

# MARKET REVIEW

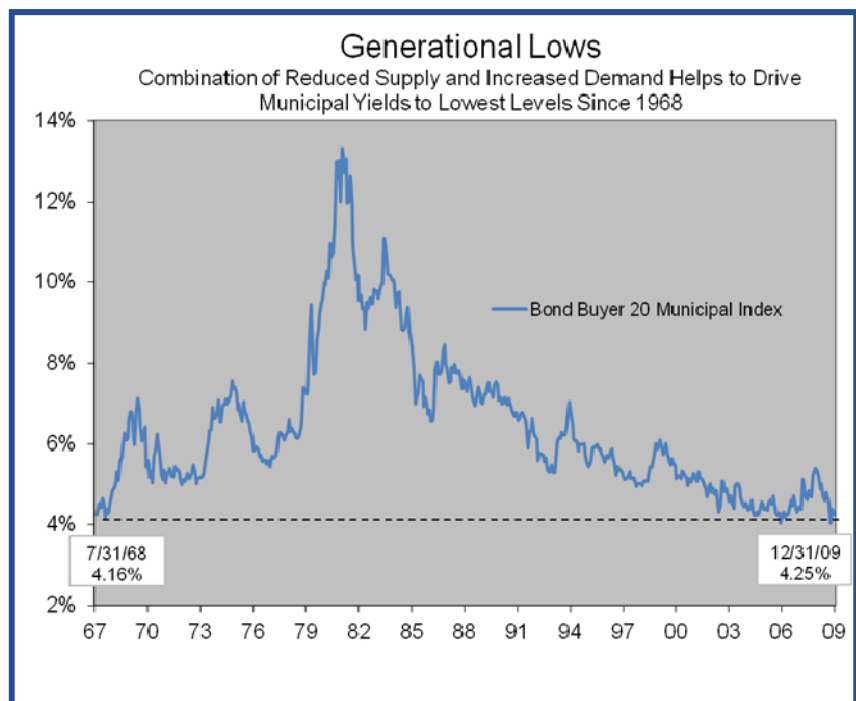
Fourth Quarter 2009 Report

## Overview of Municipal Markets

During the fourth quarter of 2009, short-term municipal yields rallied modestly while intermediate and long-term yields rose, causing the municipal yield curve to undergo a modest **bearish steepening**, with the pivot point located around the 5-year maturity area. (See **Figure 5**) As a result, municipal returns for the fourth quarter were **bifurcated** with maturities of 5 years and less posting positive returns due to falling yields while maturities greater than 5 years posted negative returns due to rising yields. However, for all of 2009, municipals turned in a very strong performance, with longer maturity municipals markedly outperforming short and intermediate maturities. Referring to **Figure 5**, we can see that for the entire year, municipal yields rallied sharply across the entire yield curve as the municipal market experienced a strong recovery following the dramatic collapse of the ARS market and the loss of the monoline insurers in 2008. By way of contrast, over the same period, Treasury yields rose sharply as they rebounded from crisis-induced 50-year lows, with the 10-year Treasury yield rising 170 basis points to close out 2009 at a level just under 4 percent. As a result, for all of 2009 the Barclays Municipal Master Index returned **12.9%** versus **-3.6%** for the Barclays Treasury Master Index. And as we discussed last quarter, despite relatively weak market fundamentals, **favorable technical conditions** consisting of an **increase in demand** for tax-exempt income and a **reduction in the supply** of traditional tax-exempt municipals, continues to exert downward pressure on municipal yields, driving them to **generational lows**. (**Figure 1**) In addition, referring again to **Figure 5**, we can see that with the additional bearish steepening that took place during the fourth quarter, the municipal yield curve remains **historically steep**. As measured by a 2s-to-30s

yield spread of **436 basis points**, the current municipal yield curve is more than **twice as steep** as the 10-year average yield curve spread of **207 basis points**. As a result, the steep slope of the municipal yield curve continues to offer excellent opportunities for increasing **total return** through capital gains from the **yield curve roll**. Currently the **4-to-7 year maturity area** offers the most compelling curve roll return opportunities with annual yield drops of **30 to 44 basis points**. In many cases, the additional **roll return** available in these maturities exceeds the return available from the **purchased yield** alone. As such, the steep yield curve continues to be a source for active managers to markedly increase total return over and above the historically low nominal purchase yields currently offered in municipals.

**Figure 1**

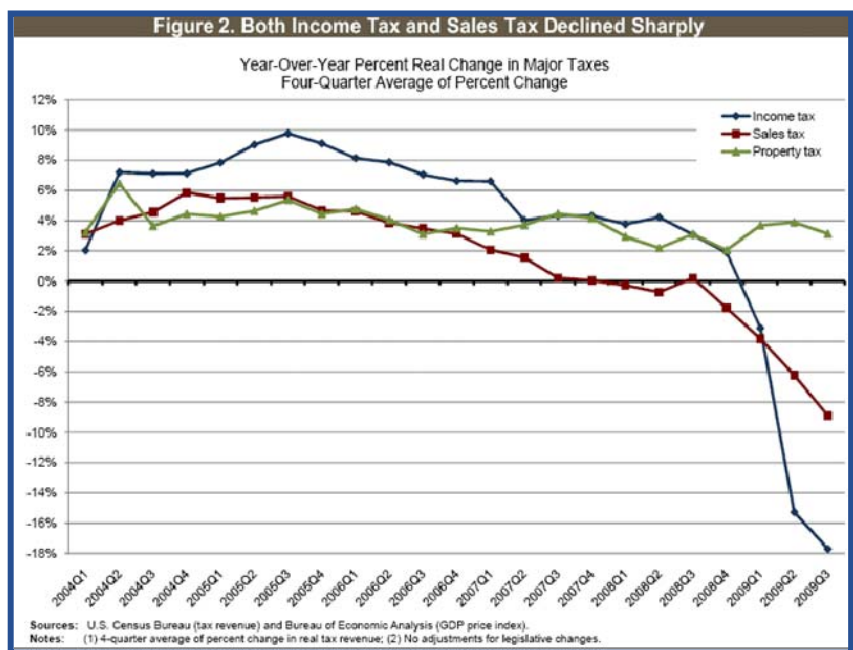


Referring to **Figure 6** we can see that during the fourth quarter of 2009, municipal yields as a **percentage of Treasury yields** continued their reversion to more normative levels. Currently, yields on maturities of less than 15-years are at relative value levels to Treasury's equal to their trailing 10-year average, suggesting short and intermediate municipal bonds are **fairly valued** relative to underlying Treasury's. At the same time, yields on maturities greater than 15-years remain at relative value levels that exceed their trailing 10-year average, thereby making longer-term bonds appear more attractive from a relative valuation perspective. Typically, municipal bonds are priced at yield levels less than that of underlying Treasury's due to the tax preference component of municipal yields whereby after adjusting for the exclusion of municipal bond interest, **tax-equivalent municipal yields** exceed Treasury yields. (**Figure 4**) The extent to which tax-equivalent municipal yields exceed nominal Treasury yields reflects both the perceived **incremental credit risk** in municipals as well as any expectations regarding **changes in tax rates**. We believe the reason for the current dichotomy between the relative value of short-term and long-term municipal bonds is being driven by the sharp increase in demand for the tax preference of municipal bonds due to expectations of an **imminent tax increase** tempered by concerns over the **near-term fiscal problems** confronting many states. As a result, as investors move money out of money market funds in search of higher yields, more of the increased demand for tax-free income is being directed to shorter maturities because of the increased level of uncertainty surrounding the resolution of state fiscal issues.

According to the most recent State Revenue Report published by the Rockefeller Institute, *"the first three quarters of 2009 were the worst on record [since 1963] for states in terms of the decline in overall state tax collections, as well as the change in personal income and sales tax collections."* Referring to **Figure 2** from the report, we can see that the adverse impact of the **Great Recession** has fallen hardest on personal income and general sales tax revenues. On a year-over-year basis, total state tax revenue as of the third quarter of 2009, fell by **11 percent**, with the income tax down 12 percent, the sales tax down by 9 percent and corporate income taxes down by 23 percent. Total tax revenues declined in 48 states, with the decline in state income and sales tax directly related to the continuing high levels of unemployment. Referring to **Figure 3** from Calculated-

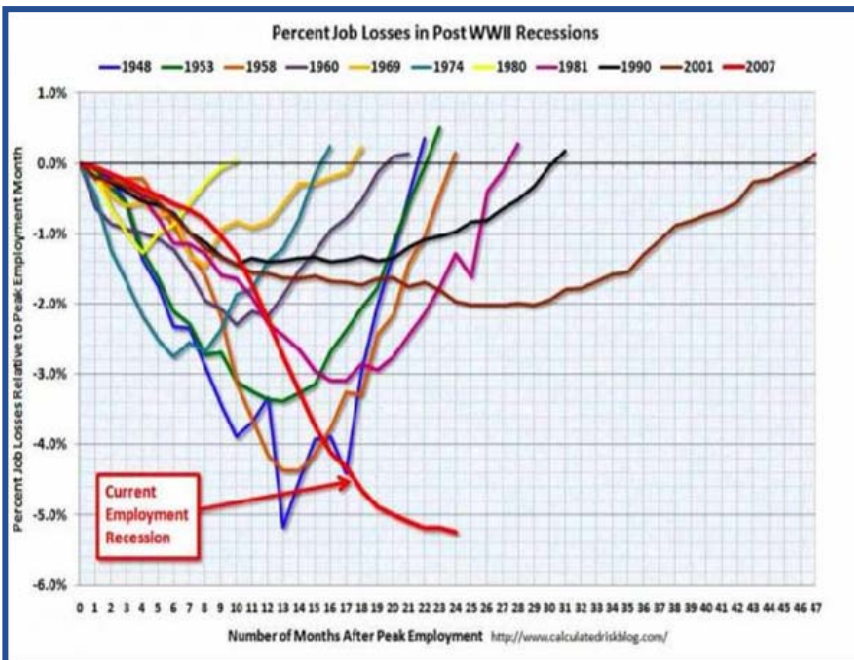
RiskBlog.com, we can see that both the **percentage of job losses** relative to peak employment and the **duration of job losses**, is the **most severe** of any post-WWII recession on record. It is this fact, above all others, that is adversely impacting the revenue outlook for many states. However, to be sure, the adverse impact of the **Great Recession** has not been evenly distributed across all states. Some states have been impacted more than others, in particular those states whose housing markets were hardest hit by the collapse of the housing bubble like California, Arizona, and Nevada. Other states such as Illinois, Michigan and New Jersey have also been particularly hard hit due to the downturn in the auto industry, unfunded pension obligations and a combination (New Jersey) of falling revenues and mandated moratoriums on

**Figure 2**



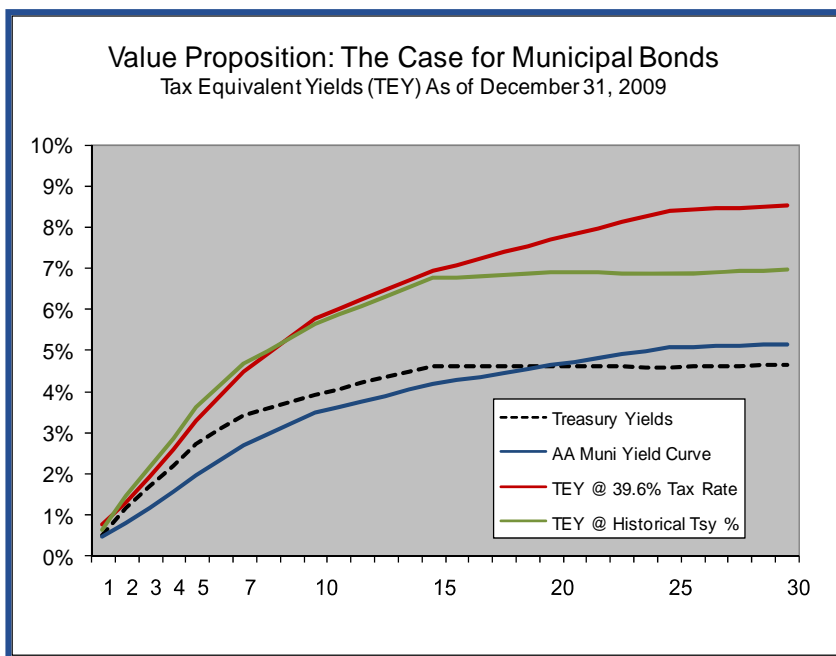
property tax increases. However, unlike the federal government, most states are constrained by law to balance their budgets, meaning revenue shortfalls must be met by a combination of increased taxes and reductions in state services. Additionally, the local tax slowdown has been less severe than the state tax slowdown. As such, while we remain confident that with few exceptions, the **underlying credit quality** of general obligation and essential service state and local municipal debt remain **unimpaired** as to the payment of principal and interest, we believe it is prudent to resist the temptation to move down the credit quality ladder in pursuit of incremental return. We also remain committed to our long-standing philosophy of avoiding overreliance on outside rating agencies for the evaluation of credit quality, choosing instead to invest only in credits which we know and understand.

Figure 3

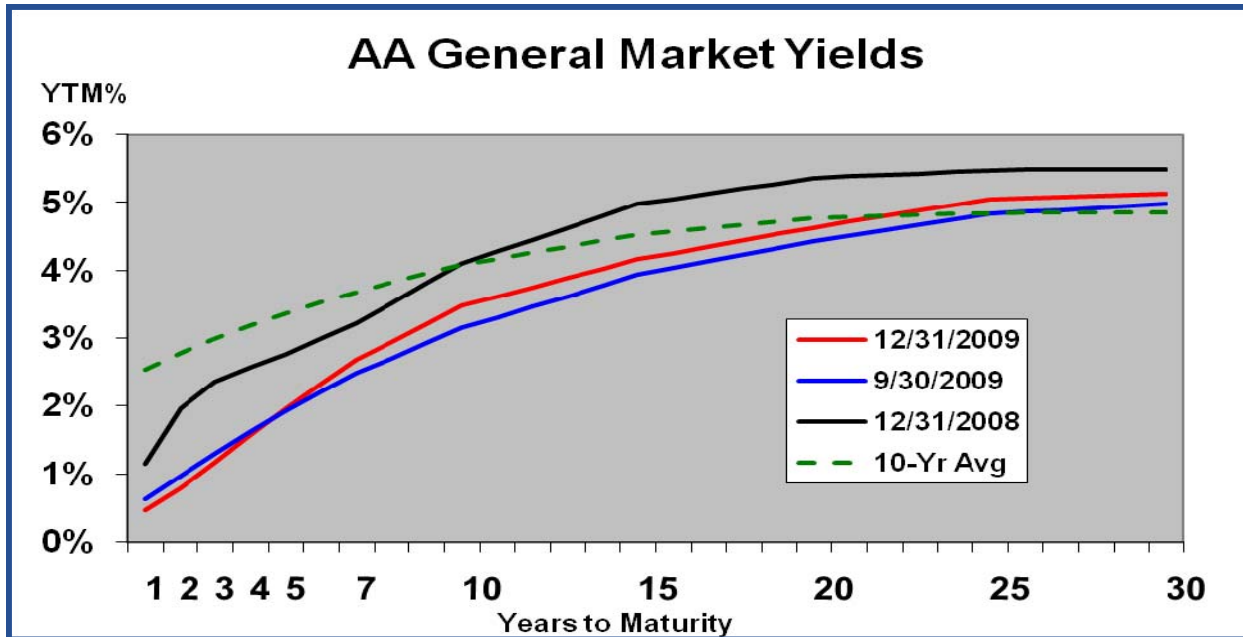


With the continuation of factors favorable to the municipal market including the structural supply constraints created by the substitution of taxable BABs in lieu of traditional tax-exempt bonds and the continued strong demand for tax-exempt income, we continue to believe that the municipal market provides an excellent value proposition for taxable investors. Referring to **Figure 4**, we can see that 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 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. As such, we believe tax-free municipals are well-positioned to outperform most other fixed income assets in 2010.

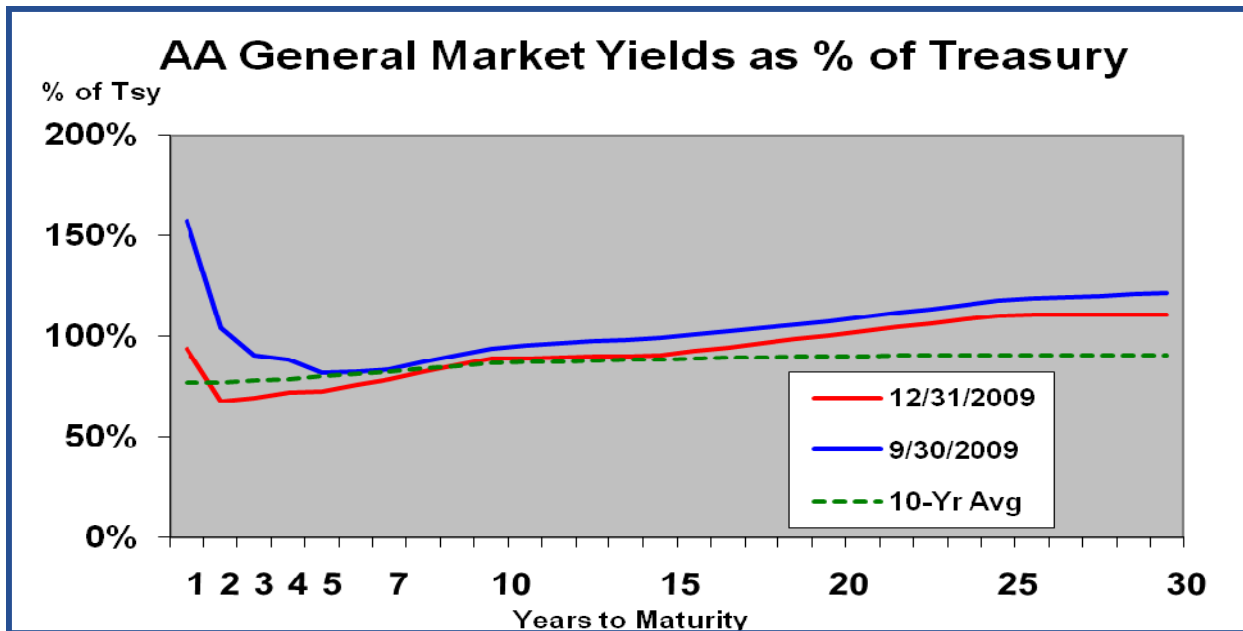
Figure 4



**Figure 5**



**Figure 6**



	10 Yr Avg	9/30/2009	12/31/2009
2-Year AA Municipal	77%	105%	68%
5-Year AA Municipal	80%	82%	73%
10-Year AA Municipal	87%	94%	89%
25-Year AA Municipal	90%	118%	110%