REDSTONE ADVISORS INC.

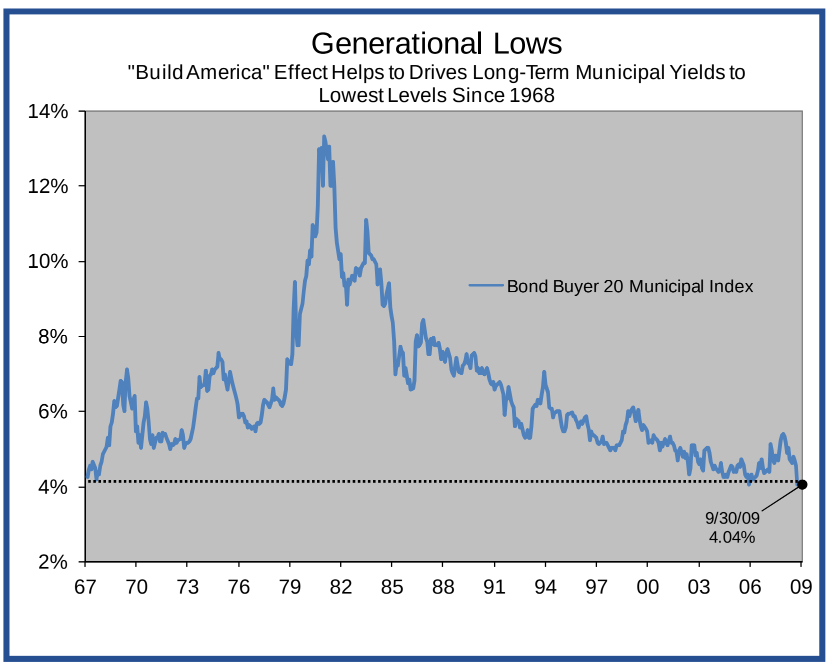
# MARKET REVIEW

Third Quarter 2009 Report

## Overview of Municipal Markets

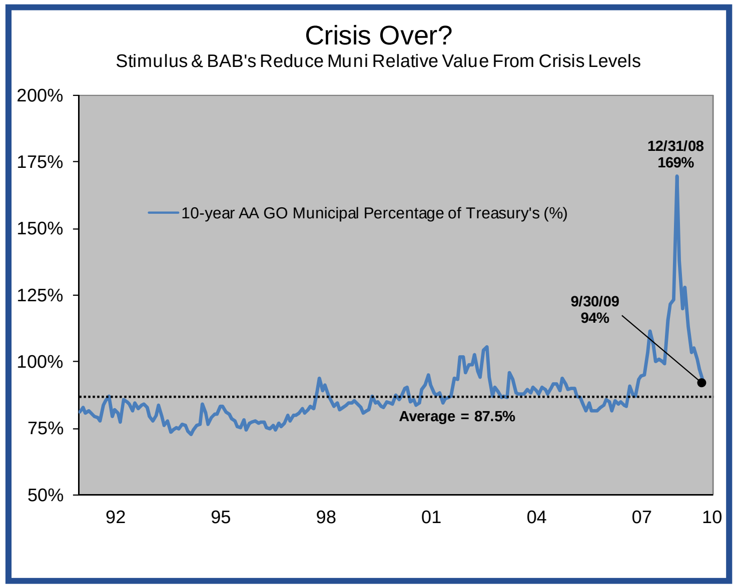
Municipal yields rallied sharply during the third quarter of 2009 with intermediate and long-term yields falling more than short-term yields. As a result, the municipal yield curve underwent a modest **bullish flattening** during the quarter. Referring to **Figure 4** on page three, we can see that with the sole exception of the 30-year yield, as of September 30, 2009, the entire municipal yield curve was at levels substantially beneath the trailing 10-year average yield curve. Municipal bond yields either rallied or trended sideways every week between mid-June and the end of September 2009 for a string of 16 straight weeks without a weekly rise in yields. As we discuss more fully below, driven by a combination of a marked **increase in demand** for tax-exempt income and the **"*effective*" reduction in the supply** of tax-exempt municipals due to the issuance of taxable **"Build America Bonds"** in lieu of tax-exempt bonds, yields on tax-exempt municipal bonds have fallen to levels not seen in over 40 years. (**Figure 1**) However, despite the bullish flattening of the yield curve, the municipal yield curve remains **historically steep** due to the Fed's zero interest rate policy or ZIRP. With the federal funds rate currently at zero percent, short-term municipal yields, despite trading at yield levels nearly 160% of Treasury's, are nevertheless, currently at historically low levels. As a result, as measured by a 2s-to-30s yield spread of **400 basis points**, the quarter-ending municipal yield curve remains nearly **twice as steep** as the 10-year average yield curve with a 2s-to-30s yield spread of just **207 basis points**. The steep slope of the municipal yield curve continues to offer opportunities for capital gains from **yield curve roll**. And while the quarterly yield curve reshaping has modestly reduced the yield drops, the **3-to-7 year maturity area** of the yield curve currently offers the most compelling curve roll return opportunities with annual yield drops of between **30 and 35 basis points**. By way of illustration, the yield to maturity on a current 5-year AA GO is **1.93 percent**. With the yield to maturity on a current 4-year AA GO at **1.62 percent**, there is a one-year yield drop or ***"roll down"*** of **31 basis points**. Buying and holding the 5-year bond over a one year horizon would generate a total return of **3.15 percent** assuming yield levels remain effectively unchanged. As such, the steep municipal yield curve continues to offer investors an opportunity to markedly increase **total return** over and above the low nominal purchase yield levels offered.

**Figure 1**



Referring to **Figure 5** on page three, we can see that, with the exception of very short maturities, during the third quarter of 2009, municipal yields as a **percentage of Treasury yields** continued their reversion to more normative levels. This moderation in relative value was more pronounced in the intermediate maturities. As a result, the yield level of 5-year municipals as a percentage of Treasury's, declined to **82 percent** from a second quarter level of 96 percent, a level just slightly above the trailing 10-year average of **80 percent**. Referring to **Figure 2**, we can see that after spiking at a crisis-induced high of nearly **170 percent** of Treasury's, the relative value of the 10-year maturity sector declined to **94 percent** during the quarter, a level only modestly higher than the 10-year average of **88 percent**. Is this, as many suggest, an indication that the crisis is over and the markets are returning to normal? As we discuss in greater detail in our **Quarterly Market Review**, we would suggest the correct answer is no. Instead, the municipal market, as with all financial markets are being impacted by the unprecedented level of liquidity injections and government intervention in the markets. In short, all markets, to a greater or lesser degree, are now **"medicated markets."**

## Figure 2




In the case of the **municipal market**, while the degree of medication is substantially less than other credit markets (i.e., no direct security purchases by the Fed via quantitative easing, no blanket guarantee of all municipal debt, etc), there are both direct and indirect effects from the actions of the stabilizers. Certainly the most **direct effect** has come from the nearly **$200 billion** in federal stimulus to state governments via the **American Recovery & Reinvestment Act** or ARRA. Given the near death experience of the mono-line bond insurers, the collapse of the auction rate securities market, and state deficits projected to reach $145 billion in 2010, the federal stimulus provided by the ARRA has clearly played an important role in restoring investor confidence in the municipal market. In fact, so much so that demand in 2009 for tax-exempt municipal securities has exploded. According to the Investment Company Institute, long-term, tax-exempt mutual funds have received net cash inflows of **$45 billion** during the first eight months of 2009. That compares to average annual net cash inflows of just **$14.7 billion** per year from 1998 to 2008. Net sales in August of **$9.1 billion** set a record for a single month and the sales for the four week period ended September 23 reached $**9.5 billion**. In fact, for the eight month period ended August 2009, the total assets of tax-exempt bond funds have grown by nearly 25% to $420 billion.

However, juxtaposed against this marked increase in investor demand for tax-exempt securities, has been the **"effective reduction"** in the supply of tax-exempt municipal debt due to the increased issuance of taxable municipal debt, an **indirect effect** of another provision of the ARRA, the creation of **Build America Bonds** or BABs. Referring again to **Figure 2**, municipal yields skyrocketed to extreme levels relative to Treasury yields during the height of the crisis as investors, driven by the most severe crisis and collapse in assets prices since the 1930s, rediscovered risk aversion. The ARRA provision to create BABs brought investors back to the municipal market by tapping the broader and more liquid **taxable bond market**. Year to date, taxable issuance is **up over 115%,** with 70% of taxable issuance coming in the form of BABs, while tax-exempt issuance is actually **down 15.4%**. By way of contrast, if all BABs had been issued as tax-exempt bonds, issuance of tax-exempt municipals through September would be down just 3.5% from a year ago.

By shifting issuance away from the **saturated tax exempt market** to the more liquid taxable bond market, 10-year AA municipals have fallen to their lowest absolute yield level since 1967. (**Figure 1**) The impact of federal intervention, i.e., the federal stimulus money and ARRA provisions favoring the issuance of taxable municipal debt, has also been a driving force behind the continuing reversion to the mean in the relative value of tax-exempt municipals. In addition, there has also been a confluence of other factors favoring municipals including record cash flows into mutual bond funds driven by artificially low rates on money market funds, crossover taxable accounts attracted to municipals for their higher credit quality and a reluctance on the part of investors to put money back into the stock market. In addition, we believe the marked increase in demand by retail investors in particular, is in large part due to the strong expectation of **increasing tax rates**. It is more than a little ironic that the very means by which confidence in the financial markets in general and the municipal market in particular, has been partially restored is also the impetus which is driving perceptions about an imminent increase in state and federal tax rates, i.e., the unprecedented level of stimulus and the **resulting burgeoning deficits**. Given the continuation of factors favorable to the municipal market including the structural supply constraints created by BABs and the strong demand for tax-exempt income, we maintain our bias that the municipal market provides an **excellent value proposition for taxable investors**. Referring to **Figure 3**, we can see that current nominal yield levels on AA GO municipals **exceed** those of taxable Treasury yields on a **before-tax basis** in the 15-year and longer maturity area. This is one reason behind the current attractiveness of tax-exempt municipals to **cross-over taxable investors**, the opportunity to increase yield on a before-tax basis with little to no diminution in credit quality. However, it is with **taxable investors** who can benefit from tax-exempt income that the real value proposition lies. As illustrated in **Figure 3**, at current yield levels, municipal bonds offer individual investors yields nearly twice that of Treasury yields on a tax-equivalent basis. The value of the tax-exemption in the **current environment** is underscored by a comparison to what current tax-equivalent yields on municipal bonds *would be* if they traded at their **historical relationship to Treasury's**. (Green line) When viewed from this vantage point, the exceptional value of the current level of after-tax yield available to investors in the municipal market becomes apparent. And given the government's demonstrated willingness to do **"whatever it takes"** to restore normalcy to the markets and prevent a debilitating recession, we believe that those factors which are currently favoring the municipal market will continue for the foreseeable future.

**Figure 3**

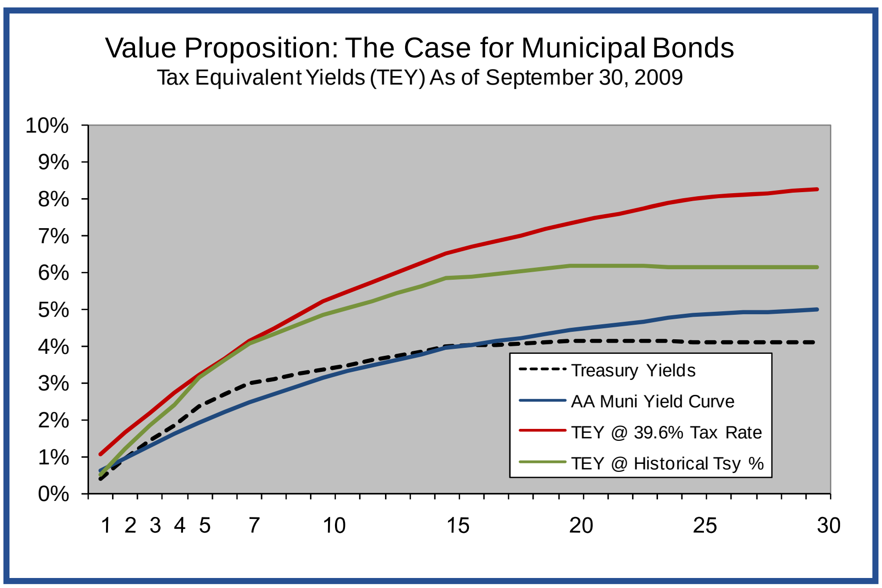


Figure 4

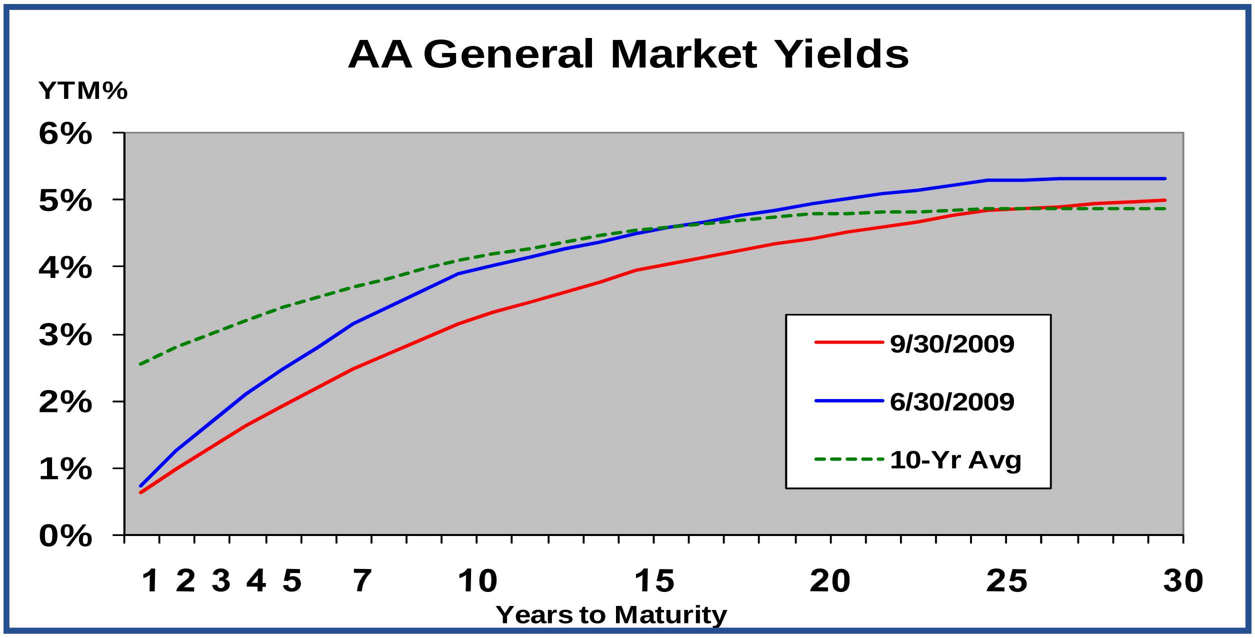
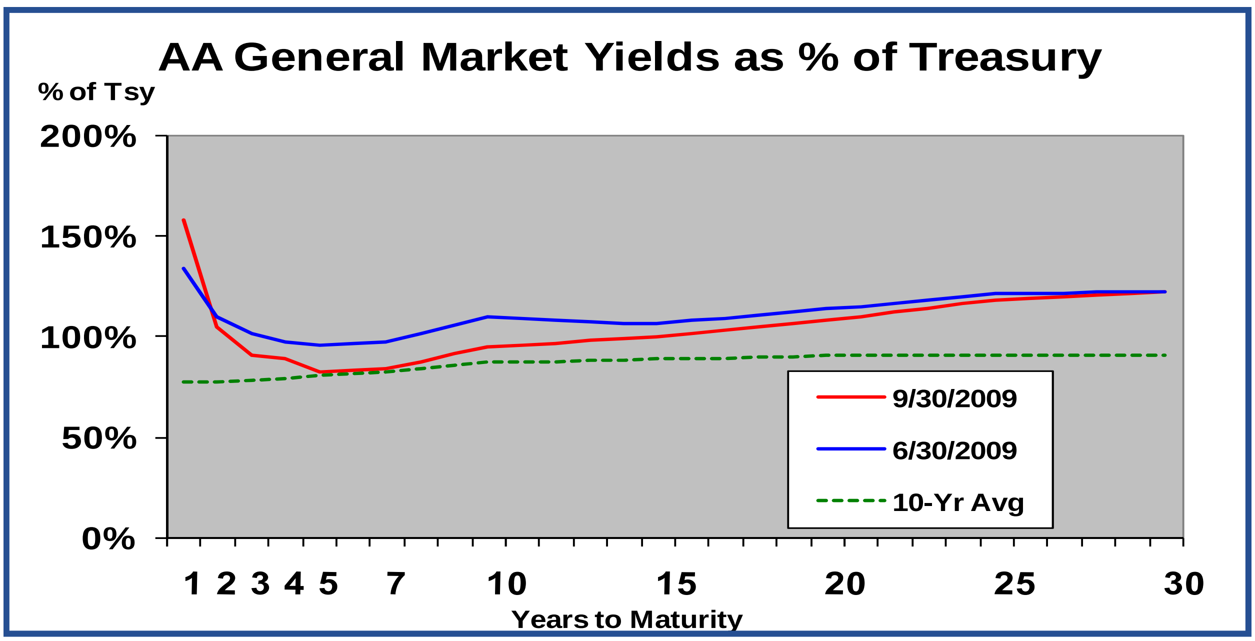



Figure 5




| | 10 Yr Avg | 6/30/2009 | 9/30/2009 |
|---|---|---|---|
| 2-Year AA Municipal | 77% | 110% | 105% |
| 5-Year AA Municipal | 80% | 96% | 82% |
| 10-Year AA Municipal | 87% | 110% | 94% |
| 25-Year AA Municipal | 90% | 121% | 118% |