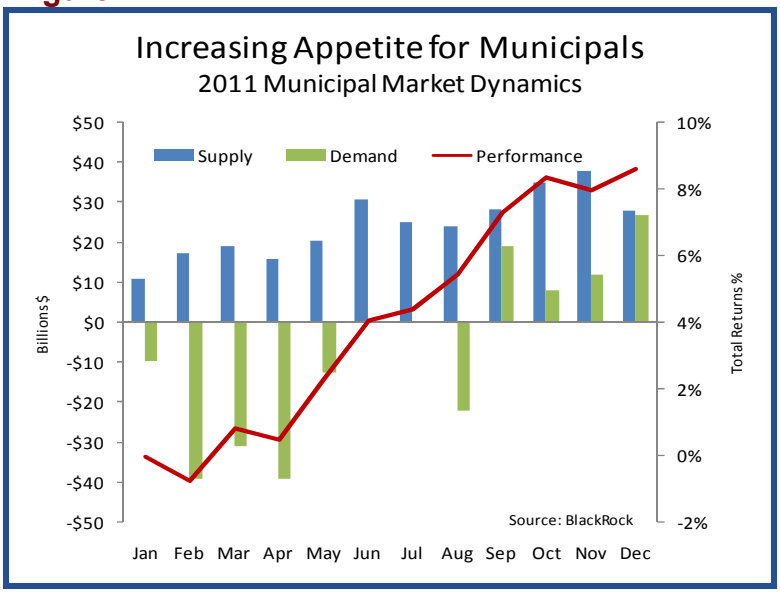
Redstone Advisors

# Municipal Market Review

First Quarter 2012

Despite coming off a very strong performance in 2011, with the exception of the 5-to-10 year area of the yield curve, municipal bond yields rallied again during the first quarter of 2012, bringing the total number of consecutive quarters in a row that municipal yields have declined to five. Referring to **Figure 9**, we can see that yields declined modestly across the front and back ends of the municipal yield curve, while yields in the 5-to-10 year area increased modestly. As a result, the municipal yield curve underwent a slight **downward butterfly shift** resulting in a modest bullish flattening of the yield curve during the first quarter. After a strong rally in January and a modest rally in February, municipal yields rose sharply in March. March typically marks the start of a traditional seasonal weakness for municipals that tends to run until after the tax filing deadline in mid-April. Aside from the temporary seasonal lapse associated with tax-filing, supply and demand conditions have been quite favorable for municipal yields since the fourth quarter of 2010 and the first quarter of 2011. Referring to **Figure 1** we can see that assets poured out of the municipal market from mid-November 2010 through April 2011, due in no small part to the highly publicized prognostications of doom and gloom regarding municipal bond defaults from a well-known analyst. However as the year progressed, real improvements were realized with respect to state revenues and increased investor understanding of the **structural protections** inherent in the municipal market. As such, over the course of the year, fear of massive defaults transformed into concern over the possibility of downgrades. Against this backdrop, **"appetite"** or demand for municipal bonds has increased and supply has lagged somewhat behind, creating favorable conditions for municipal bonds as reflected in **Figure 1** by the stellar performance of the Barclays Municipal Bond Index for 2011. For all of 2011, total issuance was down approximately **32 percent** as compared with 2010. Yet even if new issuance remains muted, the low-interest-rate environment will continue to be supportive of demand from strong refunding and refinancing activity. In addition, the increasingly attractive **relative value ratios** of municipals to corporate bonds, has enticed nontraditional or **crossover buyers** looking for additional yield in high quality assets, into the municipal market, providing an additional demand boost which in turn, has acted to maintain downward pressure on yields.

**Figure 1**

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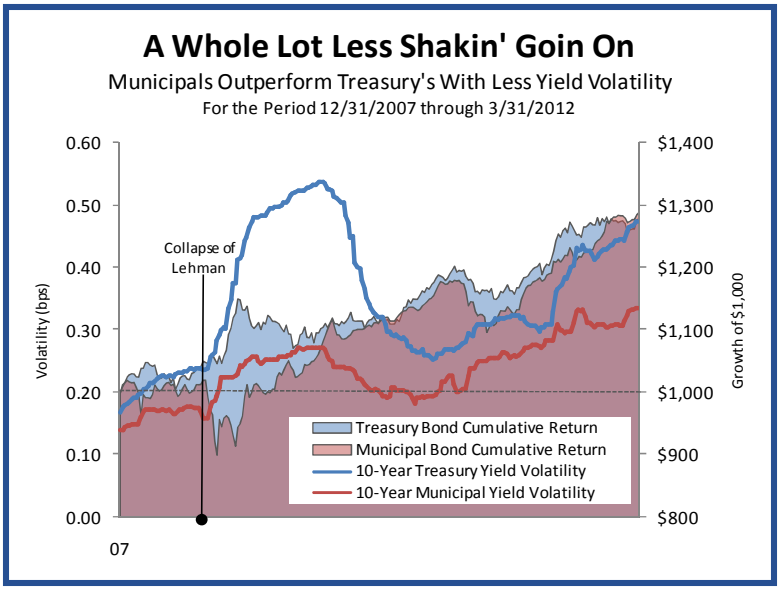
However juxtaposed against the modest rally in municipal yields, **Treasury yields rose sharply** during the first quarter in response to misplaced fears of accelerating economic growth. In our opinion, the rise in Treasury yields was driven not by fears of a self-sustaining economic expansion, but by the math of supply and demand as corporations issued a record **$444 billion** during the first quarter as corporate Treasurers scrambled to lock-in the **lowest borrowing rates** in a generation. This record level of corporate issuance created a temporary supply imbalance which caused Treasury yields to rise in order to clear the market. Because of the rise in Treasury yields, the **relative value ratio** of municipals to Treasury's declined modestly during the quarter. This is reflected in **Figure 10** where we can see that despite this modest decline in relative value ratios during the quarter, they still remain above both their one-year ago and trailing 10-year averages across the entire yield curve.

Overall, since the onset of the **Great Recession in 2007**, municipals have offered better relative and absolute returns than Treasury's, while doing so with **less volatility**. This is reflected in **Figure 2** where we can see that expressed as "Growth of $1,000 Investment", the cumulative return on the Merrill Lynch Municipal Index has exceeded that of the Merrill Treasury Index for the period December 31, 2007 through March 31, 2012. This, despite the strong head start secured for Treasury's as 10-year Treasury yields declined nearly 200 basis points in the fall of 2008 in the wake of the collapse of Lehman. Note that subsequent to the collapse of Lehman, not only did the cumulative performance of Treasury's outpace that of municipals, but shortly thereafter, the yield volatility of Treasury's spiked to a level nearly double that of municipals. However this spike was driven by the 200 basis point **decline** in Treasury yields and serves as a reminder that **not all volatility is bad**. Finally, it should be noted that the outperformance of municipals over Treasury's for this period is presented **before any adjustment for the tax exemption on municipals**, underscoring not only the impressive absolute performance of municipals during this period, but the fact that the tax advantage provided by municipals continues to be **grossly undervalued** by the market.

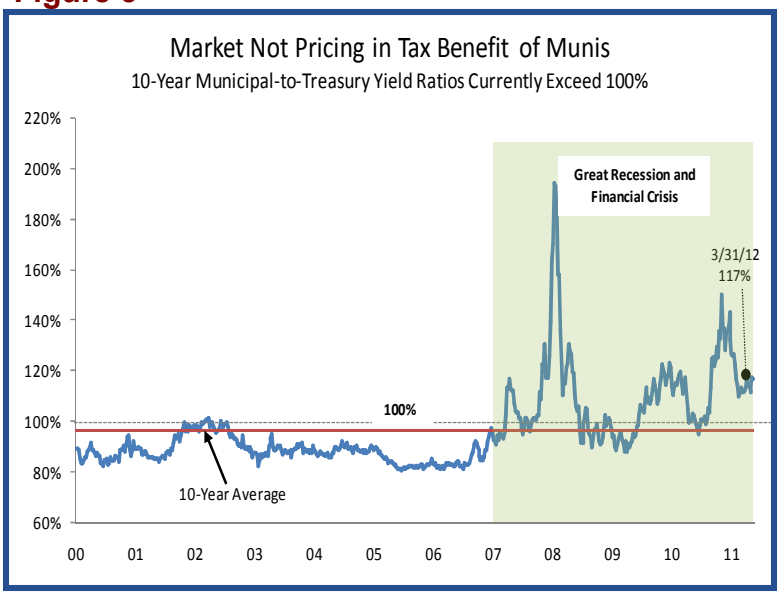
**Figure 2**




We believe that this continues to be a very important, yet overlooked factor which favors municipals bonds; the fact that despite its recent outperformance, **municipals continue to out yield Treasury's on a before-tax basis**. This implies that municipals continue to be priced at very close to a **zero percent tax rate**, effectively discounting the entire value of the tax exemption to investors. We have been emphasizing this value aspect of municipals for the past several years. This can be clearly seen in **Figure 3** which graphs the 10-year municipal-to-Treasury yield ratio over the past decade. And while the ratio was at **117 percent** as of the end of the first quarter of 2012, still above its 10-year average of **97 percent**, more importantly the ratio remains **above 100 percent**. Given the value of the **interest exemption** for municipals versus taxable securities, municipals should trade at yields less than 100 percent of Treasury's. And as reflected in **Figure 3**, prior to the onset of the financial crisis, they did. Looking again at **Figure 3**, we can see that the 10-year municipal yield ratio, while well below the late

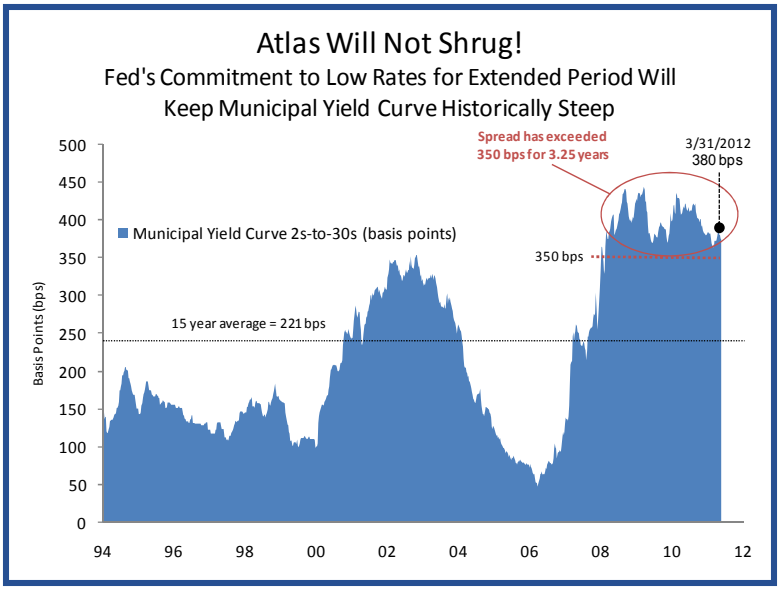
2011 period highs, nevertheless remains elevated relative to the early 2012 lows despite the sharp backup in Treasury yields during the first quarter of 2012. To the benefit of taxable investors, this disconnect between municipal and Treasury yields which began with the onset of the crisis in 2007 and the loss of the monoline insurers and the auction rate securities market, has, with the exception of part of 2009, continued without interruption. And in the current **risk-averse** environment, the flight-to-quality bid that has driven Treasury yields to historic lows will continue to support this relationship. Given the Fed's ongoing public commitment to keeping interest rates artificially low for an extended period of time, we believe that municipals will remain attractive relative to Treasury's for some time.

**Figure 3**




Another "intentional" outcome of the Fed's commitment to low nominal interest rates is the historically steep slope of the municipal yield curve. We have written extensively over the past several years in our Economics and Market Review about the Fed's "necessity" to keep interest rates low and yield curves steep in an all out effort to avoid a debilitating debt deflation by pursuing reflation. This policy of **"financial repression"** [so-called by economist Carmen Reinhart] has had specific implications for financial savings and investors. In particular the goal of the Fed is, through the maintenance of their **zero interest rate policy** (ZIRP), to **"encourage"** [coerce] investors to move out the yield curve and down the credit quality scale. [It also encourages banks and speculators to increase their participation in the leveraged carry trade of borrowing short and lending (investing) long] As such, this is another **"disconnect"** that while directly attributable to the heavy-handed intervention of the stabilizers, can be of great benefit to investors, particularly in the municipal market. Referring to **Figure 4**, we can see that the commitment by the Fed to keep rates low has translated into a 3-plus year period of an unprecedentedly steep municipal yield curve. Given their public commitment that **"Atlas will not shrug"**, municipal investors can lock in **higher absolute yield levels** [income] and with them, **long-term tax benefits** by extending maturities. And given the

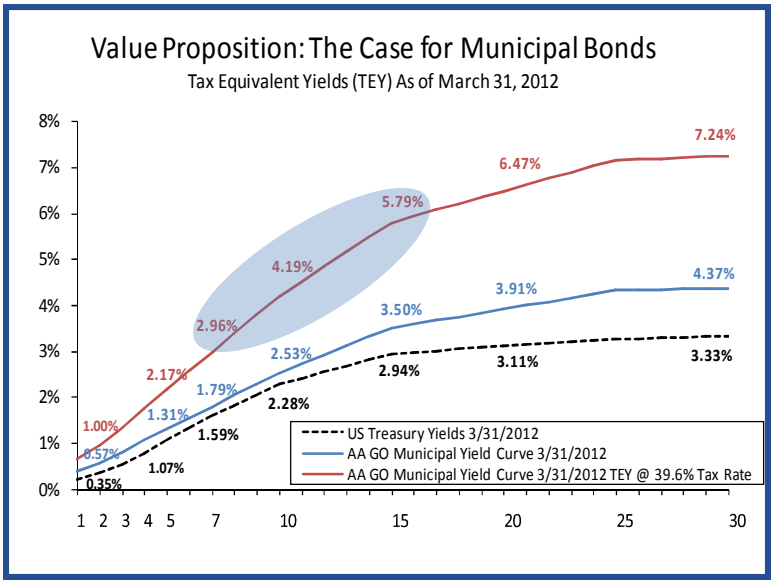
**Figure 4**



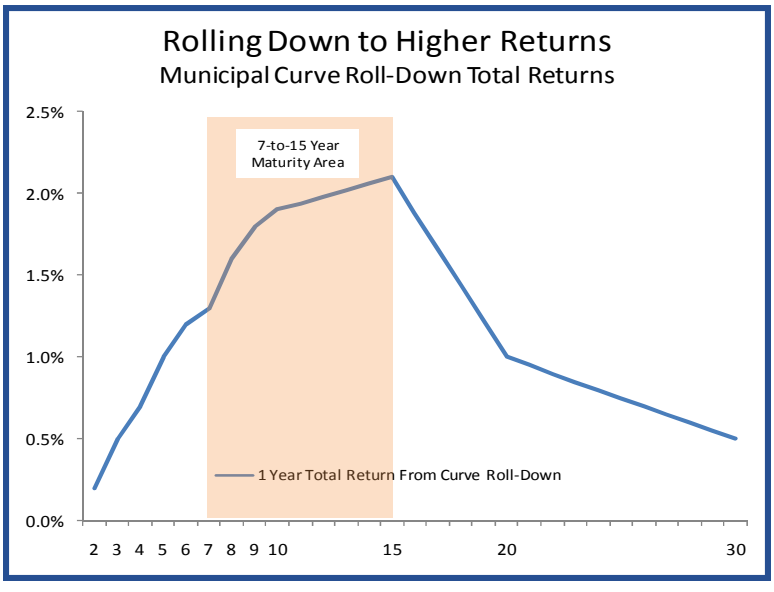
Fed's recent reaffirmation of their commitment to keep interest rates low through 2014, we continue to prefer to seek **yield enhancement** through **duration risk** rather than through **credit risk**.

The not-so-insignificant benefit to investors from this persistently steep municipal yield curve is reflected in the updated chart in **Figure 5**. Here we compare the US Treasury yield curve to the AA GO municipal yield curve, presented on both a nominal and tax equivalent basis, as of March 31, 2012. Again, given the Fed's resolute commitment to keep short-term rates at or near zero, cash continues to yield **"zero"** and the short end of both yield curves remain historically low in nominal terms. However even here, the **"value"** of the tax benefit is apparent as the TE yield on a 2-year municipal bond, at a lowly 1%, is still nearly three times that of a 2-year Treasury yielding only 0.35% and is fully 100 basis points over cash. But the real **value** can be seen when we move our focus out to the **7-to-15 year area** of the yield curve where the combination of the steep yield curve and the benefit of the tax exemption can work their **"magic"** on tax-adjusted yields. For example a five-year municipal bond which is currently priced to yield around 1.31% on a nominal basis, offers a **217 basis point increase** over the current cash yield of zero on a tax equivalent basis. Likewise a ten-year bond priced to yield 2.53%, offers a **419 basis point pick-up** over cash when yields are tax adjusted. Far too often investors focus solely on nominal yields in the determination of value and fail to consider the **"real value"** inherent in high quality municipal bonds, their tax exemption. It is also important to remember that value of the interest exemption in an investor's portfolio compounds over time, which can have a significant impact on the growth of a portfolio's value across time. By way of example, due to the power of compounding, a 3.5 percent yield over 15 years, has a terminal value **32 percent higher** on a tax adjusted basis than a nominal 3.5 percent yield. Given Einstein's insight regarding *"compound interest as the most powerful force in the universe"*, clearly any high-quality investment with a **built-in yield enhancement** of up to 35 percent should be a part of every investor's long-term investing strategy.

## Figure 5

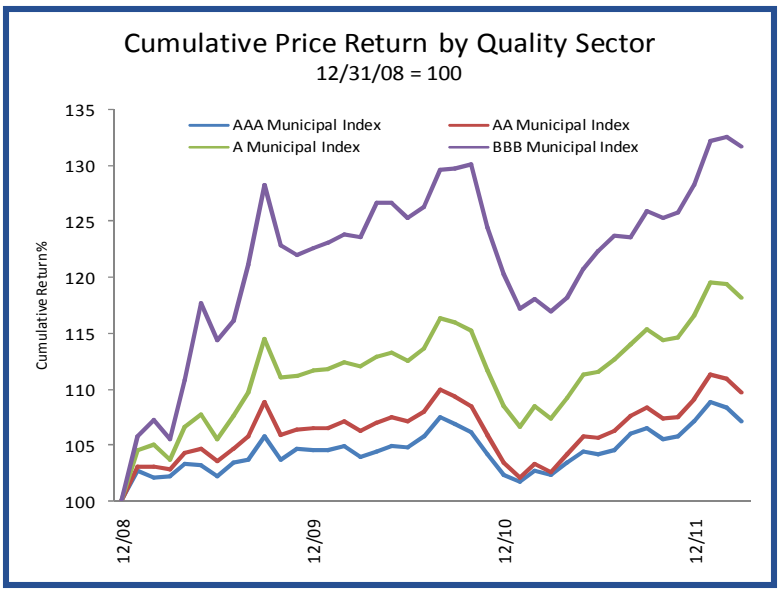



## Figure 6



Still another **investment implication** of the Fed's zero interest rate policy and the resulting steep slope of the municipal yield curve are the additional return opportunities available to investors from curve roll. This opportunity is illustrated in **Figure 6** which graphs the projected 1 year total return attributable solely to curve roll on a nominal basis. In other words, this represents the **potential additional annual return** to an investor from municipal securities as they **"age"** and roll down a **"static"** yield curve. As highlighted on the chart, the greatest potential impact occurs for those maturities in the **7-to-15 year area** of the yield curve where the yield curve is steepest and offers the largest **annual yield drops**. The total return is generated by assuming a one-year holding period with interest rates unchanged in order to isolate the total return attributable to yield curve roll. Due to the fixed nature of bond coupons, bond prices rise as yields fall, causing the market value of the bond to rise by an amount approximately equal to its duration times the annual yield drop for each maturity. As such, those areas of the yield curve which offers the greatest annual yield drop on a volatility-adjusted basis have the potential to provide significant incremental return to a municipal portfolio.

**Figure 7**




Finally, we believe that **Figure's 7** and **8** augur caution for those investors who may be indiscriminately pursuing yield by going down the credit quality ladder. **Figure 7** graphs the cumulative price return by quality sector in the municipal market since 2008. This represents that portion of the total return due solely to a change in yields. **Figure 8** graphs the change in yield spreads between the AA, A and BBB quality municipal indices versus the AAA index over the same period of time. As we can see, most of the compression in risk spreads and the associated price gains attributable to them, has already taken place in the lower quality sectors suggesting the **credit correction phase** may be over and investors are no longer being adequately compensated for the risks taken. As such we would recommend that investors avoid **reaching too far for yield** at this point in the credit cycle, again pointing up the value of a professionally managed portfolio.

**Figure 8**

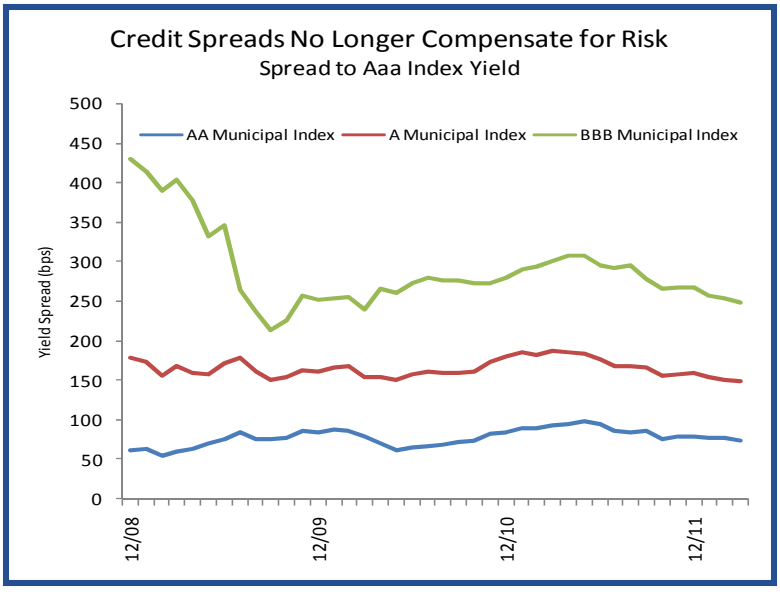


**Figure 9**

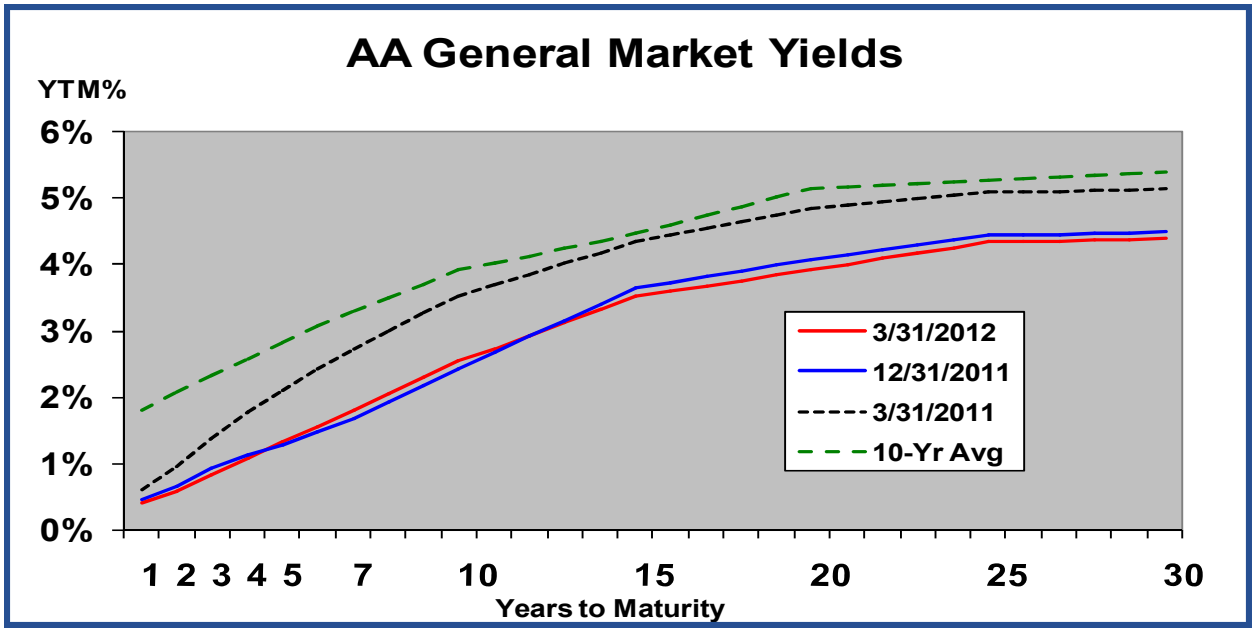
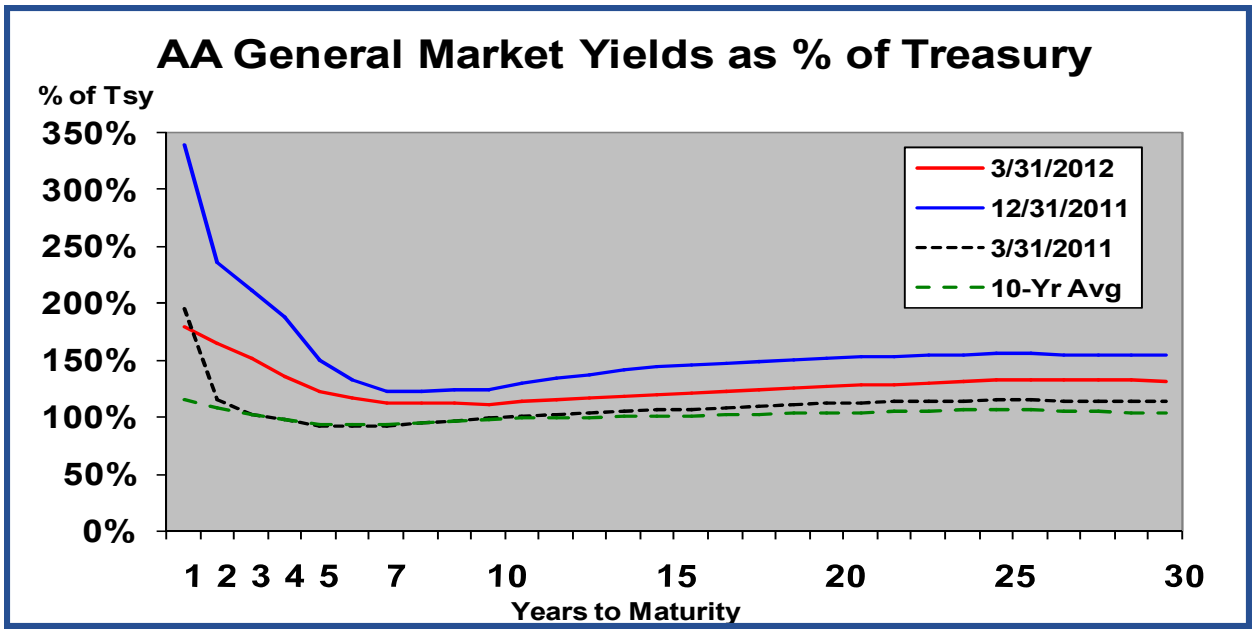



**Figure 10**




| | 10 Yr Avg | 12/31/2011 | 3/31/2012 |
|---|---|---|---|
| 2-Year AA Municipal | 107% | 236% | 164% |
| 5-Year AA Municipal | 93% | 149% | 127% |
| 10-Year AA Municipal | 97% | 124% | 111% |
| 25-Year AA Municipal | 106% | 155% | 133% |