REDSTONE ADVISORS INC.

MARKET REVIEW

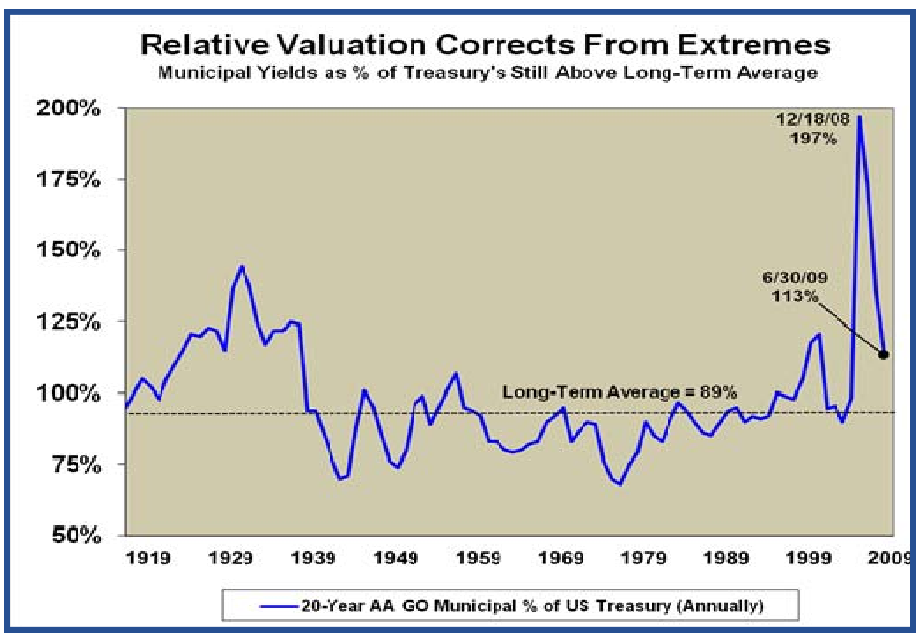
Second Quarter 2009 Report

Overview of Municipal Markets

After falling modestly in both April and May, municipal yields rose in June to close out the second quarter of 2009 effectively unchanged. Referring to **Figure 4** on page three, we can see that with the exception of a modest rise in yields in the 7-to-10 year maturity area, the municipal yield curve was effectively unchanged relative to first quarter ending levels. Municipal yields rallied early in the quarter on continued strong demand from the household sector, only to reverse course, and back up modestly during June in response to concerns over reduced revenue collections among state and local governments and some negative budget news in several key states. As a result, the June 30, 2009 municipal yield curve, with a 2s-to-30s yield spread of **407 basis points**, remains quite **steep** relative to the **trailing ten-year average yield curve**, with a 2s-to-30s yield spread of **207 basis points**. (see **Figure 4)** The **cross-over yield**, or the yield at which current nominal yields exceed those of the trailing ten-year average curve, remains positioned around the **15-year** maturity area. As such, the steep slope of the current municipal yield curve, when combined with the location of the cross-over yield, continues to favor investment of **new money** in the **10-to-20 year area** of the curve. However, this should be balanced against both **curve roll opportunities** as provided by current yield levels, as well as an assessment of curve reshaping probabilities. With annual **yield drops** of between 44 and 26 basis points, the **4-to-8 year maturity area** of the yield curve currently offers the most compelling **curve roll return opportunities**. If however, we assume that the municipal curve is likely to **flatten** from its' record steep slope, then a barbell could offer better return prospects. Taken together, we would recommend a bullet portfolio concentrated in the long-intermediate area of the curve (7-12 year maturity area), or a barbell portfolio with positions in the 4-to-8 year area combined with positions in the 20-to-25 year area, with a weighted duration equal to the bullet portfolio. The decision would be driven primarily by the clients tax attributes and sensitivity to volatility of return attribution.

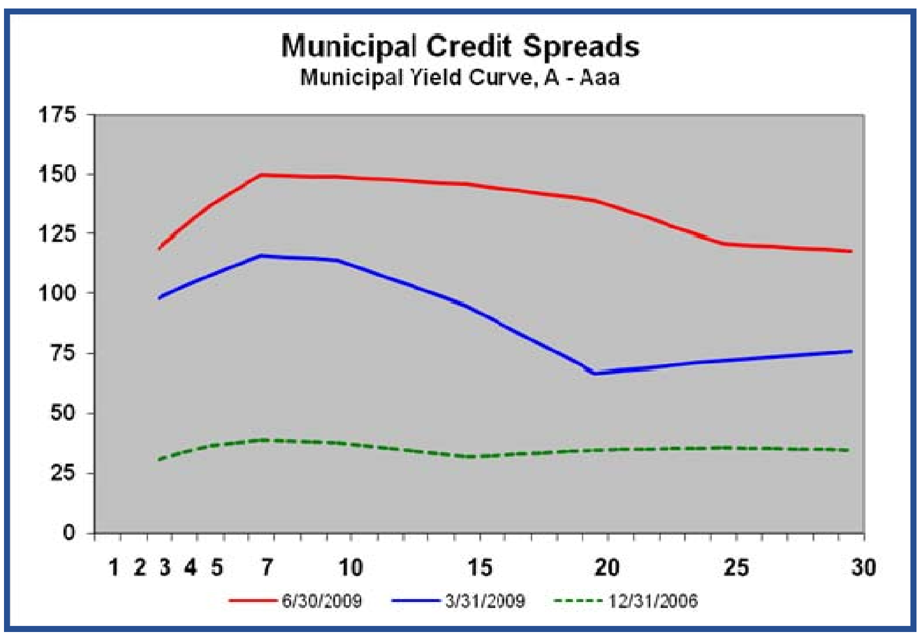
Referring to **Figure 5**, we can see that during the second quarter of 2009, municipal yields as a percentage of Treasury yields continued their descent toward more **normative levels** from the record levels reached during the fourth quarter of 2008. With municipal

Figure 1



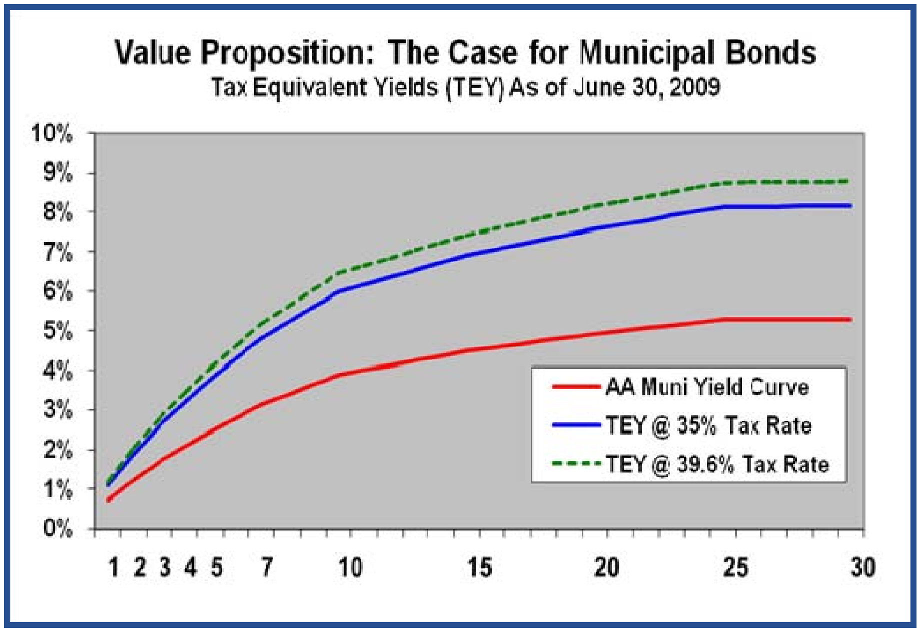
yields unchanged for the quarter, the entire decline in the ratio of municipal yields to Treasury yields was due to the sharp rise in Treasury yields across the entire Treasury yield curve. The persistently high relative valuation in municipals at the short end of the yield curve reflects the degree of leverage inherent in the ratio due to the **extremely small nominal yields** involved in the calculation. By way of example, the yield on a 1-year municipal AA GO is currently around 0.72% versus the current yield on a 1-year Treasury note of 0.54%. While the municipal only offers **18 basis points** in additional yield over the Treasury note, because of the **small absolute yield level**, it represents a **33 percent increase** on a relative basis. Despite the decline in the relative valuation of municipals, when we compare the current valuation to the trailing 10-year average, municipals still offer compelling value for taxable investors across the curve. This is illustrated by **Figure 1** which graphs the ratio of 20-year municipal yields to 20-year Treasury yields over the past century. And as we can see, despite the correction of the first two quarters, municipal yields are still trading at levels markedly above their long-term average. Referring back to **Figure 5**, we can see this is true across the entire municipal yield curve with 10-year municipals trading at yields equal to **110 percent** of Treasury's versus the trailing 10-year average of 87 percent, and 25-year municipals trading at yields equal to **121 percent** of Treasury's versus the trailing 10-year average of 90 percent. These above-average relative valuations represent **26** and **34 percent premiums** over their long-term historical averages, respectively. And should the relative valuation of municipal bonds continue their ***"progression to the mean"*** and return to their long-term average over the next year, they will have the potential to provide outsized returns.

Figure 2



There are a several developments in the municipal market that, in our opinion, will provide continuing support for municipal bond prices in general, and the return of relative municipal valuations to more normative levels in particular. First as we mentioned last quarter, as a result of the severe dislocation during 2008 in the municipal markets, the **demand structure** for municipal bonds shifted toward an increase in demand from the **household sector** as institutional demand waned. As of quarter end, demand from the household sector remains strong, both from the direct retail sector as well as **municipal bond funds**, where the flows continue to come in at an **all-time record pace**. In our opinion, concerns surrounding the prospects for an increase in personal tax rates in order to pay for a national health care program are most likely adding to the strong demand from the household sector as individuals brace themselves for higher tax rates. In addition to the increased demand from the household sector, there has been a change in the structure of supply, whereby a marked increase in the **percentage of fixed-rate issuance** relative to total issuance is also providing ongoing support for municipal prices. The household sector, which tends to be risk averse, favoring short-to-intermediate maturities and higher quality bonds, also prefers fixed rate coupons. This **household bias** toward short-tem, high quality debt can be seen in **Figure 2**, where we see that the **municipal credit spread**, or yield differential between Aaa and A municipal debt, is widest in the short-to-intermediate maturities, the natural habitat for household demand. Interestingly, we can also see from the chart, that municipal credit spreads widened from first quarter ending levels, even though municipal yields were unchanged. This, in our opinion, is indicative of the impact of the increasing reliance on household demand in reshaping the yield curve. A final development which we believe will continue to support municipal bond prices are the impacts from the **American Recovery and Reinvestment Act of 2009**, or ARRA. In particular, the provision which effectively created a new outlet for municipal debt issuance, **Build America Bonds,** or **BABs**. BABs are **taxable** obligations issued by state or local governments whereby the issuing entity receives a **35 percent direct subsidy** against their interest payments for the life of the bond. **Yield spreads** on BABs are currently very attractive relative to **corporate bonds**, and as such, much of the demand for BABs are coming from both the institutional market and taxable investors who view them as a corporate bond substitute with a more attractive risk profile. For this reason, demand has been strong for BABs. Also, the issuance of BABs has been focused at the **long end** of the yield curve, and as such will act to **"flatten"** the yield curve. Nevertheless, in as much as market participants view BAB issuance as **reductive to traditional tax-exempt issuance**, this will have a positive impact on the supply-demand dynamics for tax exempt bonds.

Figure 3



Parroting our assessment of last quarter, we continue to believe that the municipal market provides an excellent **value proposition** for taxable investors. This value proposition is anchored by the fact that municipals remain at historically **high relative valuations** compared to high quality alternatives such as Treasury's, making this a very **attractive entry point**. In addition, the changes to both the **structure of demand and supply**, will, in our opinion, continue to **provide support** for municipal bond prices, particularly in the short and intermediate maturities. This coupled with the very real prospect of **higher taxes** in the future, should lead investors to favor a **higher allocation** to municipals over time.

Figure 4

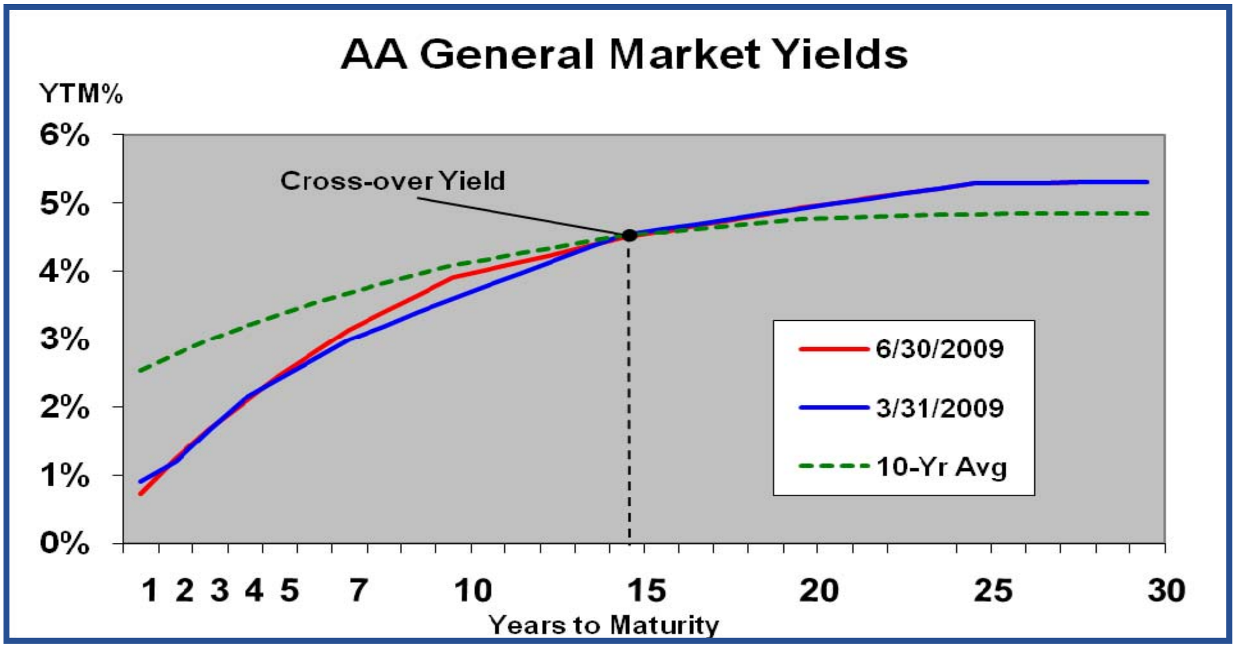
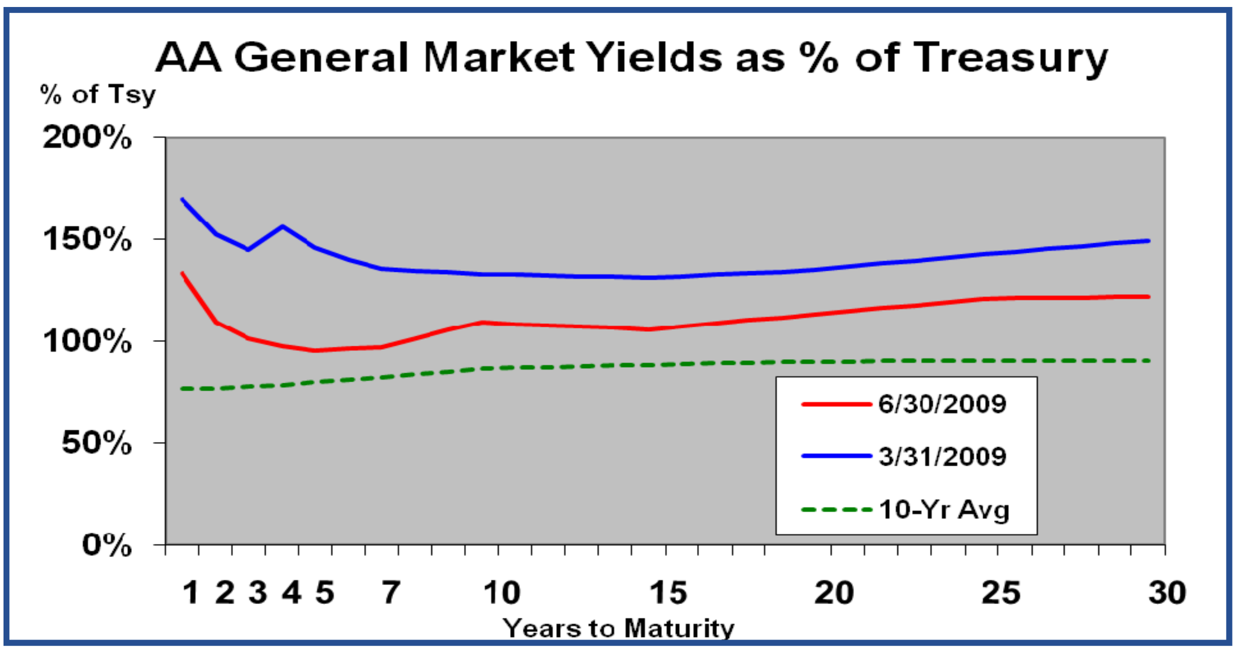


Figure 5



	10 Yr Avg	3/31/2009	6/30/2009
2-Year AA Municipal	77%	152%	110%
5-Year AA Municipal	80%	146%	96%
10-Year AA Municipal	87%	133%	110%
25-Year AA Municipal	90%	143%	121%