



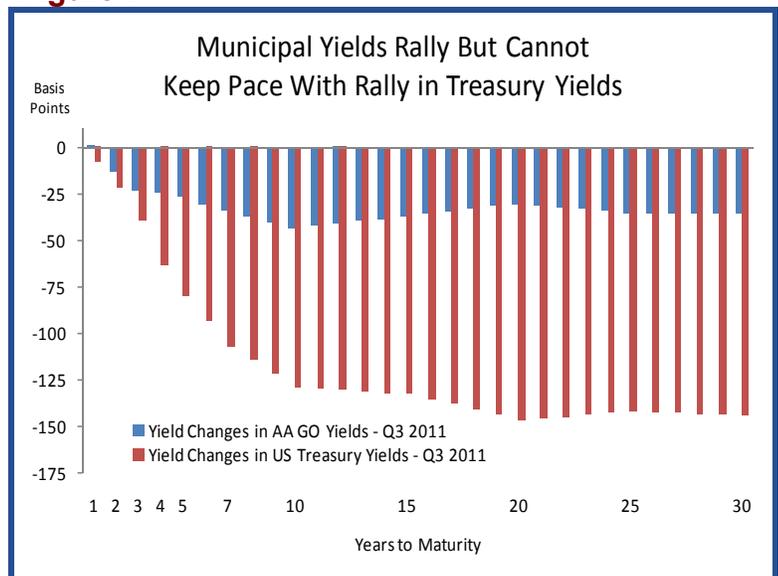
Municipal Market Review

Third Quarter 2011

Municipal bond yields again **rallied sharply** during the third quarter, with most of the decline in yields occurring in the month of August. Referring to **Figure 8**, we can see that yields declined across the entire municipal yield curve, resulting in a modest shift downward in the entire curve. The rally in yields was the greatest in the 7- to 10 year and 25-plus year maturity areas. This curve reshaping is highlighted by **Figure 1** where we can also see that while municipal yields declined during the quarter, they could not keep pace with the impressive rally in Treasury yields. It is interesting to note that the rally in both Treasury and municipal bond yields took place amidst the shadow of the credit downgrade of US Treasury debt by Standard & Poor's. On August 5th, S&P lowered its rating on US Treasury's from AAA to AA+ with a negative outlook. At the time, the rating agency cited its concerns about the resolve of a deeply divided and partisan Congress to deal with the country's rising debt levels in a timely and effective manner. Far from a negative reaction to the announcement, both Treasury and municipals yields fell sharply with the yield on 10-year Treasury notes declining by approximately 85 basis points to a level of 1.71 percent, its lowest level since WWII. Additionally, many analysts believed that the Treasury downgrade would have an adverse knock-on effect on municipal yields due to the funding relationship between the federal government and state and local municipalities. According to the Office of Management and Budget, federal grants to state and local governments are expected to total \$425 billion in fiscal 2012. To date, the impact of the US Treasury downgrade on the municipal market has been non-existent.

As a result of the rally in municipal yields, the municipal yield curve experienced a modest bullish flattening with intermediate and long-term yields declining more than short-term yields. Specifically, the **front-end** of the curve, as measured by the 2s-to10s spread, **flattened** by 30 basis points as 10-year yields declined more than 2-year yields, while the **long-end** of the curve, as measured by the 10s-to-30s spread, experienced a **bullish steepening** of 8 basis points as the decline in 10-year yields exceeded the decline in 30-year yields. For the quarter, this curve reshaping favored investments in the **intermediate to long maturity area** of the yield curve.

Figure 1

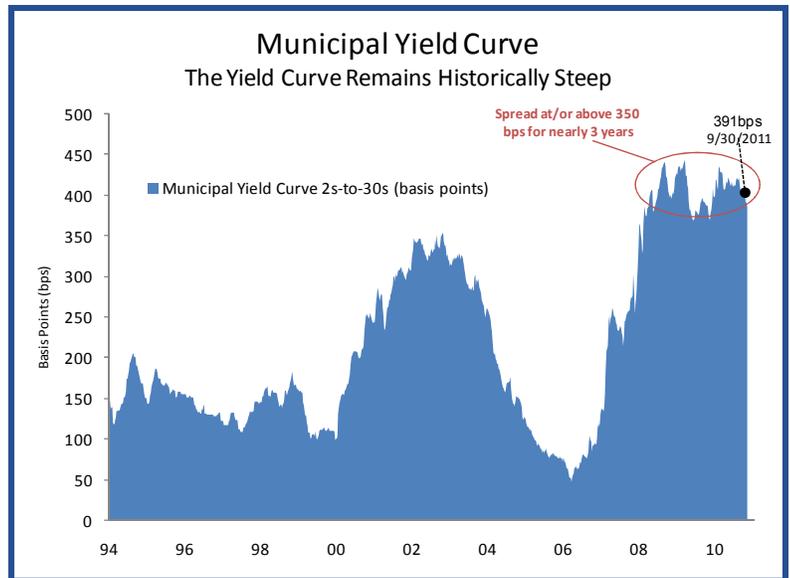


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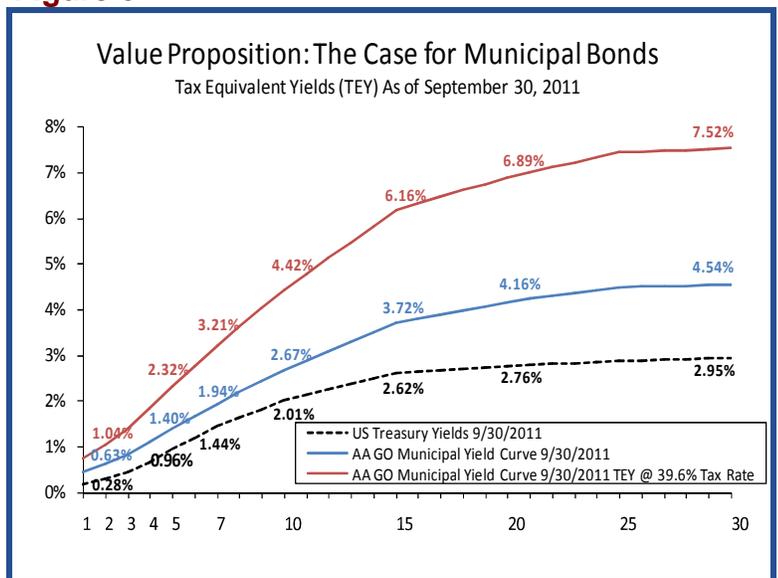
Referring to **Figure 2**, we can see that despite the modest bullish flattening during the third quarter, year-to-date the overall shape of the municipal yield curve, as measured by the 2s-to-30s yield spread, remains historically very steep at its quarter ending level of 391 bps. The primary driver of this steep yield curve continues to be the Federal Reserve's zero interest rate policy or **ZIRP** whereby they remain committed to keeping short-term interest rates at or near zero for an "extended period of time." The impact of the Fed's transparency regarding ZIRP is reflected in **Figure 2** by the *extended period of time* over which the yield curve has **remained** historically steep. In fact the 2s-to-30s municipal yield spread has held at or above **350 basis points** since the Fed reduced the Funds Rate to 0.25 percent in December of 2008 on the heels of the **Lehman Brothers bankruptcy**. That is a period of nearly 3 years and holding, and as such, it is without historical precedent. And given that the Fed recently publicly reiterated their commitment to ZIRP until at least 2013, there is very little indication that this situation will change soon.

Figure 2



The import of the steep slope of the yield curve and the Fed' continuing commitment to maintaining it, lie's in the potential opportunities it offers investors to generate increased returns in a low nominal yield environment. The two primary sources of this increased return are an **incremental pick-up in nominal yield** and **curve roll**. Because the slope of the yield curve remains steep, investors can significantly increase the nominal yield in their investment portfolio with an extension from cash to the intermediate area of the yield curve. **Figure 3** illustrates this on both a **nominal** and more importantly, on a **tax equivalent basis**. The black line illustrates US Treasury yields, the blue line AA GO municipal yields and the red line represents those same AA GO municipal yields on a tax equivalent basis using an effective tax rate of 39.6 percent, all as of September 30, 2011. Thanks to the unflagging commitment by the Fed to keep interest rates low, the current yield on cash remains near "zero." However a five-year AA GO mu-

Figure 3



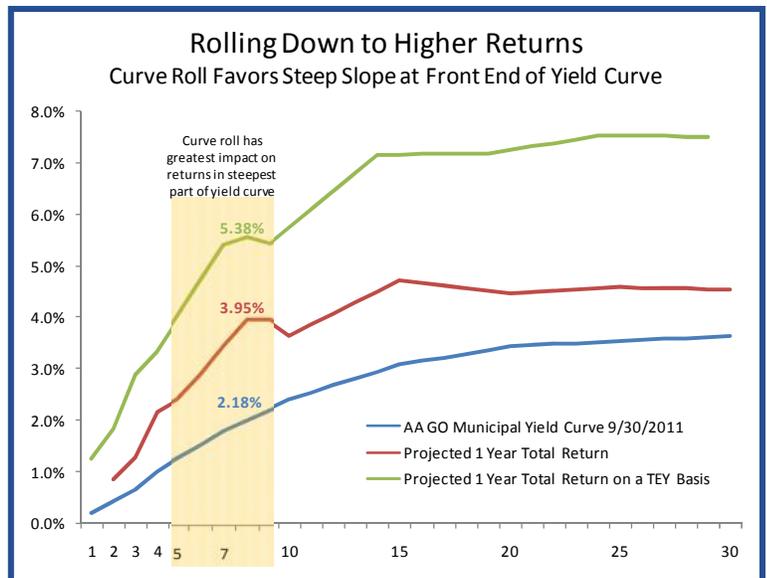
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municipal bond which currently yields around 1.40% nominally, offers a **232 basis point increase over cash on a tax equivalent basis**. Likewise, a ten-year AA GO municipal bond which currently yields around 2.67%, offers a **442 basis point increase over cash on a tax equivalent basis**. In this low nominal yield environment, investors far too often focus solely on the nominal purchased yield and fail to consider the real value of a municipal bond, its tax adjusted yield. This is especially important in an environment where the yield curve is historically steep and the return on cash is zero and may reasonably be expected to remain so for an extended period of time. Additionally, many investors continue to view money market funds as a safe haven investment with minimal to no risk. However, according to data filed with the SEC, nearly 50 percent of the **\$1.8 trillion** in prime money market fund assets are invested in the **debt of European banks**. Recall that at the height of the financial crisis in 2008, one major money market fund, the Reserve Fund, “**broke the buck,**” falling below the sacred \$1 mark for the first time in history because of its short-term debt holdings in Lehman Brothers which ultimately filed for bankruptcy.

In addition, the persistently steep slope of the municipal yield curve, particularly in the intermediate part of the curve, continues to offer investors additional return opportunities in the form of **curve roll**. As we wrote last quarter; “*by holding short-term rates near zero, they (Fed) 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.*” This opportunity is illustrated in **Figure 4** which graphs the same AA GO municipal yield curve (blue line) from Figure 3 against the projected 1 year total return for each maturity period (red line). By holding bond yields unchanged over a simulated 1-year holding period, we are able to isolate the potential increase in total returns attributable solely to curve roll. As we can see, curve roll has the greatest potential impact on those maturities in the steepest part of the yield curve, i.e., the area on the chart denoted by the highlighted rectangle. The green line presents the same 1-year projected total returns **after adjusting the return from income to a tax equivalent basis**. Again we see that the steepest part of the curve offers the greatest incremental return per unit of interest rate risk. For example, an 8-year AA GO municipal bond which currently yields **2.18 percent** would generate a 1-year total return of **3.95 percent** assuming interest rates remained unchanged. The difference, **177 basis points**, is attributable to the impact of **curve roll** as the bond ages. And after adjusting the income return to a tax equivalent basis, the 1-year projected return rises to **5.38%** or fully **320 basis points** above the nominal yield of 2.18 percent. That represents an impressive **146 percent** increase in return over and above the simple nominal yield. As such, while in this period of ultra-low nominal yields it might, at first glance, appear that an investor must move further and further out both the yield and risk curve to increase total return, this is simply not true. We believe the 3-to-10 year maturity area of the

Figure 4



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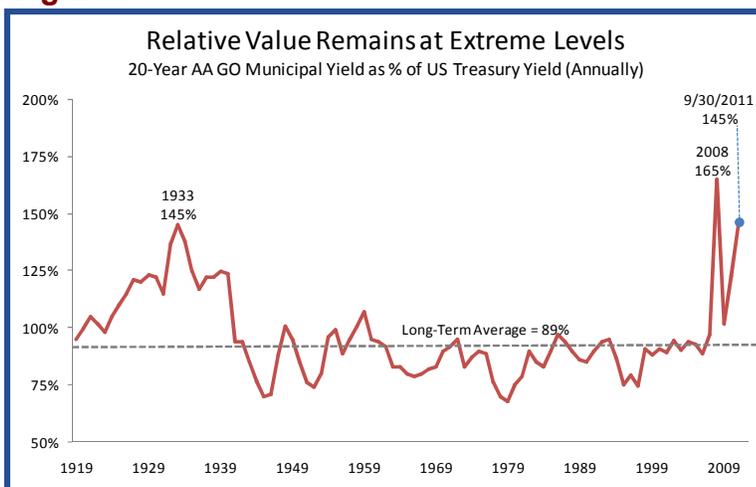
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municipal yield curve continues to offer the most compelling curve roll opportunities due to annual yield drops of 34 to 43 basis points. In addition to emphasizing purchases that are positioned in short-to-intermediate maturities in order to benefit from curve roll, we also emphasize the use of high coupon or “**cushion bonds**” where practicable. By using cushion bonds, the total return profile of the portfolio is moderately biased toward income over capital gain. Our objective is to reduce return volatility and provide downside price protection against an unexpected rise in interest rates.

Referring to **Figure 9**, we can see that owing primarily to the sharp rally in Treasury yields, **municipal yields as a percentage of Treasury yields**, i.e., **relative values**, are again well above both their long-term average and year-end 2010 levels across the entire municipal yield curve, suggesting that municipal bonds remain cheap relative to overvalued Treasury’s. Again due to the extremely steep curve slope, short and intermediate bonds appear more attractive from a relative valuation perspective, with 5 and 10-year municipal yields currently at **146** and **133 percent** of Treasury yields respectively, compared to their 10-year averages of **80** and **87 percent** respectively.

[Note: The extremely high relative value of short-term municipals represents an anomaly created by the Fed’s zero interest rate policy] **Figure 5** helps to put this current period of extreme relative value in municipal yields into a longer-term historical perspective. Referring to the chart which graphs the 20-year AA GO municipal yield as a percentage of the 20-year US treasury yield annually since 1919, we can see that the levels reached in the current financial crisis are rivaled only by those of the 1930’s crisis. Further, at its current quarter ending level of **145 percent**, the relative value of municipal bond yields remains well above the long-term average of only **89 percent**. Historically municipal

Figure 5



bonds have yielded less than 100 percent of underlying Treasury’s due to the value of the **tax exemption**. Nevertheless, municipal yields have exceeded those of underlying Treasury’s since the inception of the current financial crisis due to the extreme dislocation which has occurred in the municipal market with the loss of the monoline insurers, and subsequently the Auction Rate and Variable-Rate demand note markets, combined with the extreme flight-to-quality response into Treasury’s. Given today’s ultra-low nominal yields, municipals continue to offer excellent relative value, particularly on a tax equivalent basis.

As we discussed in our last Market review, with the collapse of the monoline insurers, came the end of a long running era when monoline insurers “**roamed the earth**” and over **60 percent** of all municipal issues carried bond insurance. Subsequent to the Great Recession and financial crisis, all but one monoline insurer either exited the market, filed for bankruptcy or had their own credit rating downgraded beneath that of most of the underlying municipal bonds they insured. As a result, the municipal market underwent a tectonic shift as the process of “**credit discovery**” replaced undifferentiated trading based on an overreliance on bond insurance. This tectonic shift is reflected in **Figure 6** where we can see that under the old era of monoline bond insurance, the average yield spread between a AAA and A municipal bond was less than 20 basis

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points. Given the non-homogenous nature of municipal market, 20 basis points represents very little differentiation across the **seven discrete quality ratings** that exists between AAA and A. Contrasting the monoline era with the new era of credit discovery, we find that risk spreads have undergone a nearly **six-fold increase**, giving rise to the recognition of the vast differences in the underlying credit profiles of the municipal issuers. We continue to believe that this dislocation as represented by the increase in credit spreads represents an enormous opportunity for adding value to those who can properly evaluate the underlying credit profile.

State tax revenues continue to register positive growth. Through the second quarter of 2011, total tax revenue for state and local governments rose **6.9 percent** versus a year earlier, representing the seventh consecutive quarterly increase since revenues hit their nadir in the third quarter of 2009. Referring to **Figure 7**, we can see that total state revenue has nearly recovered to its 2008 high, reinforcing our oft expressed view regarding the overall **high credit quality of municipal** credits due to their constitutional mandate to balance their budgets and their **captive revenue streams** from water, sewer and transportation fees. Revenues at the local government level continue to trend sideways due to the unresolved crisis in housing and the associated decline in property taxes, their largest source of revenue.

Finally, the Obama administration's **Jobs Bill** includes a proposal that would cap the **exemption** for municipal bond investors at **28 percent**, down from the current **35 percent**. It would apply to single taxpayers with incomes over \$200,000 or married couples with incomes over \$250,000. While we do not believe this proposal will be enacted, the **uncertainty** surrounding the passage of this proposal is helping to keep municipal yields higher than they would be otherwise, making entry yields more attractive for new investors.

Figure 6

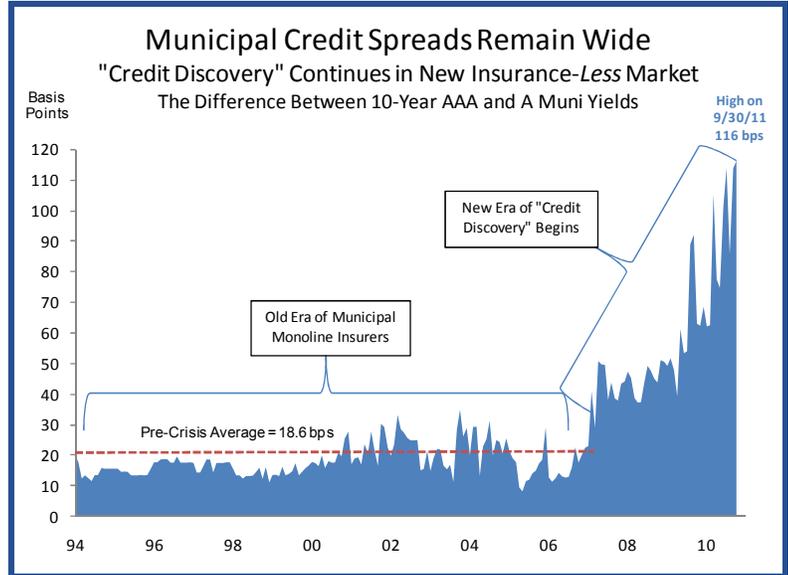
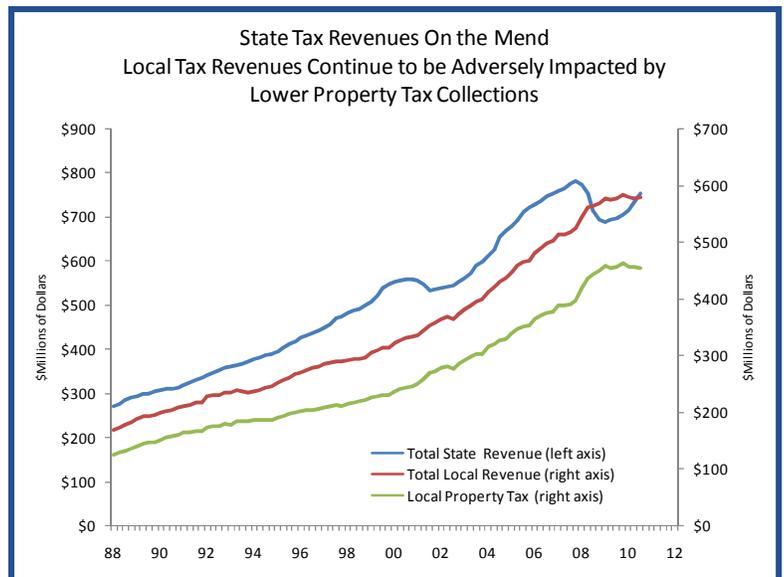


Figure 7



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Figure 8

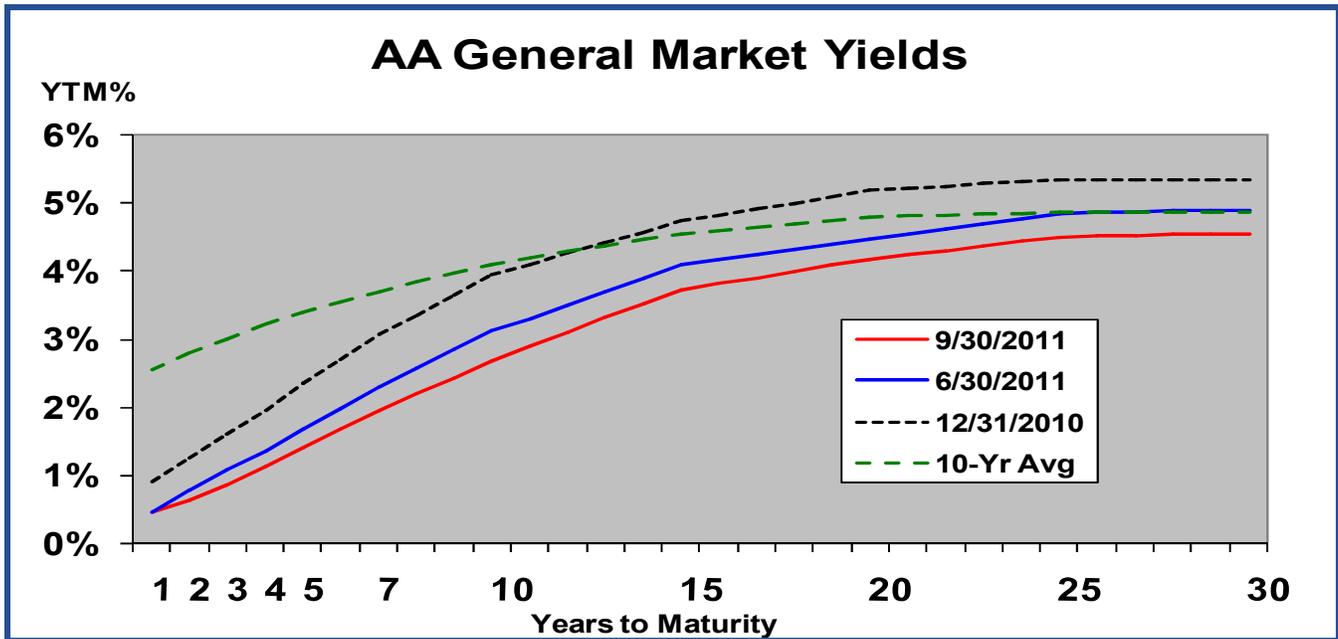
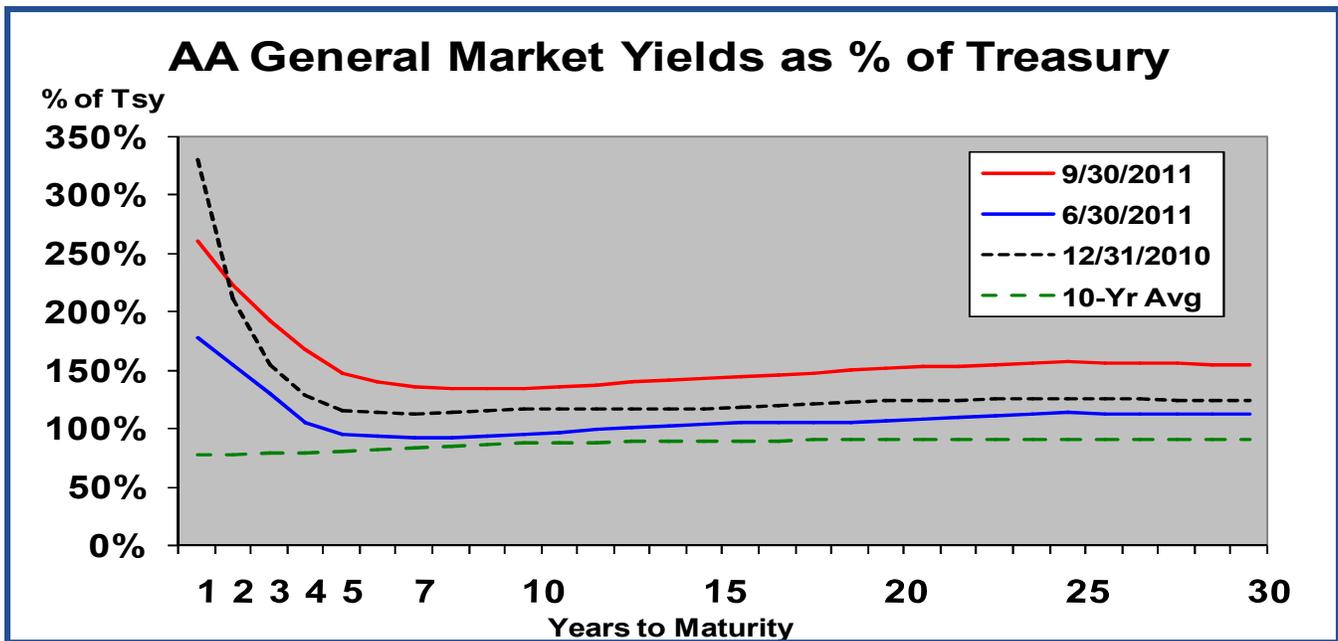


Figure 9



| | 10 Yr Avg | 6/30/2011 | 9/30/2011 |
|----------------------|-----------|-----------|-----------|
| 2-Year AA Municipal | 77% | 154% | 223% |
| 5-Year AA Municipal | 80% | 95% | 146% |
| 10-Year AA Municipal | 87% | 94% | 133% |
| 25-Year AA Municipal | 90% | 113% | 156% |