Insights into the Municipal Market for 2011

January 2011

What's Driving the Muni Market? Five Insights on the Municipal Market by MacKay Municipal Managers™

*As U.S. states and localities struggle under the weight of the economic slowdown and reduced revenues, the question asked by many investors is, **"Why buy municipal bonds?"** Our response in one word: **Opportunity**.*

While many states and municipalities still have to balance their budgets, MacKay Municipal Managers™ believes that the fiscal conditions of the municipal market may recover for many municipalities and states that have already made the hard decisions to reduce spending, and/or are in the process of implementing those changes. As the economy slowly improves, we believe states that have addressed their revenue shortfalls are poised to rebound. Since all municipal credits are not created equal, a laddered "one size fits all" approach to investing could prove costly. We think that security selection and market experience will be critical contributors to performance in 2011.

With this in mind, we offer our five insights into the market for 2011:

1. Municipal bond defaults will increase, but will remain under 1%.[1]

Although news headlines have focused on non-municipal analyst predictions of municipal market defaults reaching hundred of billions of dollars in 2011, we believe that defaults will remain limited. (Moody's reports, as of February 2010, the 10-year cumulative default rate for the public finance market to be 0.09% from 1970-2009.) In 2010, there were only five municipal bankruptcy filings, down from ten in 2009 (Bank of America Merrill Lynch, *"Municipal Year Ahead Outlook"*, December 13, 2010). However, as states look to restore their fiscal balance sheets, in part by reducing state aid to local governments, we expect to see an increase in the use of Chapter 9 of the United States Bankruptcy Code by local entities. Lastly, it is our opinion that bonds related to specific sectors, such as financings tied to real estate values, will face higher levels of defaults.

2. State municipal bond spreads will narrow (particularly California) as state budgets improve faster than projected.

We anticipate that the budget cycle for states will improve as federal stimulus spending leads to increases in sales and corporate tax receipts. In addition, the shift in public perception that expenditure cuts are needed will spur politicians to support tough budget decisions. Specifically, in California the budget process change approved by voters in November (that has since been enacted) should also assist the state in passing a budget on time without the need for the issuance of IOUs. Based upon these factors, we believe State of California general obligation bonds will outperform the broader index, the Barclays Capital Municipal Bond Index, in 2011.

3. Privatization efforts will accelerate.

As states, cities and towns look to find new sources of capital to solve budget and pension deficits, we believe many will look to lease and/or sell nonessential assets such as parking garages, parking meters, roads, governmental buildings, public utilities and/or airport facilities.

4. Health care bonds will outperform the broad municipal index.

In our view, balance sheets of health care systems should improve due to the cuts made during the downturn over the last two years, better utilization of technology, higher returns on their endowments and the announcement of mergers prompting investors to enter this sector. We believe that we will continue to see a variety of entities looking to acquire both not-for-profit and publicly owned hospitals. State and local governments looking to exit the healthcare business will likely respond favorably to inquiries from potential acquirers.

5. The municipal yield curve will flatten.

We believe that the municipal curve will see new demand and supply dynamics as market participants change, especially in the shorter end of the yield curve. As the credit environment proves less treacherous than many now fear, we think the appetite for income should become the dominant force shaping the yield curve. We expect many tax-exempt money market investors will move from the safety and relatively low yields of shorter maturity bonds and seek out the higher yields of bonds with longer maturities and/or lower investment grade ratings. As a result of these flattening actions, we anticipate that short- to- intermediate bond performance may surprise to the downside while longer-term bonds and high yield municipal bonds may surprise to the upside.

[1]Historical experience does not guarantee future results.

Before You Invest

Municipal bond funds' income may be subject to state and local taxes or the alternative minimum tax. High-yield securities (sometimes called "junk bonds") are sometimes considered speculative because they present a greater risk of loss than higher-quality debt securities, may be less liquid, and can also be subject to great price volatility. High-yield municipal bonds may be subject to increased liquidity risk as compared to other high-yield debt securities. Funds that invest in bonds are subject to interest-rate risk and can lose principal value when interest rates rise.

A general obligation bond is a common type of municipal bond in the United States that is secured by a state or local government's pledge to use legally available resources, including tax revenues, to repay bond holders.

Chapter 9 of the United States Bankruptcy Code is a bankruptcy proceeding that provides financially distressed municipalities with protection from creditors by creating a plan between the municipality and its creditors to resolve the outstanding debt.

The yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates.

The Barclays Capital Municipal Bond Index is an unmanaged index that includes approximately 15,000 municipal bonds, rated Baa or better by Moody's, with a maturity of at least two years. Bonds subject to the Alternative Minimum Tax or with floating or zero coupons are excluded. Index results assume the reinvestment of all capital gain and dividend distributions. An investment cannot be made directly into an index.

For performance information on MainStay Tax Free Bond Fund and MainStay High Yield Municipal Bond Fund current to the most recent month-end, please visit our web site at mainstayinvestments.com. For more information about MainStay Funds, call 800-MAINSTAY (624-6782) for a prospectus, and, if available, a summary prospectus. Investors are asked to consider the investment objectives, risks, and charges and expenses of the investment carefully before investing. The prospectus, and, if available, a summary prospectus, contains this and other information about the investment company. Please read the prospectus, and, if available, a summary prospectus, carefully before investing.

mainstayinvestments.com