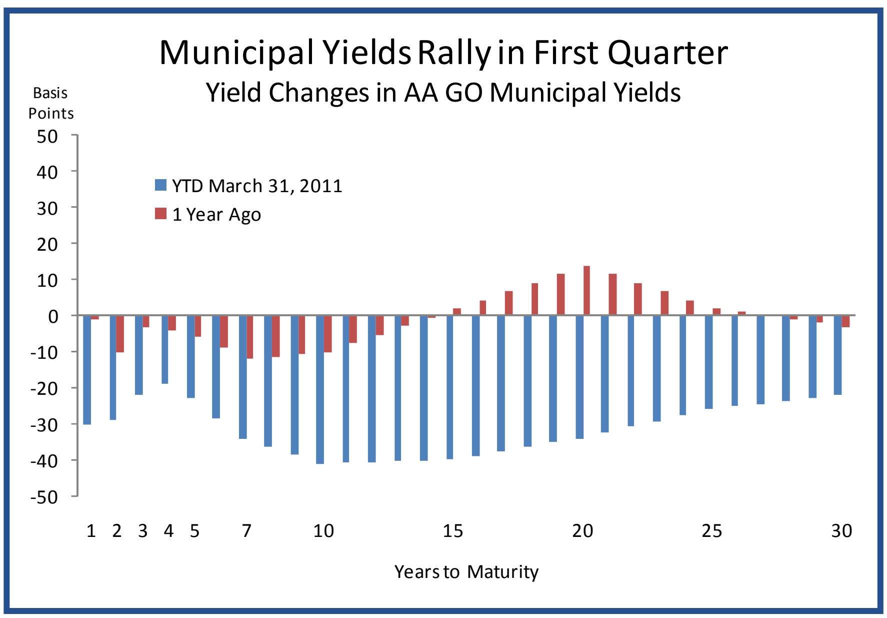
Municipal Market Review

First Quarter 2011

Municipal yields **rallied sharply** during the quarter, with most of the decline in yields occurring in March. The predominant trends acting on municipal yields during the first quarter of 2011 included the dearth of supply, the continued outflow from municipal bond mutual funds and a modest recovery from the "Whitney effect" of last December. Referring to **Figure 1 and Figure 6**, we can see that while yields declined across the entire yield curve during the quarter, the rally in yields was more pronounced in the 10-to-15 year area of the yield curve. Yields in the 10-to-15 year area of the curve rallied by approximately 40 basis points on average, while the rally in yields at both the front and back end of the yield curve were more moderate, averaging between 20 and 30 basis points for the quarter. Referring to **Figure 1**, we can see that relative to year ago levels, municipal yields are modestly lower in the short to intermediate area, while modestly higher in the longer maturities. This type of yield curve reshaping (bullish steepening) has favored investments in the 3-to-7 year maturity area of the yield curve. As a result of yet another asymmetrical rally in yields during the first quarter, the municipal yield curve experienced a modest **bullish steepening** as intermediate-term yields declined more than either short or long-term yields. As such, while the overall shape of the municipal yield curve ended the quarter steeper, the yield curve **flattened at the front end**, while **steepening at the long end**. Specifically, the front end of the municipal yield curve as measured by the 2s-to-10s yield spread, ended the quarter at 257 basis points, 12 basis points flatter than the third quarter ending level of 269 basis points. Conversely, the long end of the municipal yield curve as measured by the 10s-to-30s spread, precisely reversed the change of the fourth quarter, ending the first quarter at a level of 160 basis points, 19 basis points steeper than the fourth

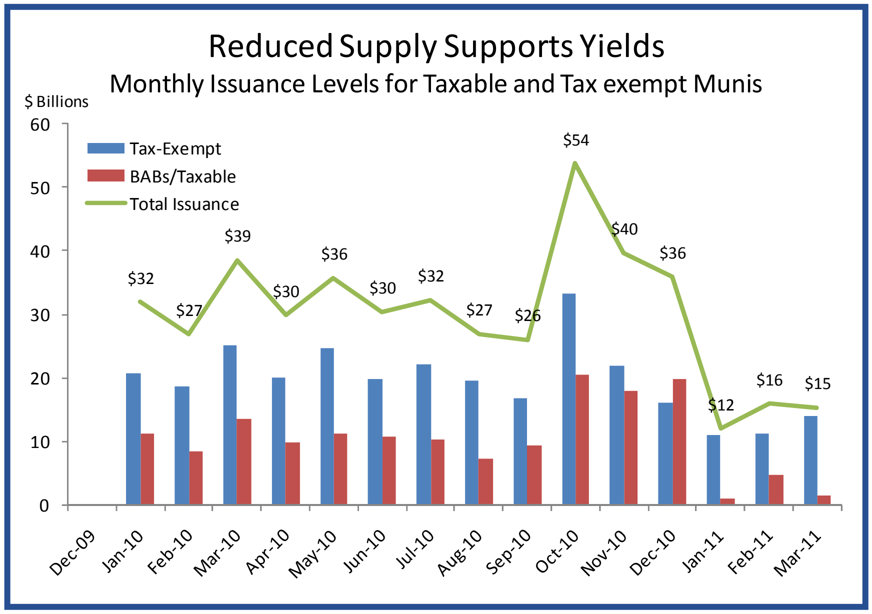
Figure 1



quarter yield spread of 141 basis points. As a result the overall municipal yield curve as measured by the 2s-to-30s yield spread closed out the quarter 7 basis points steeper at an ending level of 417 basis points.

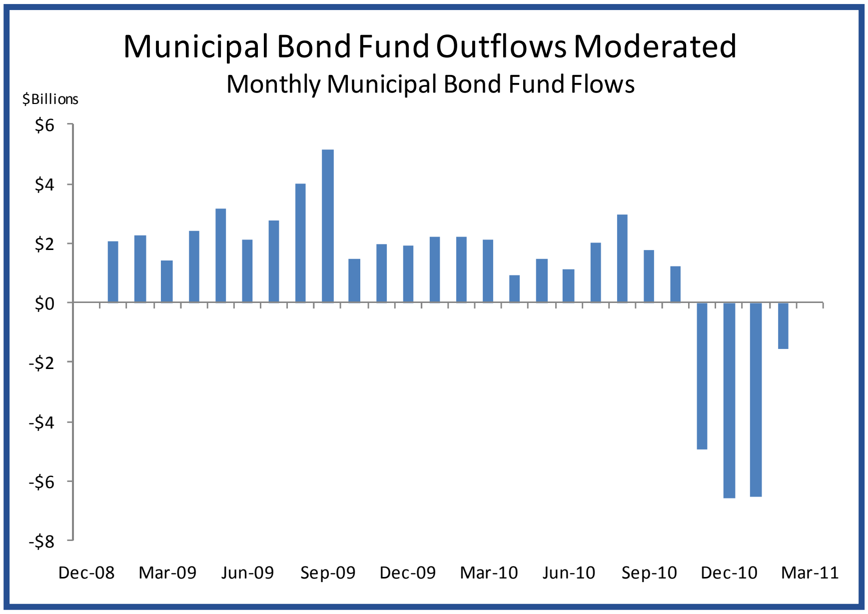
Supply, or new issuance for the quarter, was, in a word underwhelming. Referring to **Figure 2** we can see that relative to either last quarter or to year-ago levels, supply for the first quarter of 2011 was down dramatically. At approximately **$43 billion,** total municipal supply, which includes both tax-exempt and taxable issuance, was down roughly **70 percent** from the elevated level of nearly **$130 billion** for the fourth quarter of 2010 and was down approximately **55 percent** from year ago levels. As we can see from the chart, part of the explanation for the marked decline in total issuance from the fourth quarter of 2010 lies with the elimination of the **Build America Bond** program (BABs) which was discontinued in December of 2010. As a result of the programs non-extension, issuers of BABs rushed to market during the final quarter of 2010, increasing the issuance of taxable municipals by approximately **$30 billion** during the fourth quarter of 2010. However, even adjusting for the loss of the BAB program, **tax-exempt issuance was down markedly**, as reflected by the comparison to year ago levels. The ongoing reduction in supply is indicative of issuers staying away from the market as municipalities **cut spending levels** to work toward balanced budgets. And according to the *Wall Street Journal*, when state and local governments have borrowed, they have borrowed less. According to the Journal; *"The median municipal-bond deal in the first quarter was $5 million, the lowest since 1999. In 10 of the past 11 years, the median first-quarter deal was $6 million to $8 million."* And with the phase-out of Federal ARRA funds to the states in 2011, supply may remain well below the record 2009-2010 issuance levels. Thus far, however, the **reduction in supply** has acted as a partial off-set to the outflow from municipal bond mutual funds, providing **support for municipal yields** during the first quarter.

Figure 2



According to information from the Investment Company Institute or ICI, investors have pulled approximately $32 billion from US municipal bond mutual funds since November of 2010. And while these fund outflows have placed significant pressure on municipal yields over the past four months, the outflows moderated during the month of February as negative credit headlines receded. This is reflected in **Figure 3** which graphs the monthly net cash flow data for municipal mutual funds from ICI. However, Federal Reserve Flow of Funds (FOF) data shows that households, the largest buyer of municipal bonds, were adding to their holdings during the fourth quarter of 2010 even as money was being pulled from mutual funds that invest the municipal securities. In addition, the FOF data also indicated that financial institutions increased their holdings by more than any other quarter since before the financial crisis began. Prior to the release of the fourth quarter 2010 FOF data on March 10, 2011, the record redemptions in municipal mutual funds was reported as evidence of a loss of faith in municipal credit by individual investors, with many prognosticators ascribing the exodus specifically to the **"Meredith Whitney effect."** (Recall from our last commentary that Meredith Whitney was the analyst who on a December 19th interview given on *60 Minutes*, asserted that in 2011, *"50 to 100 significant local municipal bond defaults would occur, totaling hundreds of billions of dollars."*) In our opinion, this dichotomy of behavior highlights the fundamental difference between the investing behavior of retail fund advisors concerned with underperforming short-term benchmarks and those of buy-and-hold individuals and advisors focused on long-term investment value.

Figure 3



And as illustrated by **Figure 7**, municipal bonds continue to offer good relative value as reflected by the ratio of municipal yields to Treasury yields. As can be seen in **Figure 7**, municipal yields as a percentage of Treasury yields remain at historically high levels with ratios for all municipal maturities exceeding **100 percent of Treasury yields**. This represents an average premium in municipal bond relative value of just under **30 percent** across the entire yield curve. Historically, municipal bonds have always been priced to yield less than taxable Treasury bonds due to the value of the embedded tax preference in tax-exempt municipal securities. However, referring to **Figure 4**, we can see that since the start of the current financial crisis in mid-2007, municipal yields have consistently traded above taxable Treasury yields. This on-going divergence between taxable and tax-exempt yields, continues to provide a **unique opportunity** for long-term buy-and-hold investors who can benefit from the tax exemption of municipal bonds, to profit from this **anomaly**. As can also be seen in **Figure 4**, municipal yields, which rose sharply and independent of Treasury yields after the **Meredith Whitney interview**, have now retraced most of that rise, benefitting those who added to their positions during the fourth quarter of 2010.

In addition to individual investors, the ongoing anomaly in municipal yields has increasingly attracted **cross-over investors**, i.e., institutional and non-taxed non-traditional investors who believe there is value in tax-exempt municipal bonds which are trading at yields very close to equivalent quality corporate bonds. However, as the marginal professional investor enters a municipal market that has historically been dominated by individual investors and **"insured bonds"**, distinctions in credit quality are receiving much greater attention. Referring to **Figure 5**, we can see that prior to the 2007 financial crisis, the **average yield spread** or **risk premium** between AAA and A municipal bonds was less than 20 basis points. This was reflective of an era when the majority of municipal bond issuance was backed by insurance from one of a half-dozen large monoline insurers. With the collapse of the monocline insurers in 2007 and 2008, the municipal market has undergone a seismic shift as the process of **"credit discovery"** has replaced **undifferentiated trading** based on an over reliance on credit ratings overly influenced by the presence of municipal bond insurance. This is reflected in **Figure 5** by the marked increase in the risk premium to a level **five-times** the historical average. While clearly this has created dislocation in a market overly dependent on third-party insurance, it has also created **enormous opportunity** for those with both the ability and experience to properly evaluate the underlying municipal credit. In his book, *'The Intelligent Investor'*, premier value investor Benjamin Graham defined the difference between an investment and a speculation as follows: *"An investment operation is one which, upon through analysis promises safety of principal and an adequate return. Operations not meeting these requirements are speculative."*

As we stated in our last quarterly commentary, we continue to believe that the fiscal crisis facing states and municipalities, is **cyclical** and not **systemic**. As such, we have maintained that many of the recent Cassandra-like reports extolling the

Figure 4

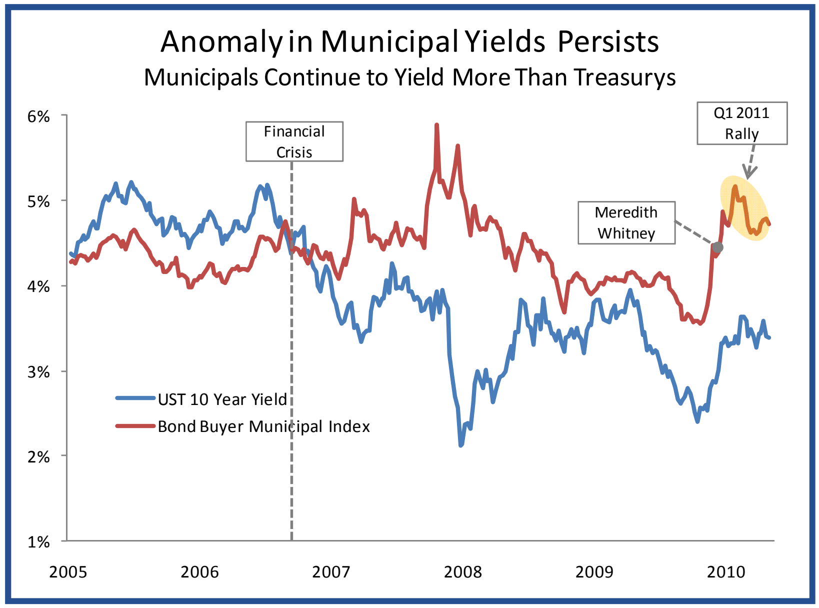
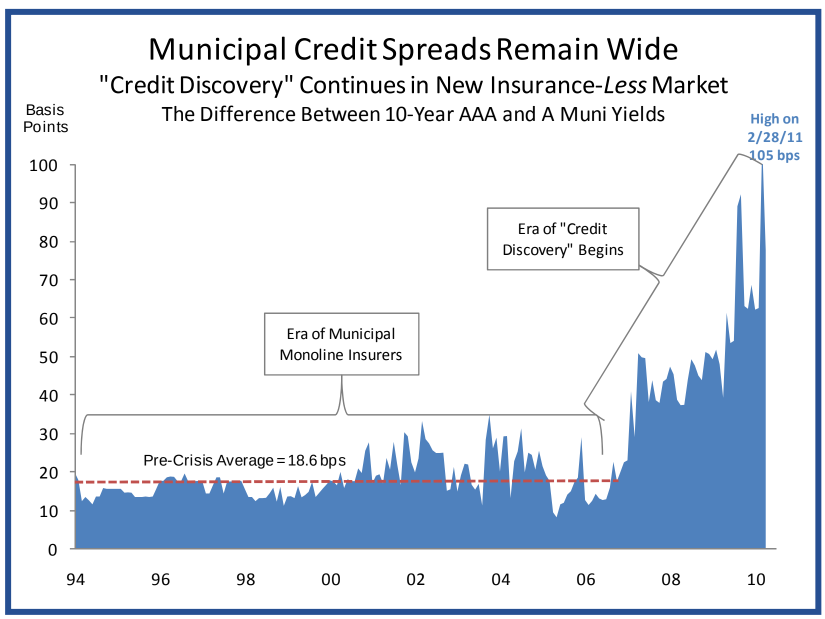


Figure 5



coming market-wide calamity in municipal debt greatly exaggerates the nature of the problem by ignoring the vast differences in fiscal conditions across states and localities and most particularly within different segments of the municipal market itself. Clearly state and local governments are facing significant near-term fiscal challenges driven primarily by a cyclical decrease in revenues stemming from the most debilitating recession since the Great Depression coupled with the particular impact of the collapse of the housing bubble on property tax values. Given our outlook for a slow and extended recovery, particularly with respect to employment, we believe these pressures will continue to impact governments and impair their ability to provide services at current levels, resulting in additional reductions to local services in an effort to reduce budget deficits. To date, most municipalities are taking responsible action to reduce fiscal imbalances. For this reason we continue to maintain that this is an **operating crisis** not a **debt crisis** and as such, the vast majority of state and local governments will remain both creditworthy and solvent. As we stated last time; *"security for GO and dedicated revenue bonds is very strong, and is provided for in state constitutions, statutes, covenants with bondholders and local ordinances".* Therefore we believe that the risk of impairment for municipal state and local government bondholders is quite limited and as such, we believe that municipal bonds remain an excellent investment option, *"promising safety of principal and an adequate return"* to those able to separate the wheat from the chaff by way of *"thorough analysis."*

Figure 6

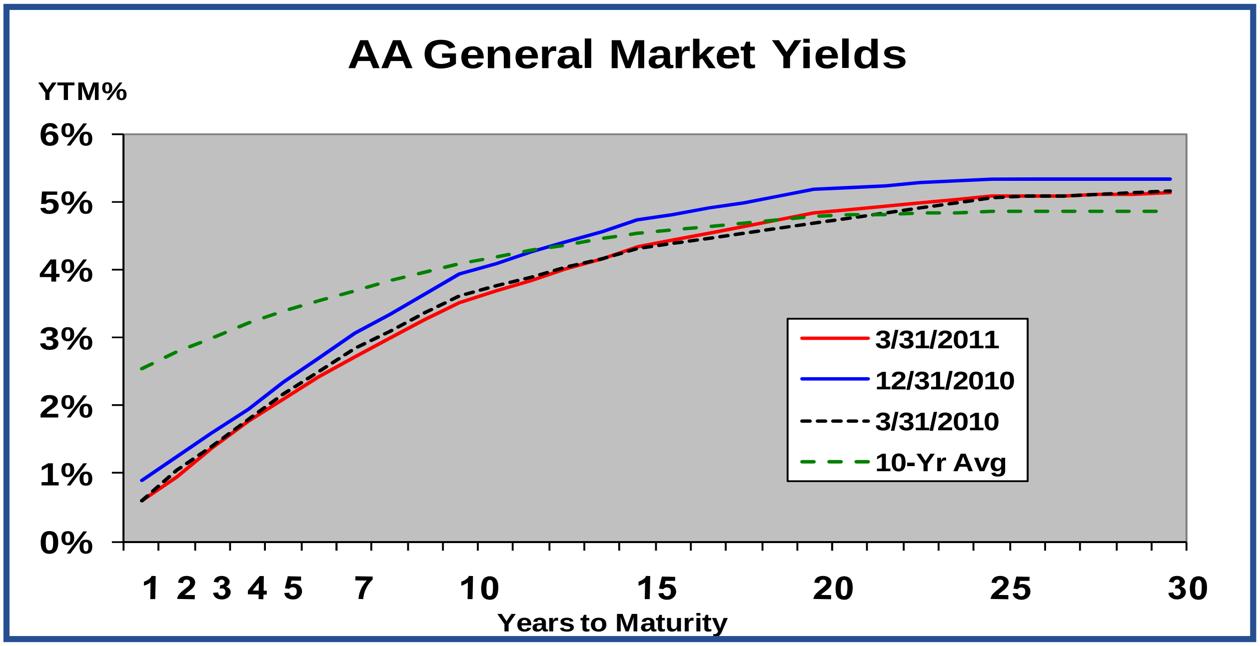
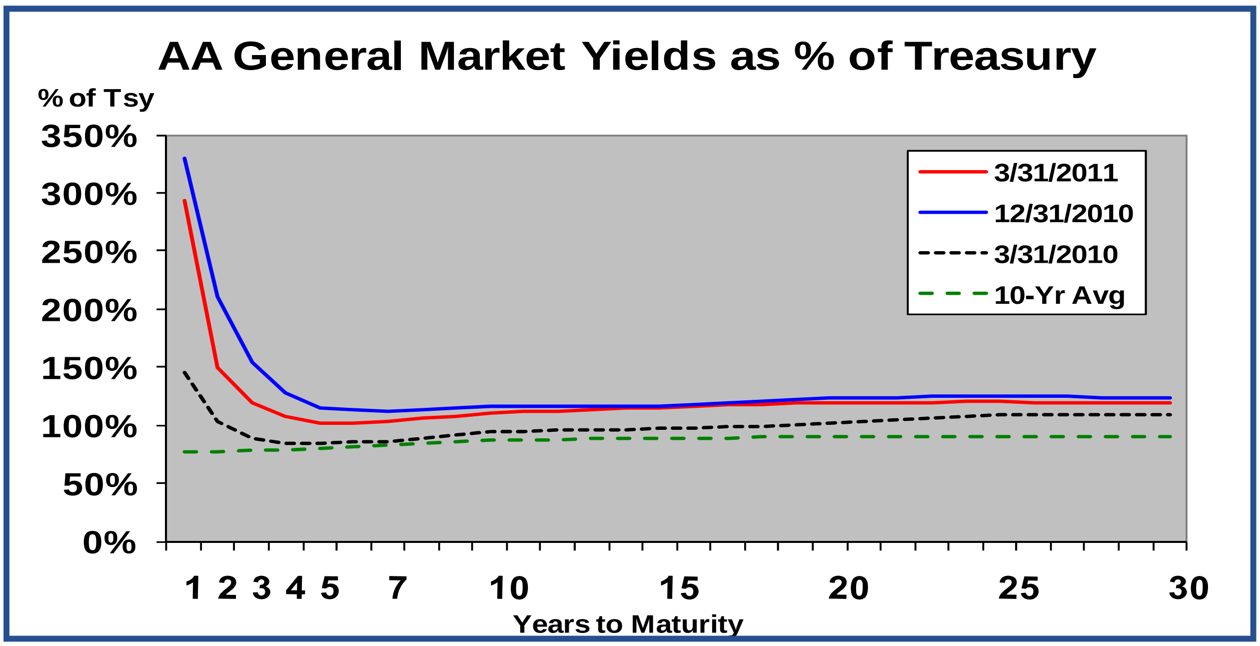


Figure 7



	10 Yr Avg	12/31/2010	3/31/2011
2-Year AA Municipal	77%	210%	150%
5-Year AA Municipal	80%	115%	101%
10-Year AA Municipal	87%	116%	110%
25-Year AA Municipal	90%	125%	120%