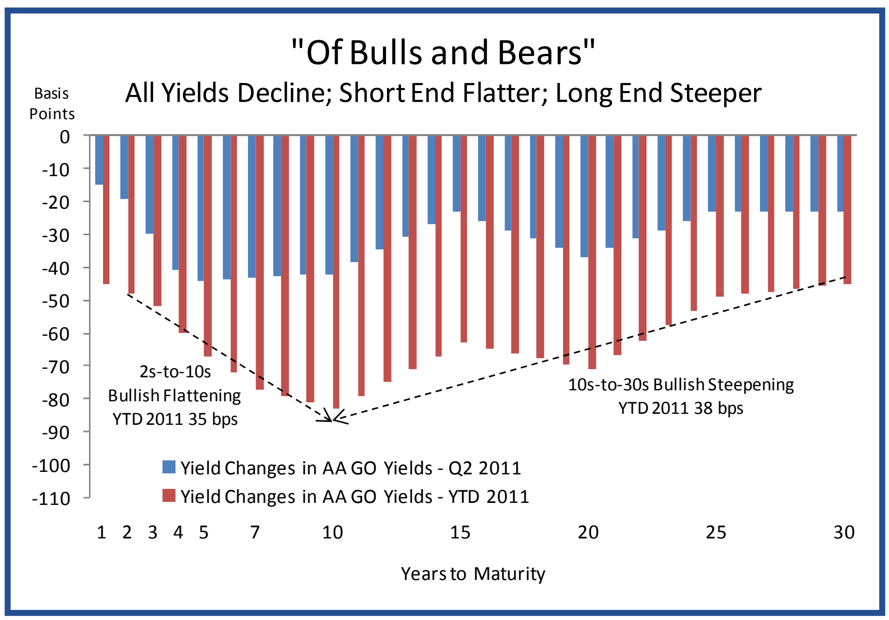
Municipal Market Review

Second Quarter 2011

Despite a number of cross-currents impacting the municipal market, municipal yields again **rallied sharply** during the second quarter, with most of the decline in yields occurring in May. The predominant trends acting on municipal yields during the second quarter of 2011 included a continued reduction in new issuance, a reversal in investor flows whereby flows into municipal bond mutual funds turned positive in June for the first time since November 2010, a continuing decline in Treasury yields which has helped to pull municipal yields lower, a diminution of the "Whitney effect", and as we go to press, some impact from the debt ceiling debacle and possible agency actions as they relate to certain states and municipalities. Referring to **Figure 1 and Figure 7**, we can see that while yields declined across the entire yield curve during the quarter, the rally in yields resembled something of a **"wave pattern"** with the decline in yields more pronounced in the 4-to-10 year (intermediate) area of the yield curve as well as the 19-to-21 year (long-intermediate) area. Yields in both of these areas rallied by an average of 40 basis points, while the rally in yields at both the front and back end of the yield curve were more moderate, averaging between 20 and 25 basis points for the quarter. Referring to **Figure 1**, we can see that this is a continuation of a **"move-to-the-middle pattern"** which has developed over the first half of 2011. In our opinion, this reflects a confluence of supply and demand issues including the extension of individual portfolio holdings **"out the curve"** due to the continuing dearth of yield in short maturities, as well as a modest reduction in institutional activity in the long-end due to loss of the Variable Rate Demand Note (VRDN) and Auction Rate Securities (ARS) markets. Additionally the structure of new issuance for 2011 has been dominated by offerings at the long end, the impact of which has been to put upward pressure on yields at the long end of the curve. Referring again to **Figure 1**, we can see that year-to-date, this **"move-to-the-middle pattern"** has resulted in a **reshaping of yield curve** whereby the **front-end** of the curve has experienced a **35 bps bullish flattening** (10-year yields decline more than 2-year yields), while the **long-end** of the curve has experienced a **38 bps bullish steepening** (10-year yields fall more than 30-year yields). For the first half of 2011,

Figure 1



this curve reshaping has favored investments in the **3-to-10 year maturity area** of the yield curve on a **risk-adjusted basis**. Year-to-date, the overall shape of the municipal yield curve, as measured by the 2s-to-30s yield spread, at 413 bps, is only 3 bps steeper than the December 31, 2010 ending level of 410 bps.

As we have discussed in the past, the **slope** of the municipal yield curve, at 413 basis points as measured by the 2s-to-30s spread, remains historically **quite steep**. And while this is due in large part, to the historically low level of nominal municipal yields available, it still offers investors an opportunity to increase returns. Given the heightened level of instability and volatility at the long end of the curve, we have been recommending the investment of new money in the intermediate part of the curve, i.e. the 3-to10 year area. The reason for this is two-fold. First the incremental **yield pick-up** available to an investor from this strategy is aptly illustrated by **Figure 2** where we can see that the nominal pick-up in yield for moving from a 5-year AA GO bond to a 10-year AA GO bond is currently around **150 basis points**, representing the highest levels we have seen over the past 15-plus years. Second, the persistently steep slope in the intermediate part of the municipal yield curve continues to afford investors attractive **yield curve roll** opportunities. This is one of the unintended consequences of the Fed's zero interest rate policy (ZIRP). By holding short-term rates near zero, they not only encourage investors to **"roll out"** the yield curve for additional yield, but by promising to keep short-term rates low for an **"extended"** period of time, they permit active investors an opportunity to off-set a portion of the nominal yield give-up by **"rolling down"** the yield curve. And for those counting (and we are), the 5s-to-10s spread has been above 150 basis points for **thirty (30) months**. Given Chairman Bernanke's recent reaffirmation of the Fed's commitment to ZIRP, this is a strategy we will continue to purse when it is appropriate for our clients.

Figure 2

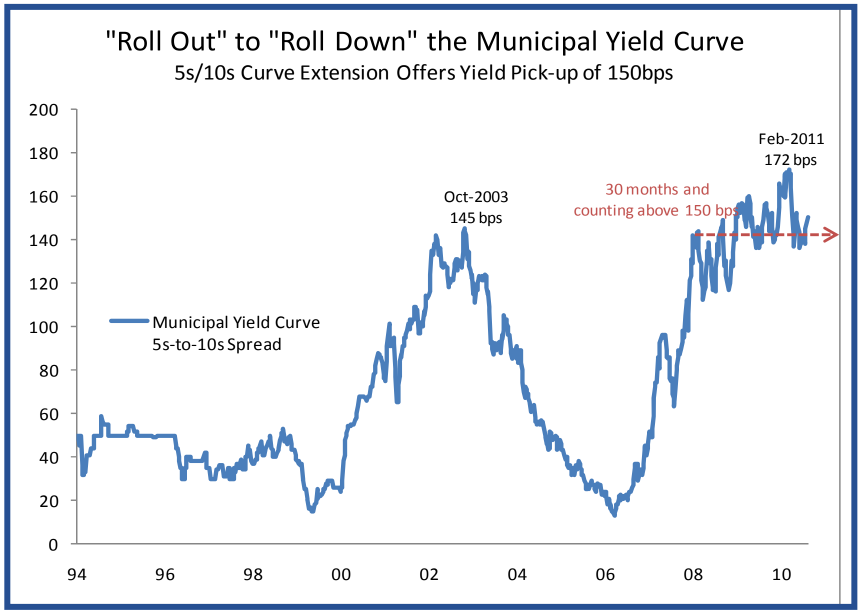
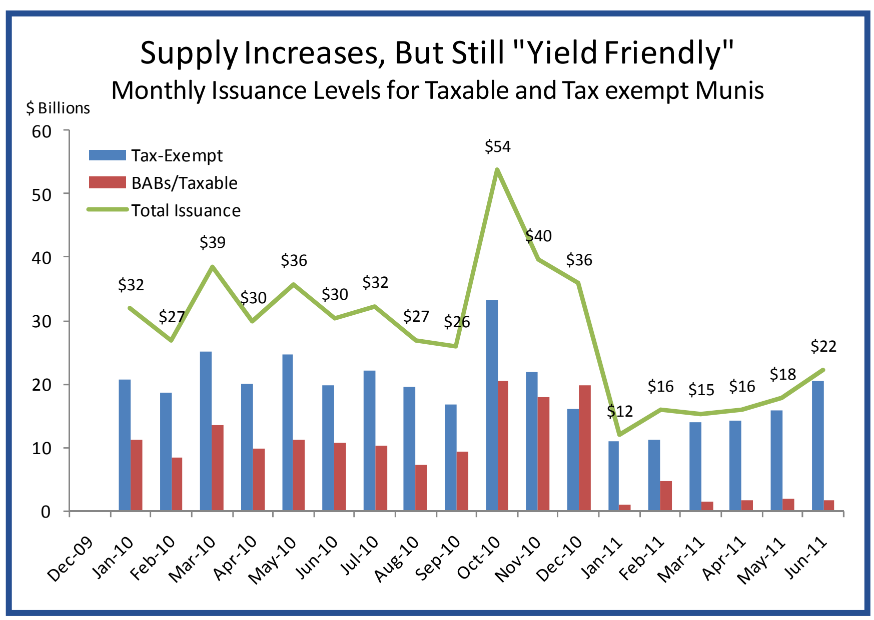
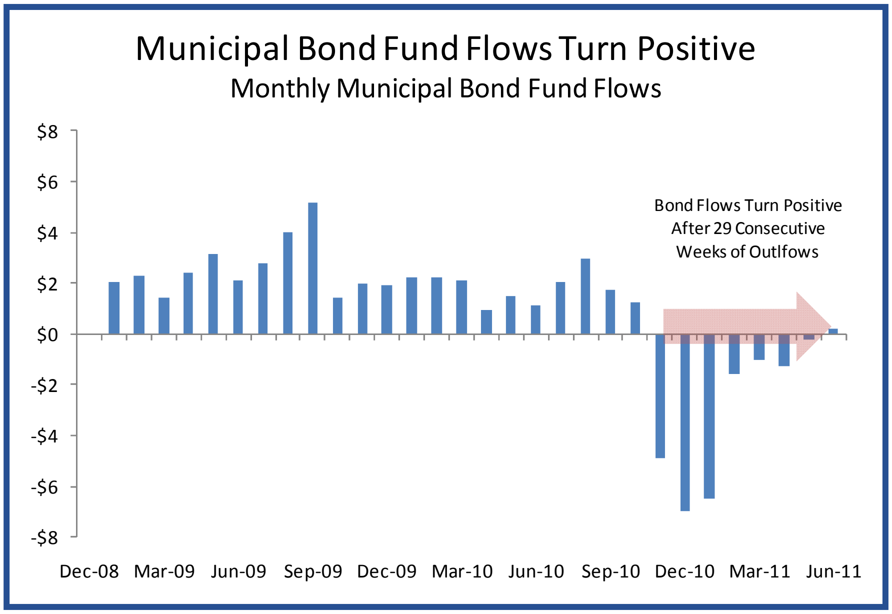


Figure 3



Supply, or new issuance, **increased** modestly for the quarter ended June 30, 2011. Referring to **Figure 3** we can see that at $56 billion, total issuance for the quarter was up approximately $13 billion over last quarter, with all of the increase coming in tax-exempt issuance. However, year-to-date, overall supply remains muted and at roughly $100 billion, new issuance is nearly **45 percent** below 2010's mid-year total. As we can see from the chart, the elimination of the **Build America Bond** program (BABs) which was discontinued in December of 2010 is responsible for the lion's share of the reduction in total new supply. However, even adjusting for the loss of the BAB program, **tax-exempt issuance remains well below year ago levels**. In our opinion, the reduced supply is largely attributable to on-going spending restraint at both the state and local level as governments struggle to reach their mandated balanced budget requirements. In addition, there has been some issuance withheld from the market toward the end of July due to concerns surrounding the debt ceiling debate. However supply and demand factors appear favorable over the near term as the third quarter is typically a slow period for new municipal issuance, with supply again increasing as year-end approaches. These factors continue to be **"yield friendly"**, providing support for municipal bond prices against a backdrop of rising demand.

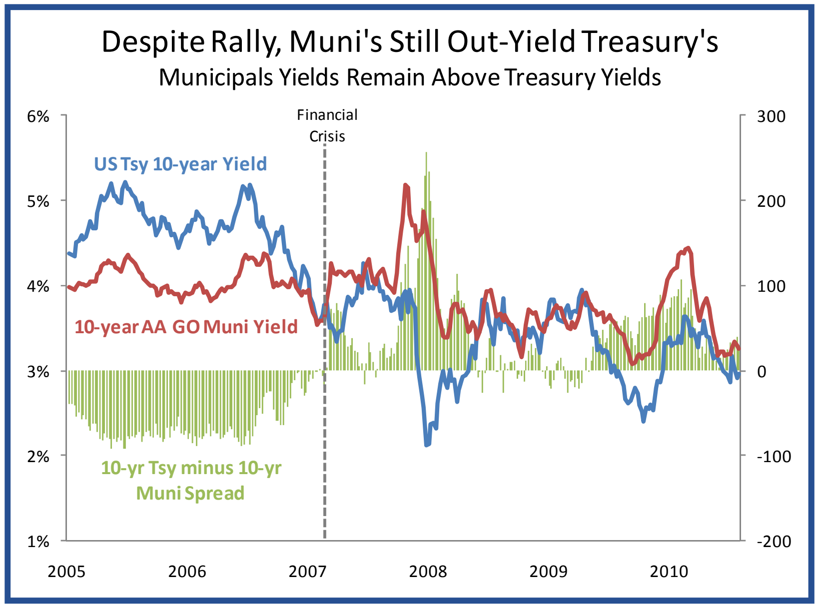
Figure 4



Part of the increase in demand has come from mutual fund flows. According to information from the Investment Company Institute or ICI, after **29 consecutive weeks of cash outflows,** municipal mutual fund bond flows became positive again. This is reflected in **Figure 4** where we can see that flows from municipal bond mutual funds had been negative for the seven month period between November 2010 and May 2011 before turning slightly positive again in June. This favorable trend, combined with the reinvestment of maturing principal and interest payments, easily supported the level of new issuance for the month of June. A review of the Federal Reserve Flow of Funds (FOF) report for the quarter ended March 31, 2011 (most recent available), shows that households, the largest buyer of municipal bonds, continued to add to their holdings during the first quarter of 2011 even while money continued to be pulled from mutual funds.

As we reported last quarter, the record redemptions in municipal mutual funds was reported as evidence of a loss of faith in municipal credit by individual investors, with many ascribing the exodus specifically to the **"Meredith Whitney effect,"** the analyst who famously asserted in December of 2010 that in 2011, *"50 to 100 significant local municipal bond defaults would occur, totaling hundreds of billions of dollars."* This was followed by another **"sky is falling"** report in February of 2011 by high-profile economist Nouriel Roubini, known to the media as **"Dr. Doom"**, who predicted *"$100 billion of municipal defaults during the next five years."* To reach that level would require an annual pace of defaults equal to **two-and-one-half times** the record of $8.2 billion reached in 2008 which was driven by the failure of property developments financed with tax-exempt debt (dirt bonds) in the midst of the greatest collapse in property values since the Great Depression. Unfortunately the real data has not been kind to either prognosticator of doom as municipal defaults have fallen **60 percent** in the first half of 2011 as compared with the same period last year. According to the Distressed Debt newsletter, for the first six months of 2011, municipal defaults fell to 24 totaling $746 million. That compares with 60 in the first half of 2010, totaling $2.29 billion, and 144 in the first six months of 2009, at $4.89 billion. To paraphrase Mark Twain, we are happy to announce that ***"the reports of the death of the municipal market have been greatly exaggerated."***

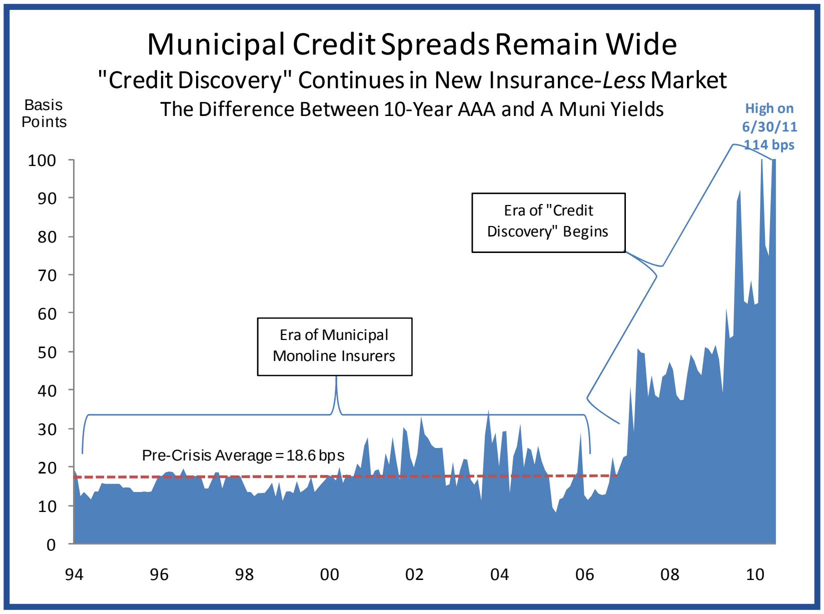
Figure 5



Referring to **Figure 8**, we can see that while municipal bonds continue to offer good **relative value** as reflected by the ratio of municipal yields to Treasury yields vs. their long-term historical average, those ratios fell across the curve during the second quarter of 2011. The compression in relative value ratios combined with the general decline in interest rates was the primary driver of the good performance in municipals for the second quarter. As can also be seen in **Figure 8**, relative value ratios for municipal bonds have declined markedly since the beginning of 2011, particularly in the middle or belly of the curve. Nevertheless, despite the rally municipals still **"out-yield'** Treasury's across the entire curve with relative value ratios at both the short and long end of the yield curve remaining at historically high levels. Historically municipal bonds have always been priced to yield less than taxable Treasury bonds due to the value of the embedded tax exemption of municipal securities. However, referring to **Figure 5** we can see that since the start of the current financial crisis in 2007, municipal yields have traded above taxable Treasury yields on a fairly consistent basis, with two period of extreme variance occurring during the end of 2008 and the other at the end of 2010 (See green bars). The on-going divergence between taxable and tax-exempt yields, and in particular those periods of extreme divergence, provide **unique opportunities** for long-term buy-and-hold investors who can benefit from the tax exemption of municipal bonds in order to profit from this **anomaly**.

However in order to benefit from the anomaly in yields, the individual investor must be able to properly evaluate the underlying credit of the issuer. To begin with, the municipal bond market is not a homogenous market. Instead, the $3 trillion municipal bond market is comprised of over 2 million dissimilar bond issues of all shapes and sizes, issued by over 80,000 separate state and local entities, each carrying its own unique credit risk profile. Contrast this with the U.S. Treasury market, where at approximately $9 trillion, the marketable Treasury market is nearly three times the size of municipals in market value, but the Treasury market consists of a single issuer and less than 300 separate bond issues, all with the same credit profile. Consequently, the only difference between one Treasury bond and another is the coupon and maturity. This is not the case with municipal bonds, where no two bonds are alike. From general obligation bonds to dedicated revenue bonds, rated to non-rated, insured to non-insured, bank qualified to AMT eligible, callable, puttable, pre-refunded and "sinking", there is simply no such thing as a "generic" credit profile for a municipal bond.

Figure 6



With the collapse of the monoline insurers in 2007 and 2008, the municipal market underwent a seismic shift as the process of **"credit discovery"** replaced **undifferentiated trading** based on an over reliance on credit ratings which were overly influenced by the presence of municipal bond insurance. Referring to **Figure 6**, we can see that prior to the 2007 financial crisis, when the majority of municipal bond issuance was insured, the **average yield spread** or **risk premium** between AAA and A municipal bonds was less than 20 basis points. That is very little risk distinction given the vast differentiation in the underlying credit profiles of the numerous issuers of municipal debt, clearly suggesting an over reliance on bond insurance. However, contrast that period with the post-monoline period and we can observe that since the beginning of the **"credit discovery era"**, there has been a **five-fold increase** in the risk premium, as the vast distinctions in the underlying credit profiles of the issuers are receiving much greater attention. This increased market dislocation and credit differentiation continues to offer **enormous opportunities** for those with both the ability and experience to properly evaluate the underlying municipal credit. Clearly this is an area where we believe we can add value for our clients.

Finally, as we go to press, some states and local governments are withholding plans to issue debt as the debt ceiling stalemate in Washington *may have* potential ramifications for certain issuers. In particular, Standard and Poor's released a report outlining three broad hypothetical scenarios under which to gauge how U.S. public finance credits might be affected by coming federal actions. Depending upon how the national debt ceiling impasse is resolved, certain debt issues such as municipal housing issues backed by the federal government, *may have* their ratings cut because in S&P's words, those debt issues *"are directly linked to the sovereign rating and will move in lockstep with it without regard to other factors."* In a related action, Moody's Investors Service recently announced that it *may* lower the credit rating on five states *if* it downgrades the U.S. government's credit rating. Those states include Maryland, Virginia, South Carolina, Tennessee and New Mexico. According to Moody's, these states' top credit ratings are potentially at risk because they are home to large numbers of federal employees and their economies are affected by government contracts, and as such might be adversely affected by certain federal spending cuts. As we noted in our taxable Market Review, we do not believe there will be any **outright or selective default** by the US Treasury. Payments will go out and issues will be refunded. Nevertheless, it is clearly time for both our President and our Congress to end the political posturing and put to rest an issue that has the potential to create unnecessary volatility in the financial markets. To quote Will Rogers: *"If stupidity got us into this mess, then why can't it get us out?"*

Figure 7

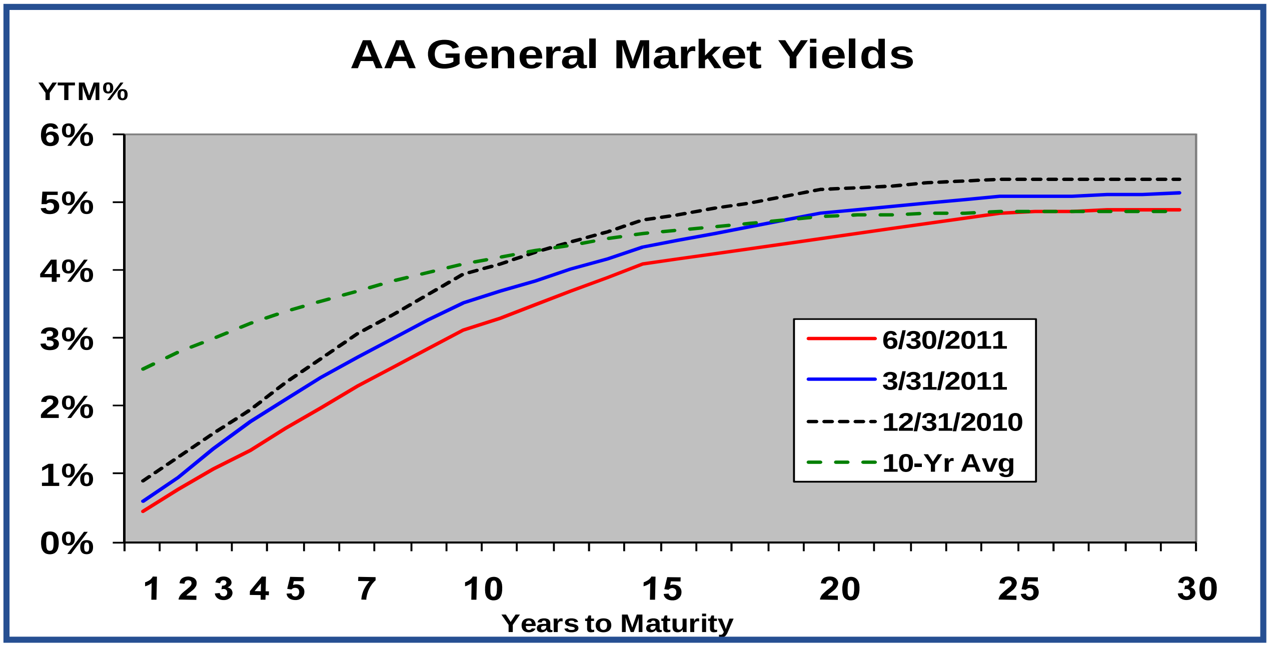
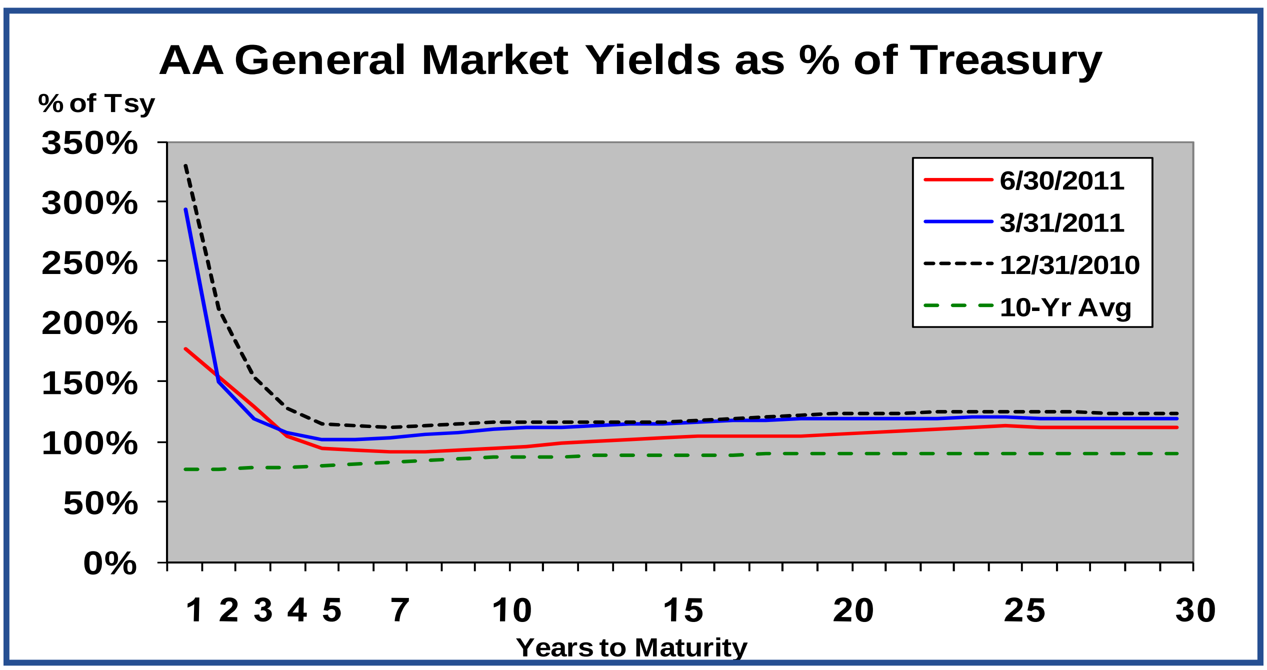


Figure 8



	10 Yr Avg	3/31/2011	6/30/2011
2-Year AA Municipal	77%	150%	154%
5-Year AA Municipal	80%	101%	95%
10-Year AA Municipal	87%	110%	94%
25-Year AA Municipal	90%	120%	113%