December 17, 2012

WELLS FARGO SECURITIES

Municipal Securities Research

Municipal Commentary

Natalie Cohen, Senior Analyst
natalie.cohen@wellsfargo.com
(212) 214-8014
Roy Eappen, Associate
roy.eappen@wellsfargo.com
(212) 214-8045

Municipal Market Outlook, 2013

The most important issue facing the municipal market is the potential elimination or reduction of tax-exempt bond interest benefits. Given that the discussions in Congress are inconclusive, we offer our views on the potential effect of various proposals. One step removed from market changes, but potentially affecting credit, state and local governments will be dealing with sequestration cuts (or their substitutes) as they enter budget season for the 2014 fiscal year, which begins for most states and local governments on July 1, 2013. Finally, volume forecasts are always front and center this time of year, and we offer some thoughts.

Fundamental changes to the tax exemption of municipal bonds are likely to be made between now and the end of H1 2013, in our opinion. There are several broad options being discussed, each with different consequences:

If tax exemption were eliminated, we envision that smaller issuers would return to bank funding and away from capital markets, which historically has been a more costly financing option.

Eliminate tax exemption: This would most likely be prospective. Retroactively taxing outstanding holdings could be extremely disruptive to the market (but would raise the greatest amount of dollars for the federal government). In the early 1980s, Senator Robert Packwood proposed the retroactive elimination of the tax exemption, and the market came to a halt. Eliminating the tax exemption for new issues would be a milder change but create a bifurcated market that would make existing tax-exempt bonds quite valuable, in our opinion. We believe that such a proposal would increase the cost or significantly limit infrastructure finance, particularly for smaller issuers. Such costs would ultimately fall on local taxpayers — essentially shifting the cost from the federal "tax expenditure" to taxpayers at the local level without regard to their income bracket.

Some argue that removing the tax exemption would broaden the buyer base. This is true, and we saw this with the Build America Bond program (BAB) when taxable fixed-income buyers crossed over into the municipal market. However, we point out that the main users of the BAB program were the largest, most frequent issuers. Corporate investors will have little patience with smaller, infrequent and less liquid borrowers, in our opinion. During the BAB era, we learned that corporate investors expected more information and more frequent reporting from municipalities (a fair expectation). Many were surprised to learn that audits are often stale relative to the corporate borrowers whose securities they are used to buying. Better reporting would be a good side effect, but this, too, would come at a cost to local taxpayers. Instead, we envision that smaller issuers would borrow less frequently, and perhaps return to bank funding, which has historically been a more costly financing option.

Eliminate tax exemption but provide a federal subsidy: Some advocate a return to BABs, which had a 35% interest reimbursement from the federal government. We recently heard that one new proposal was for a 15% subsidy — less than half of the previous BAB reimbursement. If a tax-exempt market and a

Please see the disclosure appendix of this publication for certification and disclosure information

This report is available on wellsfargoresearch.com, Bloomberg at WFMU, and MarkitHub at hub.com

Together we'll go far

"newBAB" market are allowed to exist side by side, borrowers would have little incentive to issue taxable bonds unless there was financial benefit. The previous 35% reimbursement was a rich level for issuers and helped make the program a quick success. Under such a scenario, there could again be distortions along the yield curve, similar to what we saw with "oldBABs." In that case, the taxable BABs were issued at the long end, while the tax-exempt bonds were kept short. BABs took away the tax-exempt supply, which made the tax-exempt bonds more precious, just at the point in time when significant worries about state deficits were surfacing. In addition, we believe that tethering the BAB subsidy to an indecisive Congress will subject state and local borrowers to more budgetary uncertainty. One only has to look as far as the current sequestration documents which cuts the BAB reimbursement. Shifting the cost of financing infrastructure from the point of issuance to an annual congressional appropriation process would only make long-term capital planning that much more difficult.

We see several critical flaws with the federal estimates of revenue from the proposal to cap deductions. First and foremost: investors do not stand still.

Cap deductions at a dollar amount: This proposal perhaps is as draconian as eliminating tax exemption completely, given the other deductions that could crowd out tax-exempt interest such as the mortgage interest deduction, state and local tax deductions or charitable deductions. This proposal would make municipal bond interest effectively taxable, Consequences would be the same as highlighted above under the elimination of the tax exemption.

Cap deductions at 28%: This is a more likely scenario, in our view. This proposal could cheapen the market, as high-bracket investors sell to lower brackets, who would get a good deal. However, we see several critical flaws with the federal estimates of revenue in this proposal. First and foremost: *investors do not stand still.* While most homeowners are unlikely (or unable) to run out and sell their homes because of a change in the mortgage interest deduction, investors will likely re-balance their portfolios if the exemption is no longer financially meaningful to them. On paper, federal analysts can estimate the revenue the government might get from today's investor profile — but if more tax-exempt interest tucks itself into the 28% bracket, this revenue will not be seen by the IRS. The second critical flaw is that a sizable amount of the tax-exempt interest (declared) is already received by taxpayers in the 28% bracket.

We offer a word on the following table. First, this does not represent all tax-exempt interest. The table only includes taxpayers taking itemized deductions. Corporate holdings (such as property and casualty companies) are not included, and a sizable amount of tax-exempt interest is simply left undeclared. However, relatively speaking, it is clear how much more important the home mortgage deduction is to the below $1.0 million taxpayer and how important state and local tax deductions are to all, as well as charitable contributions.

Other Consequences of Tax Reform

Curbs to tax exemption would likely send costs significantly higher for weak issuers such as Puerto Rico, where the attraction of the bonds is mainly triggered from their triple tax exemption, rather than credit quality, in our view. Given the island's recent Moody's downgrade, weak fiscal condition and sorely underfunded pension, we could envision the commonwealth facing market access difficulties. (Certainly a downgrade to junk status would also immediately intensify the cheapening of the credit and hamper market access.)

Many states link their state taxes to the federal code. Proposals that increase personal and corporate income taxes could result in higher revenue for the states as well. However, a handful of states allow the deduction of federal income taxes which, if higher, will result in a lower base for state taxes. States that could see a decline in this

case include Alabama, Iowa, Louisiana, Missouri, Montana and Oregon, according to analysis from the Pew Center on the States.

In the face of higher taxes at all levels of government, we have already seen "pull-forward" actions by companies and individuals. Dividend paying companies are making higher payments in 2012. Actions that could lead to capital gains have been moved to 2012 from 2013. While the calendar for new money municipal borrowing has been lighter than what expected in the context of low interest rates, this has not been the case on the corporate side. Demand for corporate bonds plus historically low rates has led to a surge in corporate borrowing. These behavioral changes in conjunction with the state tax links to the federal code speak to lumpy state revenue in the final months of 2012 and the first half of 2013.

Finally, should the state and local tax deduction get swept up in tax reform, we foresee significant pressure on state and local governments to lower tax revenue.

Sequestration Cuts and their Potential Substitutes

Cuts to discretionary programs will punch holes in state and local budgets just as the nascent recovery is taking hold, in our opinion. Discretionary spending includes education and key safety net programs such as food stamps. Defense cuts are currently slated to take 50% of the sequestration hit but will likely be softened in the negotiations. Locations that are heavily dependent on federal workers planned cuts could reduce GSP by as much as 20% in Maryland, Virginia and the District of Columbia, according to a recent Pew Center on the States study (*The Impact of the Fiscal Cliff on the States*, Nov. 15, 2012). According to the study, one-third of state revenue comes from the federal government. About 18% of this revenue is subject to sequestration. A core exception is Medicaid, which was exempt from sequestration. However,

Size of adjusted gross income, taxpayers using itemized deductions 2010	Tax-exempt interest		Total itemized deductions, 2009 ($000's)	Tax-exempt interest as % total deductions	Home mortgage interest as % total deductions	State and local taxes paid as % total	Charitable contributions as % total
	Number of returns	Amount ($000's)					
All returns, total	**4,186,068**	**63,654,055**	**1,216,667,246**	**4.97%**	**30.77%**	**20.52%**	**13.30%**
Under $5,000	36,691	216,474	6,735,403	3.11%	32.44%	3.58%	2.37%
$5,000 under $10,000	48,574	223,881	9,405,036	2.33%	28.86%	3.82%	5.49%
$10,000 under $15,000	79,574	388,485	14,437,754	2.62%	25.73%	3.90%	6.74%
$15,000 under $20,000	74,424	408,491	16,601,520	2.40%	29.51%	4.77%	9.12%
$20,000 under $25,000	67,605	699,305	19,248,009	3.51%	32.27%	5.73%	8.58%
$25,000 under $30,000	81,913	574,611	23,712,386	2.37%	31.65%	6.82%	9.92%
$30,000 under $35,000	70,483	619,109	26,183,813	2.31%	35.26%	7.54%	9.72%
$35,000 under $40,000	102,128	759,113	29,603,394	2.50%	34.75%	8.76%	10.46%
$40,000 under $45,000	91,959	666,277	31,607,601	2.06%	35.98%	10.08%	10.60%
$45,000 under $50,000	85,506	776,221	33,036,198	2.30%	36.43%	10.98%	10.21%
$50,000 under $55,000	108,922	886,771	33,383,603	2.59%	36.07%	11.79%	11.07%
$55,000 under $60,000	103,534	701,222	33,876,830	2.03%	36.75%	12.68%	11.81%
$60,000 under $75,000	326,933	2,450,872	103,580,504	2.31%	37.65%	14.13%	11.29%
$75,000 under $100,000	530,105	4,152,913	166,375,232	2.44%	38.40%	16.61%	11.77%
$100,000 under $200,000	1,169,195	11,458,452	329,248,558	3.36%	36.79%	21.33%	12.10%
$200,000 under $500,000	267,979	3,240,610	59,577,768	5.16%	32.17%	25.85%	12.71%
$250,000 under $500,000	535,269	10,036,729	104,534,351	8.76%	26.59%	28.51%	13.19%
$500,000 under $1,000,000	234,281	7,519,050	53,584,508	12.31%	16.76%	33.12%	15.38%
$1,000,000 under $1,500,000	69,777	3,599,840	20,913,652	14.69%	9.82%	36.54%	16.69%
$1,500,000 under $2,000,000	30,782	2,095,855	12,039,070	14.83%	7.04%	37.89%	17.50%
$2,000,000 under $5,000,000	48,258	5,057,734	28,545,465	15.05%	4.22%	39.13%	20.49%
$5,000,000 under $10,000,000	13,070	2,687,280	15,424,021	14.84%	1.74%	39.82%	24.22%
$10,000,000 or more	9,107	4,434,761	45,012,571	8.97%	0.36%	36.43%	37.88%
Total, under $200,000	**2,977,546**	**24,982,197**	**877,035,841**	**2.77%**	**36.33%**	**15.62%**	**11.22%**
Total $200,000-$1,000,000	**1,037,529**	**20,796,389**	**217,696,627**	**8.72%**	**25.54%**	**28.99%**	**13.63%**
Total $1,000,000 or more	**170,994**	**17,875,470**	**121,934,779**	**12.79%**	**3.80%**	**37.69%**	**26.16%**
Taxable returns, total	**3,604,147**	**55,959,630**	**1,027,346,618**	**5.17%**	**30.52%**	**23.07%**	**14.06%**
Non-taxable returns, total	**581,921**	**7,694,426**	**189,320,628**	**3.91%**	**32.15%**	**6.46%**	**9.10%**

Source: Internal Revenue Service, Wells Fargo Securities, LLC

we believe that Medicaid cuts will likely be traded for lower reductions elsewhere, such as defense. Heavy Medicaid cuts could be the largest budget-busting item for the states as they enter budget season in H1 2013.

Pew estimated that South Dakota stands to lose about 10% of its state revenue if the slated sequestration cuts take hold. Illinois and Georgia could lose 8.5% revenue and Texas could lose 8%. Pew estimates that the states that are best off are Delaware (4.8%), Alaska (4.9%), Minnesota (5.0%), Wyoming (5.2%) and Connecticut (5.2%).

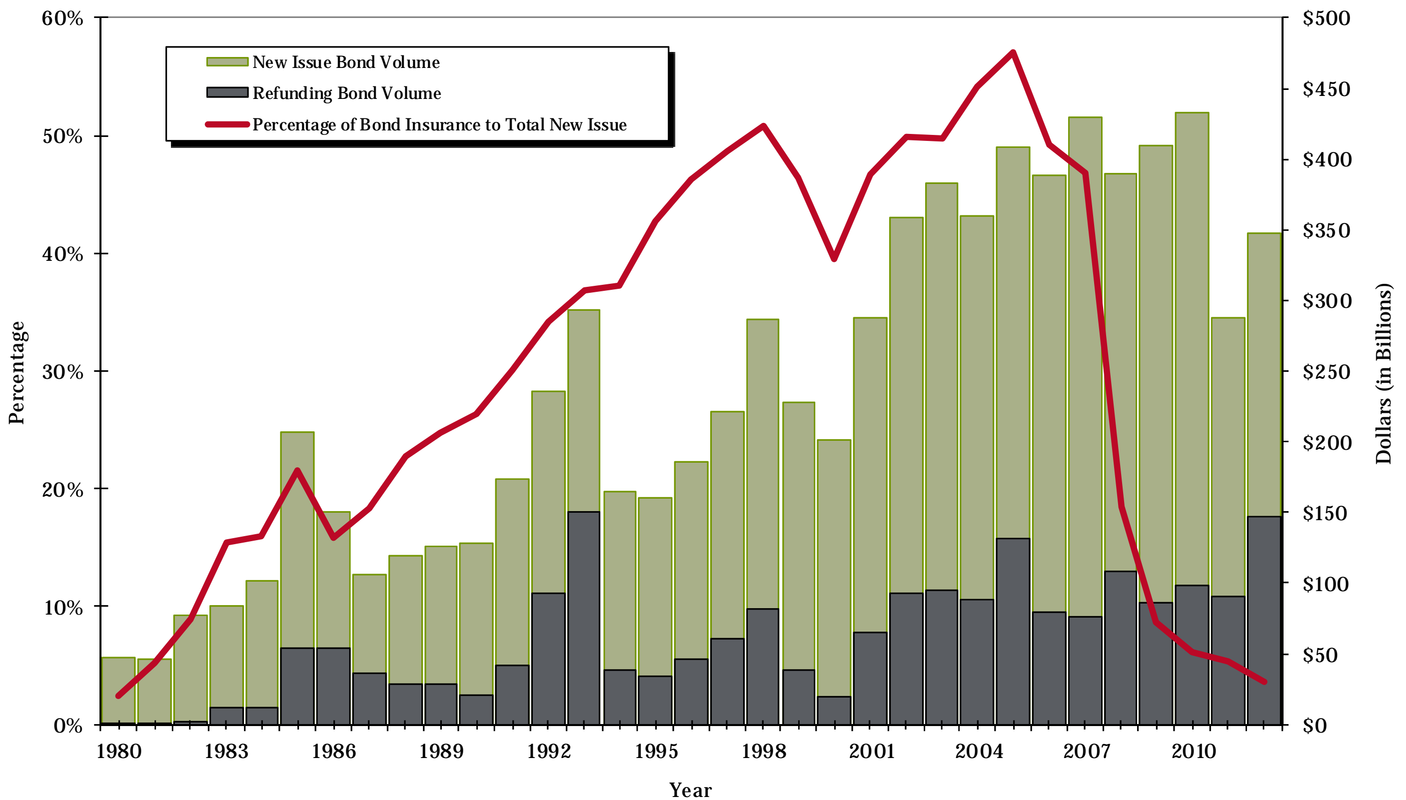
2013 Volume Likely to Remain Comparable to 2012

As we have seen numerous times in the past, market volume picks up in advance of a proposed change in federal law. We saw a dramatic surge in volume in 1985 in advance of that tax reform and again in 2010, as the BAB program and AMT carve-outs were to sunset. We could envision something similar happening once the scenario for tax-exempt interest comes into focus. (Under the 28% cap, we would expect to see re-pricing, rather than a surge in new issue, since that would affect all holders, past, present and future.)

It is notable that the increase in volume in 2012 is almost entirely due to refunding activity. If you look at the chart below the pattern of increase in new issue volume between 2001 and 2002 closely resembles the increase in total volume between 2011 and 2012, as issues have seasoned to the 10-year call date. In fact, total volumes for these two pairings are almost identical dollar amounts. Refundings will likely continue to comprise a significant part of the market given the expectation for continued low interest rates and the 10-year call from decade-old high-volume years.

New issue infrastructure volume is down from prior years and is likely to continue to be constrained. However, new money borrowing is not a completely dead story. While spending for transportation infrastructure is likely to be flat with direct federal grant funding likely curtailed, funding for the Transportation Infrastructure Finance and Innovation

New Issue Volume (1980-2012*) and the Percentage of Bond Insurance



* As of December 7, 2012
Source: Bond Buyer, Assured Guaranty, Thomson Reuters and Wells Fargo Securities, LLC analysis

Act (TIFIA) program grew a modest $120 million to $1.7 billion over two years under Moving Ahead for Progress in the 21st Century (MAP-21 — $750 million in FY 2013 and $1 billion in FY 2014). TIFIA funding could be leveraged to make up to $17 billion in loans/guarantees for infrastructure projects, which could partially offset any reductions to infrastructure funding that comes out of the fiscal cliff negotiations. Funding costs for the TIFIA are likely to remain low given historically low U.S. Treasury rates. There could also be some increased capital spending on port infrastructure with the Panama Canal expansion on the horizon.

We expect ongoing capital spending in the energy sector given the increased environmental compliance costs and state renewable portfolio standards (RPS). Attractive natural gas prices have provided an accommodative backdrop for coal fired generation assets to be retired. However, renewable production tax credits (PTCs) and investment tax credits (ITCs) face extension or extinction in 2013. Without these tax credits, the pace of renewables development could slow and costs could increase. Nevertheless, California's requirement to be powered by one-third renewables by 2020 will drive public power to market, such as the Los Angeles Department of Water and Power, which plans sizable annual offerings. In addition, the currently planned hike in dividend taxation (which may be softened) may drive corporate utility buyers to cross over into the municipal market.

Putting these plusses and minuses into a hat, we believe volume in 2013 will mirror 2012 levels, possibly a bit smaller given the political noise around the tax exemption and potential recession in 2013 — around $340 billion.

Putting these pluses and minuses into a hat, we believe volume in 2013 will mirror 2012 levels, but could possibly be a bit smaller given the political noise around the tax exemption and the potential for a recession — around $340 billion.

Additional information is available on request.

This report was prepared by Wells Fargo Securities, LLC.

About Wells Fargo Securities, LLC
Wells Fargo Securities, LLC is a U.S. broker-dealer registered with the U.S. Securities and Exchange Commission and a member of the New York Stock Exchange, the Financial Industry Regulatory Authority and the Securities Investor Protection Corp. Wells Fargo Bank, N.A. and Wells Fargo Securities, LLC are each registered with the U.S. Securities and Exchange Commission and the Municipal Securities Rulemaking Board as municipal securities dealers.

Important Information for Non-U.S. Recipients

EEA
The securities and related financial instruments described herein may not be eligible for sale in all jurisdictions or to certain categories of investors. For certain non-U.S. institutional reader (including readers in the EEA), this report is distributed by Wells Fargo Securities International Limited ("WFSIL"). For the purposes of Section 21 of the UK Financial Services and Markets Act 2000 ("the Act"), the content of this report has been approved by WFSIL a regulated person under the Act. WFSIL does not deal with retail clients as defined in the Markets in Financial Instruments Directive 2007. This research is not intended for, and should not be relied upon, by retail clients. The FSA rules made under the Financial Services and Markets Act 2000 for the protection of retail clients will therefore not apply, nor will the Financial Services Compensation Scheme be available.

Australia
Wells Fargo Securities, LLC is exempt from the requirements to hold an Australian financial services license in respect of the financial services it provides to wholesale clients in Australia. Wells Fargo Securities, LLC is regulated under U.S. laws which differ from Australian laws. Any offer or documentation provided to Australian recipients by Wells Fargo Securities, LLC in the course of providing the financial services will be prepared in accordance with the laws of the United States and not Australian laws.

Hong Kong
This report is issued and distributed in Hong Kong by Wells Fargo Securities Asia Limited ("WFSAL"), a Hong Kong incorporated investment firm licensed and regulated by the Securities and Futures Commission to carry on types 1, 4, 6 and 9 regulated activities (as defined in the Securities and Futures Ordinance, "the SFO"). This report is not intended for, and should not be relied on by, any person other than professional investors (as defined in the SFO). Any securities and related financial instruments described herein are not intended for sale, nor will be sold, to any person other than professional investors (as defined in the SFO).

Japan
This report is distributed in Japan by Wells Fargo Securities (Japan) Co., Ltd, registered with the Kanto Local Finance Bureau to conduct broking and dealing of type 1 and type 2 financial instruments and agency or intermediary service for entry into investment advisory or discretionary investment contracts. This report is intended for distribution only to professional investors (Tokutei Toushika) and is not intended for, and should not be relied upon by, ordinary customers (Ippan Toushika).

The ratings stated on the document are not provided by rating agencies registered with the Financial Services Agency of Japan (JFSA) but by group companies of JFSA-registered rating agencies. These group companies may include Moody's Investors Services Inc, Standard & Poor's Rating Services and/or Fitch Ratings. Any decisions to invest in securities or transactions should be made after reviewing policies and methodologies used for assigning credit ratings and assumptions, significance and limitations of the credit ratings stated on the respective rating agencies' websites.

Important Disclosures Relating to Conflicts of Interest and Potential Conflicts of Interest

Wells Fargo Bank, N.A., Wells Fargo Securities, LLC and certain of their affiliates are registered municipal securities dealers and may trade the securities named herein on a principal or agency basis, may act as underwriter for one or more of the issuers or securities named herein and may receive compensation for such services or other investment banking services provided to one or more of the issuers named herein.

Wells Fargo Securities, LLC does not compensate its research analysts based on specific investment banking transactions. Wells Fargo Securities, LLC research analysts receive compensation that is based on and affected by the overall profitability of their respective department and the firm, which includes, but is not limited to, investment banking revenue.

Analyst's Certification
The research analyst(s) principally responsible for the report certifies to the following: all views expressed in this research report accurately reflect the analysts' personal views about any and all of the subject securities or issuers discussed; and no part of the research analysts' compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by the research analyst(s) in this research report.

This report, IDs, and passwords are available at www.wellsfargoresearch.com

Securities discussed herein may be rated below investment grade and should therefore only be considered for inclusion in accounts qualified for speculative investment.

This report is for your information only and is not an offer to sell, or a solicitation of an offer to buy, the securities or instruments named or described in this report. Interested parties are advised to contact the entity with which they deal, or the entity that provided this report to them, if they desire further information. The information in this report has been obtained or derived from sources believed by Wells Fargo Securities, LLC, to be reliable, but Wells Fargo Securities, LLC does not represent that this information is accurate or complete. Any opinions or estimates contained in this report represent the judgment of Wells Fargo Securities, LLC, at this time, and are subject to change without notice. For the purposes of the U.K. Financial Services Authority's rules, this report constitutes impartial investment research. Each of Wells Fargo Securities, LLC, and Wells Fargo Securities International Limited is a separate legal entity and distinct from affiliated banks. Copyright © 2012 Wells Fargo Securities, LLC.

SECURITIES: NOT FDIC-INSURED * NOT BANK-GUARANTEED * MAY LOSE VALUE

Global Head of Research, Economics & Strategy

Diane Schumaker-Krieg, Managing Director, Global Head of Research, Economics & Strategy diane.schumaker@wellsfargo.com (704) 715-8437
(212) 214-5070

Municipal Securities Research

Natalie Cohen, Managing Director	**Head of Municipal Research**	natalie.cohen@wellsfargo.com	(212) 214-8014
George Huang, Director	**Municipal Analyst**	george.huang@wellsfargo.com	(212) 214-5061
Roy Eappen, Associate	**Municipal Analyst**	roy.eappen@wellsfargo.com	(212) 214-8045

Available on Bloomberg at WFMU and MarkitHub
Available at www.wellsfargoresearch.com. You can request a Web site ID and password directly on this site.
To have future reports emailed to you directly or to request access to WFMU via Bloomberg, send a request to wellsfargo.research@wellsfargo.com