Redstone Advisors

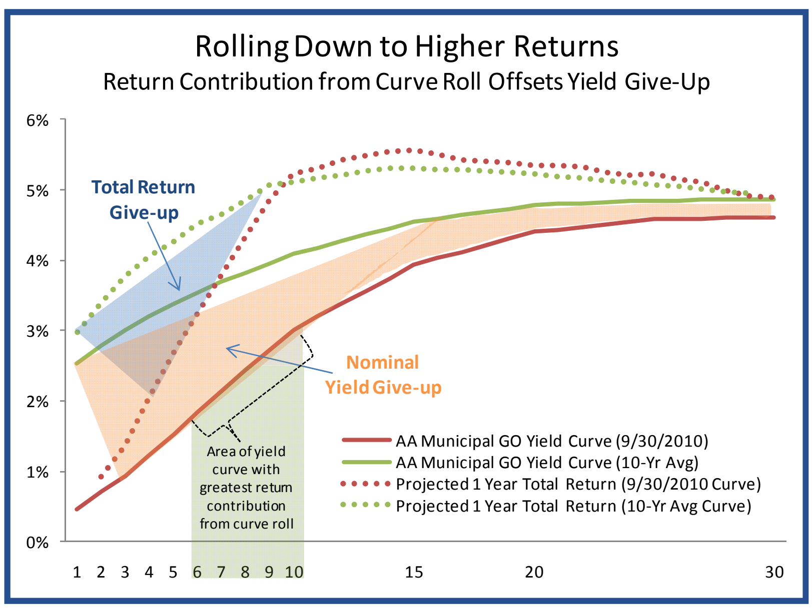
Municipal Market Review

Third Quarter 2010

Municipal yields ended the third quarter of 2010 sharply lower as assets continued to be reallocated out of municipal money market funds and into municipal bond funds, predominantly short-term funds. Referring to **Figure 5**, we can see that while yields fell across the entire yield curve, the rally was more pronounced in the short and intermediate maturities resulting in a noticeable "sag" in the belly of the curve. On average, yields for on-the-run maturities between 3 and 10 years declined by approximately 55 basis points while on-the-run maturities greater than 10 years declined by an average of 23 basis points. As a result, the municipal yield curve underwent only a very slight bullish flattening (just 3 basis points) as short and intermediate-term yields declined more than long-term yields. While the overall shape of the municipal yield curve ended the quarter modestly flatter, the change in the shape of the yield curve was again a tale of two curves with the municipal yield curve flattening markedly at the front end, while steepening sharply 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 229 basis points, 32 basis points flatter than the second quarter ending level of 261 basis points. Conversely, the long end of the municipal yield curve as measured by the 10s-to-30s spread, ended the third quarter at a level of 160 basis points, 29 basis points steeper than the second quarter yield spread of 131 basis points. As a result the overall municipal yield curve as measured by the 2s-to-30s yield spread closed out the quarter just 3 basis points flatter at an ending level of 389 basis points.

Despite the modest flattening of the yield curve, the current municipal yield curve, at 389 basis points, remains extremely steep as the Federal Reserve continues to enforce a zero interest rate policy (ZIRP) in an effort to reflate the economy. As such the municipal market continues to offer investors attractive **yield curve roll** opportunities. Looking at the historical shape of the yield curve and level of municipal yields as reflected by the 10-year average curve in **Figure 1**, we can see that while current nominal yields are markedly lower than their historical levels, the yield curve is nearly **twice as steep**. And while this **trade-off** between lower nominal bond yields and **increased total return** from curve roll is not *pari passu* across the yield

Figure 1



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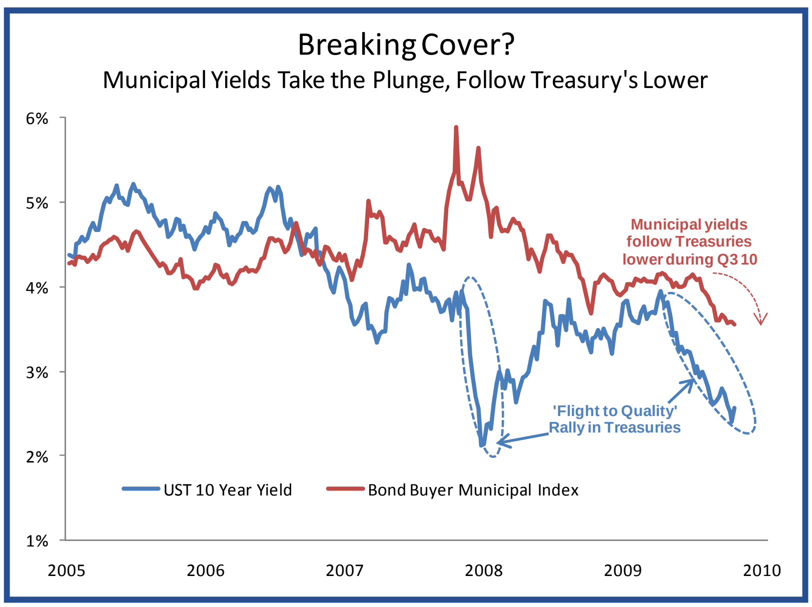
curve, nevertheless the unintended consequence of the Fed's ZIRP does offer active managers an opportunity to **off-set** a substantial portion of the nominal yield give-up on municipal bonds. This trade-off is reflected in **Figure 1** which graphs both the September 30, 2010 AA municipal yield curve (red line) and the 10-year average municipal yield curve (green line) against their respective **projected 1-year total return scenarios** (red and green dotted lines). As we can see the chart highlights the relative size of both the nominal yield give-up (orange area) as well as the total return give-up (blue triangle). And in fact the nominal yield give-up is actually **open-ended** in that current municipal yields are lower than 10-year average municipal yields across the entire yield curve. As such what is most striking is that although the gap in nominal yields is open-ended, the gap or **give-up in total return is not**. In fact the projected 1-year total return for the current municipal yield curve exceeds that of the 10-year average municipal curve from the 9-year maturity area out to 30-years, reflecting the potentially significant contribution to total returns from curve roll due to the extraordinarily steep yield curve. As such, while at first glance it might appear that an investor must move further and further out both the yield and risk curve in order to close the nominal yield gap and so increase total return, this is simply not the case. For this reason we continue to favor the placement of new money in that part of the municipal yield curve which offers the most compelling opportunities for curve roll and currently that would encompass the **6-to-10 year area** of the municipal yield curve as reflected in **Figure 1** (green shaded area). This is a strategy we continue to pursue when it is appropriate for our clients.

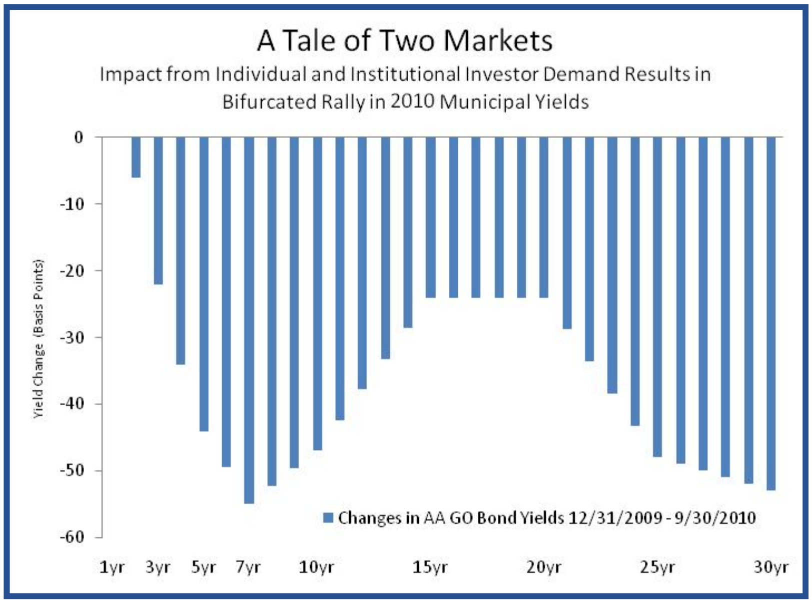
Despite the sharp rally in municipal bond yields and the modest "sag" in the belly of the curve, municipal yields as a percentage of Treasury yields, i.e., the **relative value** of municipal bonds remained **effectively unchanged**, albeit at historically high levels. (See **Figure 6**) And as we discussed last quarter, the **dichotomy** between **low absolute bond yields** and **high relative value** in the municipal bond market continues. However, last quarter relative values **rose markedly** because municipal bond yields *"failed to participate"* in the on-going *"flight to quality"* rally in Treasury yields. In contrast, relative value in municipals was **unchanged** this quarter as municipal bond yields took the **proverbial plunge** and followed Treasury yields **lower** during the third quarter. This is reflected in **Figure 2**, where we can see that after **trending sideways** for much of the last 12 months, municipal bond yields, as represented by the Bond Buyer Municipal Index yield (red line), rallied sharply during the quarter. The **reluctance** to which we alluded last quarter on the part of individual investors to participate at the **low absolute yield levels** for offer in municipal bonds was apparently overcome by the increased uncertainty surrounding **future tax policy**. With the Bush tax cuts set to sunset at the end of this year and with no legislative action on the horizon during the election cycle, many investors have chosen to increase their allocation to tax-exempt municipal bonds, particularly in short to intermediate maturities. This has been reflected by the continued strong inflows into municipal bond funds as reported by the Investment Company Institute's flow

Figure 2



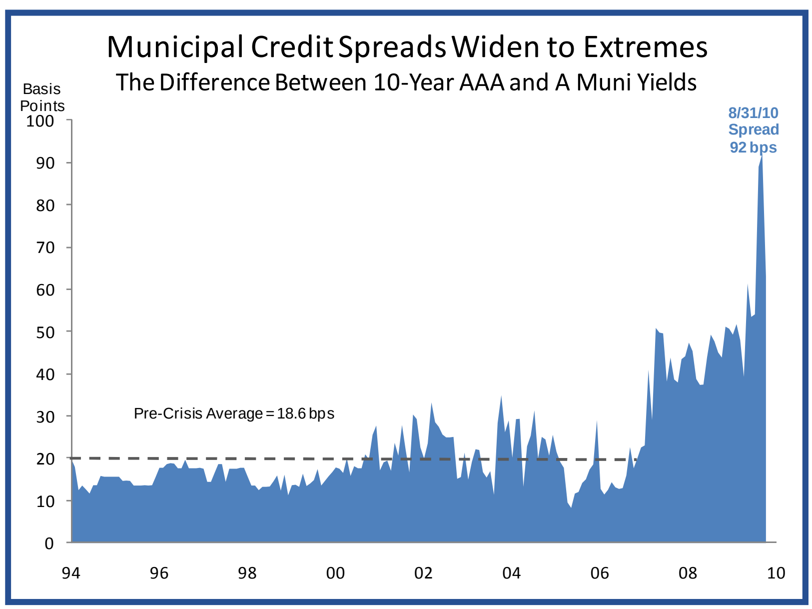
of funds data. Adding to the uncertainty, particularly for institutional municipal investors, has been the question of whether or not the Build America Bonds (BAB) program will be extended by Congress, and if so, in what form and for how long. As we have stated in previous reports, BAB issuance has effectively **reduced the supply** of traditional tax-exempt municipal bonds in favor of taxable BAB issuance, most particularly in the longer maturities. And given the increased concerns regarding the prospects for an **"orphaned"** BAB market due to inaction by Congress, there has been a marked acceleration in BAB issuance concentrated in longer maturities, effectively draining tax-exempt supply from the long end of the market. The impact of these independent actions by individual and institutional investors has resulted in a **"tale of two markets"** and is reflected in **Figure 3** which graphs the year-to-date change in municipal bond yields across the yield curve. As we can see, the increased demand by **individual investors** has had its greatest impact on yields in **shorter maturities** while the impact of the loss of supply to taxable BAB issuance can be seen in the marked rally in **longer maturities**. The overall impact of this dichotomy of demand has been a bifurcated rally in municipal bond yields thus far in 2010, resulting in a **"butterfly effect"** on yields and a bullish flattening of the overall municipal yield curve of nearly 50 basis points. The result has been a general cheapening in the belly of the curve, suggesting an incremental strategy of **"meeting in the middle"** for new money may be appropriate from an income perspective.

Figure 3



However, while the demand for municipal bonds by individual investors has increased due to heightened concerns over an anticipated increase in taxes as well as a desire to earn something above the government mandated **"zero percent"** on their investments, that demand has not been insensitive to concerns regarding risk. Referring to **Figure 4** which we introduced last quarter, we can see that the **yield spread** or the risk premium between 10-year AAA and A quality municipal bonds has **widened** to all-time historical extremes. Between 1994 and the on-set of the financial crisis and ensuing Great Recession in 2007, the yield spread between

Figure 4



AAA and A issues averaged approximately **20 basis points**. Since the beginning of the crisis, that spread has averaged just over **50 basis points** reaching an all-time high of **92 basis points** in August of 2010. As we noted last quarter, this increase in risk-premium in part reflects the dislocation from the on-going **transition** of the municipal bond market from a homogeneous, rate-sensitive, AAA-insured market, to a heterogeneous, credit-sensitive market comparable to the corporate market. This transition which began with the loss of the monoline bond insurers in 2008, was accelerated with the recent recalibration of credit ratings for municipal issuers by the credit rating agencies, effectively making municipal debt ratings compatible with those of corporate debt. Individual investors no longer able to blindly rely on the third-party guarantee of a bond insurer, have been obliged to either perform the requisite due diligence or migrate to the safe haven status of AAA-rated debt only.

In addition, as we detailed last quarter, investors concerns regarding municipals continues to be exacerbated by the **negative headlines** surrounding the financial condition of the states and by extension, municipal debt. In particular, a 600-page tome by analyst Meredith Whitney entitled 'The Tragedy of the Commons' has elicited a highly publicized stir since it was released on September 28th. While claiming that her study is the *"most comprehensive, in-depth analysis of the states' . . . ever assembled by the government, foundations, or another research firm"*, Ms. Whitney concludes that *"the states represent the new systemic risk to financial markets."* With all due respect to Ms. Whitney, given that the nearly $3 trillion municipal bond market is comprised of over 2 million dissimilar bond issues of all shapes and sizes, issued by over **50,000 separate state and local entities**, each carrying its own unique credit risk profile, an analysis of the fiscal condition of the **50 states**, no matter how comprehensive, falls woefully short of establishing the municipal bond market as the next source of systemic risk. While we readily concede and have written extensively about the state's ongoing struggle to balance their budgets against a backdrop of the most severe contraction in tax revenues since the Great Depression, the vast majority of municipal bonds are issued by separate political subdivisions, agencies or instrumentalities of the state, not the states themselves. And while we again readily concede that many local municipalities rely on their respective states for a percentage of their revenues, that level of subsidy is relatively small, with the largest source of revenue for local municipalities coming from property taxes which on average, account for over 70 percent of their total revenue. And even though property values have fallen sharply in certain parts of the country during the recession, nationwide property tax collections actually increased by more than 4 percent in 2008. In fact property tax collections were lower in only four states in 2008 versus 2007, while in three states property tax collections were up by 10 percent or more. In addition, as we discussed last quarter;

> *"The generally low credit risk of municipalities is in part a consequence of the* ***unique laws applicable to municipalities****. While corporations can file for bankruptcy under either Chapter 7 (liquidation) or Chapter 11 (reorganization), municipalities, when allowed by their governing state laws, file for bankruptcy under Chapter 9. Bankruptcies of municipalities under Chapter 9 differ from corporate bankruptcies in several important respects. First, involuntary bankruptcy filings are not permitted. Secondly, Chapter 9 provides only for an adjustment of the municipality's debts not its liquidation. And finally, the municipality's taxing powers are not affected by the filing. These bankruptcy differences specifically provide for a municipality to* ***continue its existence*** *during a bankruptcy, including maintaining its operations and revenue collections, thereby greatly increasing the opportunity for a potential recovery on its defaulted debt in the future.*

Our point is that while Ms. Whitney's report may provide valuable insight into the well-documented fiscal woes of the 50 states, it suffers from the ***'fallacy of division'*** when the analysis is uncritically transferred to the underlying issuing municipalities to arrive at an assessment of their respective financial condition. Within the intricate, interrelated and heterogeneous relationships between states and local municipalities and the debt issued thereby, what is true of the whole [state] cannot be presumed of its constituent parts. [local municipalities] Ms. Whitney's analysis overlooks the claim bondholders have over pledged revenues and the unlimited taxing authority of the issuing municipality. Bonds issued by banks and financial institutions, Ms. Whitney's specific area of expertise, clearly lack such protections. At the risk of repeating ourselves again; *"The simple fact is that state and local governments, coping with unprecedented revenue declines,* ***are*** *fulfilling their legal obligations to balance their budgets by reducing costs and raising taxes to protect a key constituency:* ***the owners of approximately $2.8 trillion of municipal bonds****."* It is clearly in the best interest of the states to avoid defaults at the local level. This was recently borne out in Harrisburg Pennsylvania, as the Governor stepped in to avert a default because of the widespread damage it could have caused across the Commonwealth of Pennsylvania for localities looking to access the capital markets. It is for this reason that U.S. state and local government bonds enjoy a proud history of a low number of defaults and, when they rarely occur, higher recoveries compared to corporate debt, both investment grade and speculative.

While we believe that states will continue to face significant challenges in managing increasing expenditures in a lower revenue environment, we nevertheless remain confident that most states will take the necessary steps to **maintain access to capital markets**. Overall, debt service is a small percentage of a state's total expenditures when pension obligations are excluded. In fact it is estimated that debt service amounts to only between 3 and 9 percent of total expenditures among all states. At those levels, the **cost of non-payment** in the form of impaired access to capital would far outweigh any temporal benefit from a payment default. Therefore, while there may be isolated defaults, particularly within the higher risk class of securities, it remains our opinion that there will not be **systemic defaults**, and as such **bonds will be paid**. As to those analysts who may wish to benefit from the current boomlet in **doomsaying**, we offer the following quote from the cartoonist Charles Schulz; ***"Don't worry about the world coming to an end today; it's already tomorrow in Australia."***

Figure 5

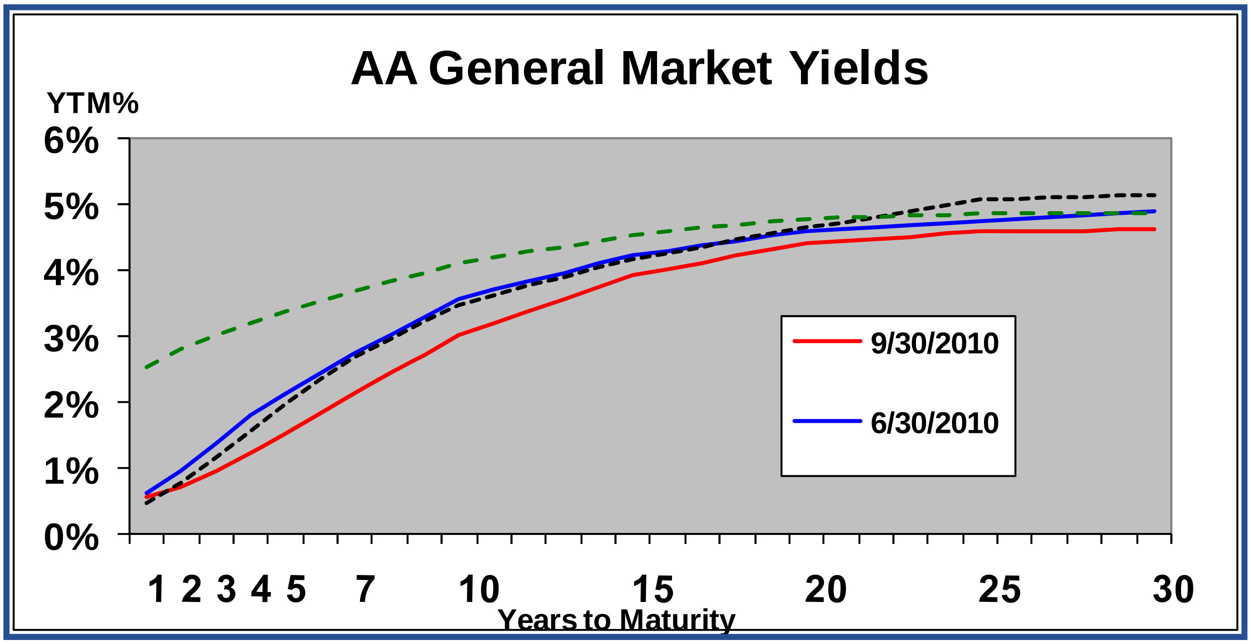
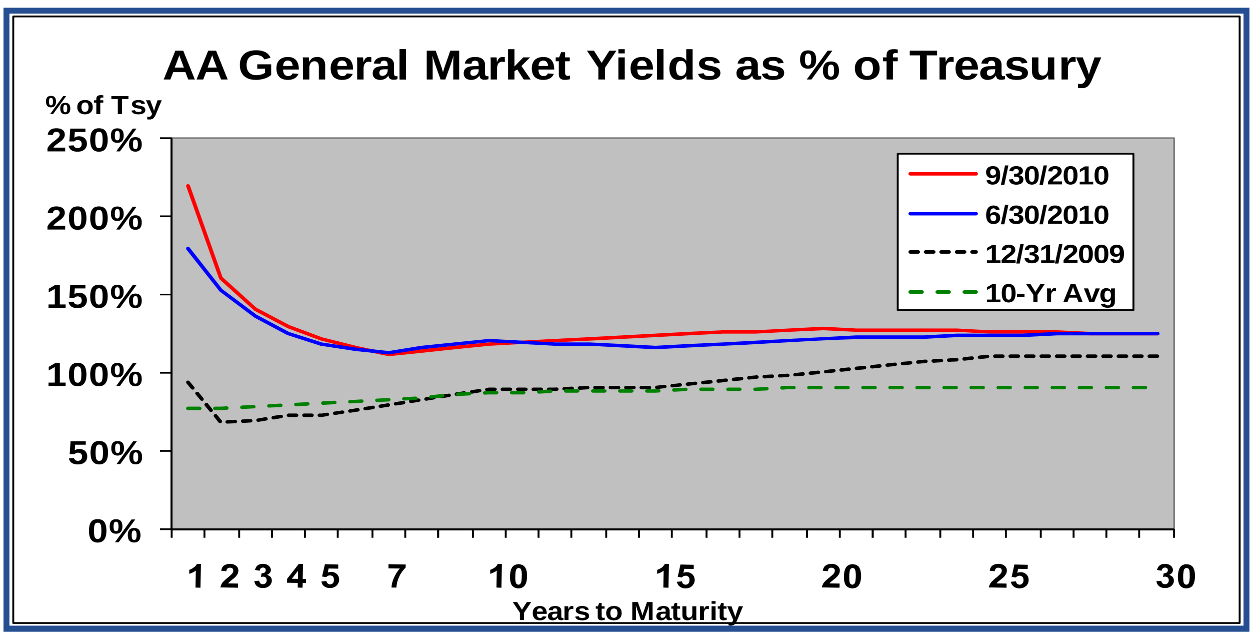


Figure 6



	10 Yr Avg	6/30/2010	9/30/2010
2-Year AA Municipal	77%	152%	160%
5-Year AA Municipal	80%	118%	121%
10-Year AA Municipal	87%	121%	118%
25-Year AA Municipal	90%	124%	126%