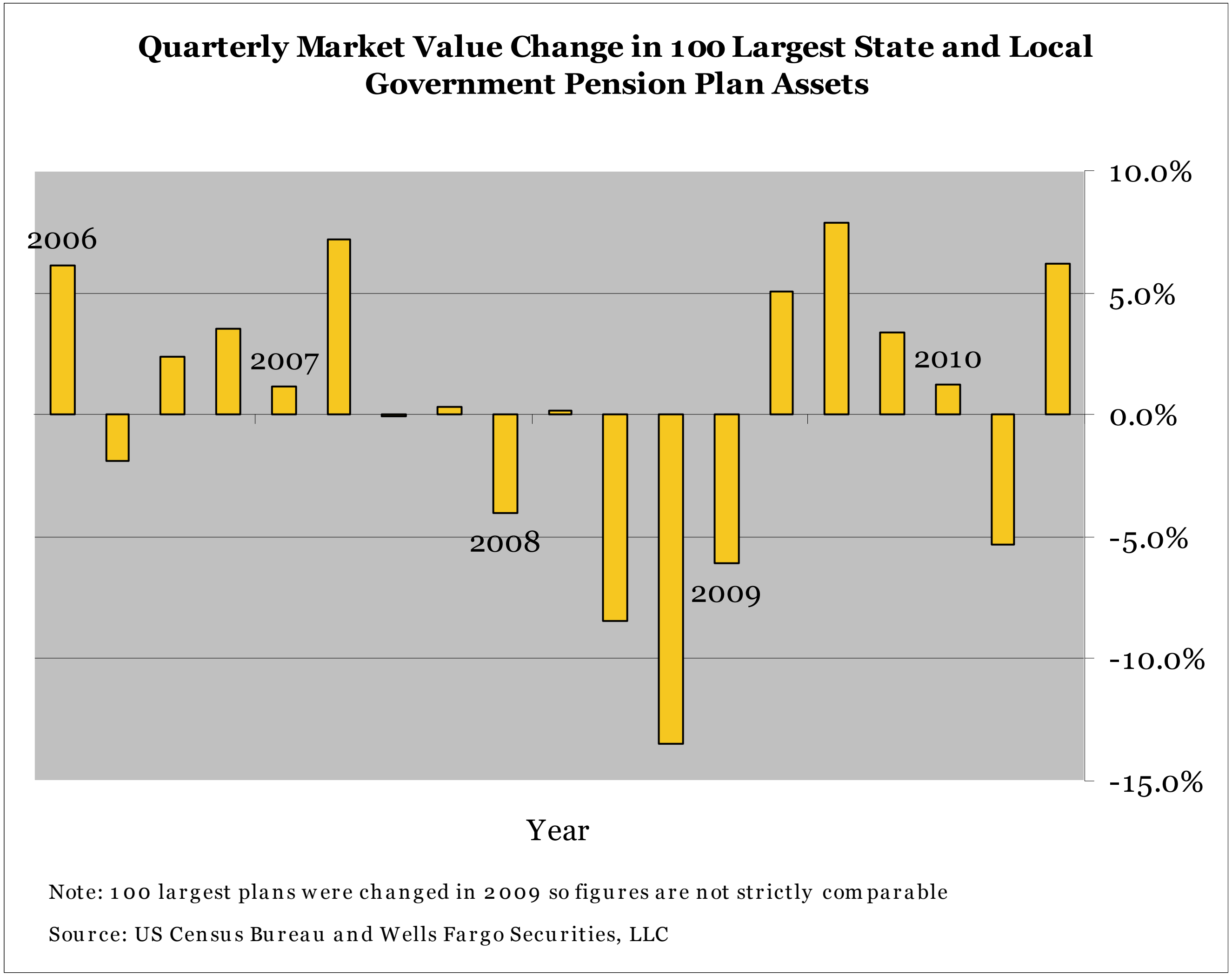
Public Pensions

- Pension funding levels differ significantly across the states. Funding levels also differ across plans within the states.
  - Teachers' plans generally have worse funding levels than other types of public employees. For example, Indiana's Public Employee Retirement Fund is funded at 93.8%, according to the Center for Retirement Research, while the Indiana Teachers' plan is only 42.8% funded.
  - The state of Washington has numerous plans, two poorly funded, with the rest well funded.
  - New York State plans are fully funded as of the latest CAFR; Illinois is only 59% (2009 CAFR; five-year smoothing); New Jersey State PERS: 56%; local PERS: 71%; Teachers: 63.8%.

As recently as 2000, most pension plans were considered well funded



Funding levels are dynamic as asset values continuously change



Other Defining Issues:
A word about demographics and municipal finance

- Migration in the 2000-2010 decade had two patterns. According to William Frey of the Brookings Institution, the first pattern occurred in 2000-2006 when Florida and inland California were magnets during the housing boom; the second pattern took place from 2006-present when we entered the housing crisis and the migration ceased.
- International immigration offset domestic outmigration in major metro areas, such as New York, Los Angeles, Chicago and San Francisco.
- Post recession, places such as Nevada, Arizona and Oregon, which took in Californians during the boom, are suffering the halt in migration.
- Aging: Places that were magnets for decades are now experiencing aging in place (West and Southeast), while older, declining industrial places that experienced the loss of the younger working-age population also have higher senior populations.
- Suburban and boom-era exurban communities are showing wear and tear.
- Household size has increased since the recession began, reducing consumption of goods and services.

The Good News: Economic Signs Show Improvement

- Jobs reports are improving, but remain sluggish.
  - Modest increase in jobs accompanied by lower participation rate
  - Largest employment increases in November were in the Washington, D.C., Dallas, Boston, Phoenix and Minneapolis metro areas
- The Institute for Supply Management (ISM) reported a 2.1% increase in their nonmanufacturing index, showing increased business activity and new supply orders.
- Manufacturing activity is also up with gains in apparel, computer and electronics, machinery and chemical products.
- These positives will, in our view, eventually work their way into higher government revenues.

Disclosure Appendix

Additional information is available on request.

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