Redstone Advisors

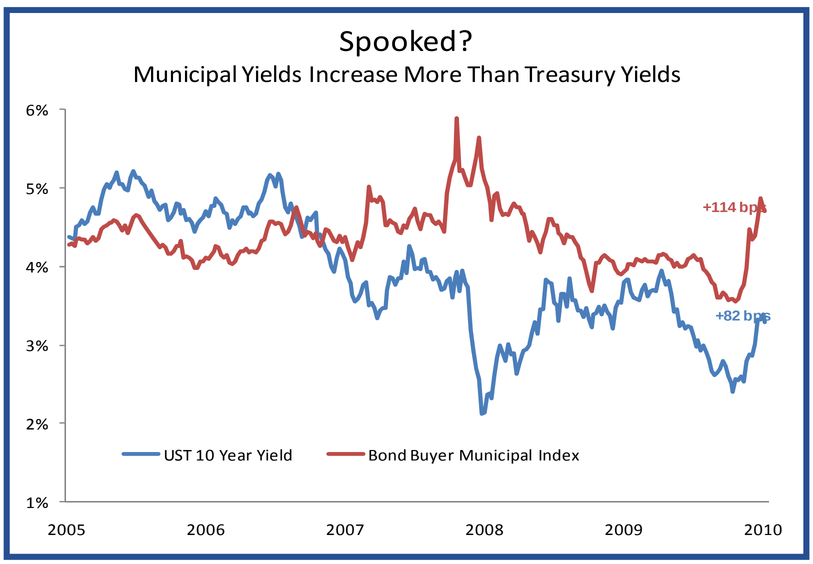
Municipal Market Review

Fourth Quarter 2010

Municipal yields **rose sharply** during the quarter, ending the fourth quarter of 2010 higher. The primary reasons for the rise in municipal yields were record outflows from tax-exempt bond funds, the failure to extend the Build America Bond program (BAB), market saturation as issuers rushed to market to avoid the sunset of provisions in the stimulus package and concerns about municipal defaults driven by the continuing onslaught of negative headlines. Referring to **Figure 4**, we can see that while yields rose across the entire yield curve, the rise in yields was more pronounced in the 5-to-10 year area of the yield curve. Yields for on-the-run maturities in the 5-to-10 year part of the curve rose by approximately 90 basis points on average, while shorter-term yields rose by an average of 60 basis points and longer-term yields rose by an average of 75 basis points. As a result, the municipal yield curve experienced a moderate **bearish steepening** as intermediate-term yields increased more than either short or long-term yields. While the overall shape of the municipal yield curve ended the quarter steeper, the change in the shape of the yield curve was again a tale of two curves with the municipal yield curve **steepening at the front end**, while **flattening moderately 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 269 basis points, 40 basis points steeper than the third quarter ending level of 229 basis points. Conversely, the long end of the municipal yield curve as measured by the 10s-to-30s spread, ended the fourth quarter at a level of 141 basis points, 19 basis points flatter than the third quarter yield spread of 160 basis points. As a result the overall municipal yield curve as measured by the 2s-to-30s yield spread closed out the quarter 21 basis points steeper at an ending level of 410 basis points.

Owing to heavy supply, large mutual fund outflows, the termination of the BAB program and continuing concerns over default risk, tax-exempt municipal bonds turned in their worst quarterly performance since 1994. As measured by the Merrill Lynch Municipal Master Index,

Figure 1



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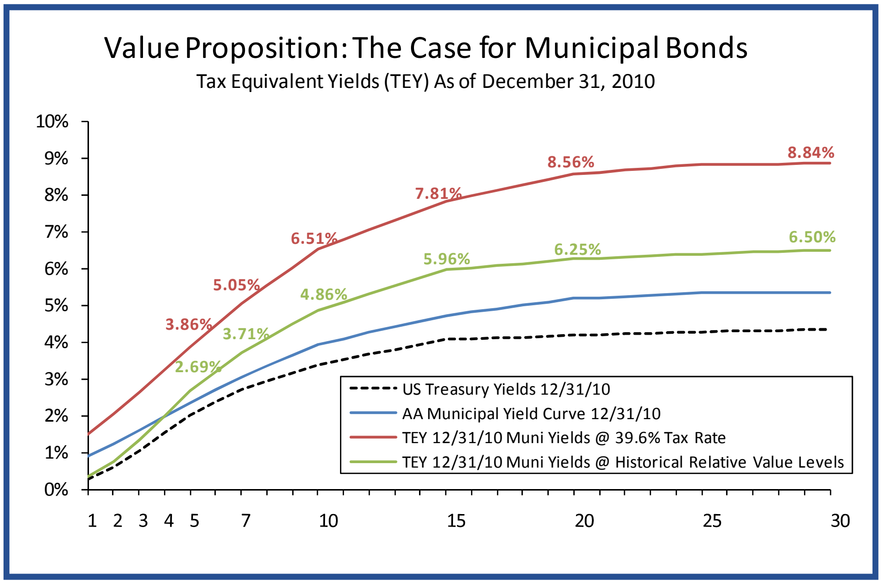
municipals returned a -4.52% for the fourth quarter of 2010, the worst quarterly performance since the first quarter of 1994 when the Merrill Index returned -5.75%. As you may recall, 1994 was marked by a bear market in Treasury yields, a currency crisis in Mexico and the bankruptcy filing of the largest county in US history, Orange County California. While clearly responding to the sharp rise in Treasury yields driven by an increase in underlying inflation expectations due to the Fed's decision to pursue the controversial $600 billion QE2 program, municipal yields were also impacted by the negative demand and supply trends that unfolded over the fourth quarter. Driven by the year-end expiration of the popular BAB program which had allowed municipalities to tap buyers in the taxable market, issuers of municipal debt brought a record **$128 billion in supply** to the market during the fourth quarter. At the same time, individual investors in municipal bonds were trying to unload holdings at the fastest pace in the last 15 years, with outflows from municipal bond funds totaling over **$21 billion** for November and December, a sum greater than the total outflows experienced at the height of the financial crisis in 2008. The record sales in municipal bond funds was driven primarily by increased **investor fears** over the risk of systemic defaults in municipal debt due to the slew of media reports surrounding the fiscal plight of state and local governments. The combination of these trends clearly **"spooked"** investors with the resulting heavy and indiscriminate selling pressure exacerbating the rise in municipal yields over Treasury yields during the fourth quarter. (See **Figure 1**)

The importance of the impact of the BAB program on municipal yields cannot be overstated. For all of 2010, municipal issuance totaled $431 billion with $122 billion of that issuance coming in the form of BABs. As such BABs have represented fully **30 percent** of municipal issuance since the program began in April of 2009. However BABs have made up nearly **two-thirds of all long-term municipal issuance**. One of the key roles played by BABs was to increase the target audience for long-term municipal debt to cross-over institutional buyers including pension funds, life insurers and foreign institutions. With the loss of the BAB program, the long-term municipal market will once again have to depend primarily upon its traditional sources of demand: individual investors, bond fund buyers and property and casualty insurers. Nevertheless, the municipal market had become acclimated to the impact of BAB issuance, particularly in the long end of the market with the result being a marked reduction in volatility in long-term maturities. As such, we would expect the municipal bond market to undergo a transition period whereby it re-acclimates to the loss of BAB issuance, with a resulting increase in market volatility in municipal bonds. Overall from the state and local issuers' viewpoint, the loss of the BAB program will result in an increase in net borrowing costs due to the higher cost of tax-exempts relative to the after-subsidy costs of BABs. However, for individual investors, the elimination of BABs may actually be a net positive. First it will keep the municipal yield curve steeper than it would have been had BABs been reauthorized, providing both higher nominal and relative yields in long-term bonds as well as continued attractive yield curve roll opportunities. Secondly, the increase in market volatility will provide added opportunities for investors to benefit from **swings** in absolute and relative value in the absence of BABs.

In fact this is, in our opinion, currently the case in the municipal market. Subsequent to the sharp rise in both Treasury and municipal bond yields during the quarter, the relative value of municipal bonds improved modestly from already historically high levels. Referring to **Figure 5**, we can see that excluding the extreme values for one-and-two year maturities (due primarily to the Fed's zero interest rate policy), municipal bond yields as a percentage of Treasury yields (red line) remain at historically high levels with an average premium in relative value ratios of 35 percent across the yield curve as compared to the 10-year average ratios (green dotted line). However, when we adjust municipal yields to a tax-equivalent basis using a tax rate of 39.6%, the currently attractive value proposition for municipal bonds is readily visible, particularly in the longer maturities. Referring to **Figure 2**, we can see that owing to the premium in relative value ratios, tax-equivalent yields on municipal bonds are currently also at historically high levels. This is reflected by isolating the impact of the increase in relative value ratios on the current municipal yield curve. The red line in **Figure 2** reflects the current after-tax municipal yields available to investors as of 12/31/10 using a tax rate of 39.6%. Contrast this with the green line which reflects the derived after-tax municipal yields as of 12/31/10 using the same tax rate of 39.6% but instead applying historical trailing 10-year relative value ratios. Even in the short and intermediate maturities, the increase in after-tax yield is significant with pick-ups of 118 basis points and 134 basis points in the 5 and 7-year maturities, representing a 43 percent and 36 percent increase in after-tax yields respectively. In our opinion, the current **"indigestion"** in the municipal market is offering investors an excellent opportunity to benefit from an increase in transitional volatility. As Warren Buffet once observed: *"Look at market fluctuations as your friend rather than your enemy and profit from folly rather than participate in it."*

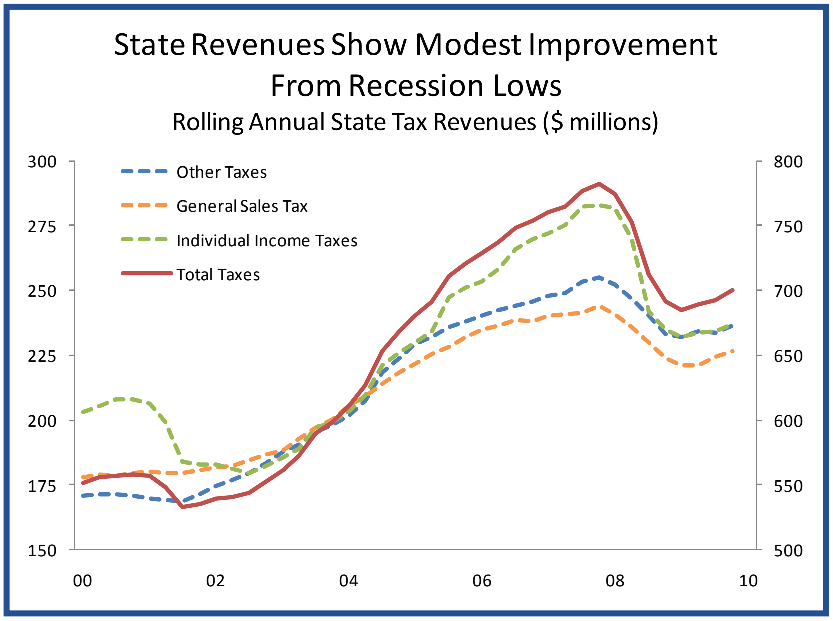
Figure 2



Without question, the greatest "folly" attaching itself to the municipal market these days, is the litany of media reports and comments by individuals from outside of the municipal finance sector offering up prognostications of gloom and doom. None have been more visible or, in our opinion, less credible than the comments by Meredith Whitney made during her December 19th appearance on *60 Minutes*. During her appearance Ms. Whitney, a banking analyst and newly commissioned municipal bond expert, boldly asserted that during 2011, *"50 to 100 significant local municipal bond defaults would occur, totaling hundreds of billions of dollars."* Importantly, Ms. Whitney's call was not that states would default, but rather the defaults would occur among local governments and issuing authorities. To begin with, there are nearly **90,000 separate state and local issuers** of the nearly $2.7 trillion municipal debt market. And according to research by Citigroup, *"all of the top 100 municipalities combined do not have hundreds of billions of dollars of debt outstanding."* Even a quick perusal of the Compendium of Government Finances published by the Census Bureau would suggest that an outcome encompassing *"hundreds of billions of dollars"* in default would of necessity, involve **tens of thousands of individual defaults** by cities, counties and towns. Perhaps in the rush to publish, the nouveau municipal bond expert meant to say *"50 to 100 thousand significant bond defaults would occur."* Be that as it may, Ms. Whitney's call clearly falls within the range of a **"black swan"** event.

The facts, however, tell a very different story. Despite the well documented financial problems of both state and local governments, defaults during the current financial crisis have been rare and when they have occurred they have been concentrated in the weakest municipal sectors. The single year record for municipal defaults occurred during the "Great Recession" year of 2008 when $7.8 billion in municipal debt went into default, an increase over the $329 million that defaulted in 2007, but still an **exponentially far cry** from *"hundreds of billions of dollars."* For 2009 the default total had fallen to $6.4 billion and through the first half of 2010, only 30 municipal issues had defaulted totaling $1.5 billion in debt, down substantially from the same period in 2009 when 138 issuers defaulted on $4.5 billion in debt. [Note that a default of 138 issuers totaled only $4.5 billion] Importantly, as the devil is always in the details, the list of municipal defaults over the past few years consists primarily of the **riskiest sectors** within the municipal bond market, including development districts built during the housing boom as well as tax-exempt debt issued by government entities on behalf of corporations and nonprofits. In fact, these **IRBs** and **private activity bonds** are not even genuine municipal credits at all, but are rather conduit financing for private entities in order to qualify for tax-free financing. When these bonds default, though counted as a municipal default, it is not strictly speaking, a default by a municipal government, but rather a default by the **underlying private issuer**. What is most notable about the list of defaults however, is the absence of cities, counties and school districts. With only a few exceptions, higher quality **GO** and **essential revenue bonds** have been largely immune from default.

Figure 3



In our opinion, US state and local governments continue to experience financial stress on a scale not seen for decades. At the nadir of the Great Recession, the US Census Bureau reported a decline in overall tax receipts to the states of nearly **$100 billion**, an amount representing a nearly 13 percent year-over-year decline in revenue. (See **Figure 3**) Since that time, state tax revenues have stabilized and have even shown a modest improvement with overall tax receipts growing by 2.5 percent or approximately $16 billion through the third quarter of 2010 with the growth in revenue primarily due to tax hikes in several large states. In addition, the Center on Budget and Policy Priorities reports that states closed a collective budget gap of **$425 billion** over fiscal years 2009 to 2011. The total gap for fiscal year 2011, projected to be approximately $140 billion, is expected to be closed with the help of around $60 billion in federal stimulus monies. For fiscal year 2012, states are expected to again face budget shortfalls of around $140 billion, with only about $6 billion in federal stimulus money remaining. This will force additional job reductions and efforts to push down costs to local governments. In the past year, state and local employment has been reduced, mostly through attrition, by approximately 250,000 jobs, or 1.3 percent, to approximately 19.2 million workers representing the deepest cuts since the recession of 1980-81. Given the unprecedented decline in revenues that has occurred and the expectation for revenues to recover slowly, we expect even deeper spending cuts will likely be required over an extended period of time.

However, we believe that it is important to stress that while state and local governments clearly have been hard hit by fiscal challenges that they will be obliged to deal with for some time to come **this is an operating crisis not a debt crisis**. The margin of safety that stands between credit deterioration from their currently strong levels to insolvency is substantial. It must be remembered that governments have captive tax bases with strong control over taxing and spending. Additionally, as we have reported previously, government debt levels are relatively low and debt service is a relatively small part of their operating budgets. Fitch estimates that net tax-supported GO debt of an average state in equal to just **2.45 percent** of the state's GDP, with the top state at only **7.3 percent**, while the average local debt is only **3-to-5 percent** of property value. Net tax supported debt as a percentage of general fund revenues is also modest, averaging just **53 percent**. Of course the more relevant figure is the annual debt service as a percentage of revenues. According to this metric, annual debt service (principal and interest), which has ranged between **6 to 12 percent** of state budgets since the great Depression, is currently around **9 percent**. For local issuers, Moody's median debt service as a percent of expenditures for all rated US cities is a very manageable **8.1 percent**. Given that debt service is a relatively small part of most budgets, not paying it (default) does very little to solve fiscal problems, particularly in light of the formidable cost of such action, i.e., the loss of access to market financing. And finally, **security for GO and dedicated tax bonds is very strong**, and is provided for in state constitutions, statutes, covenants with bondholders and local ordinances. For local municipal issuers, GO bonds are secured by their power to levy and pledge property tax revenues for debt service. Dedicated tax bonds have clearly defined, segregated and high priority payments in the flow of funds. Quoting Fitch, *"the officials managing the government's cash, in their fiduciary role, legally cannot just choose to pay other expenses as opposed to debt service; the priority of payment is generally quite high, so that a bondholder is well positioned even in financial stress."*

At Redstone we believe the financial crisis facing municipalities is **cyclical**, not systemic. Clearly even as the economy recovers, there will be longer-term pressures related to public pensions and post-retirement health care costs. However, it is important to stress that these are much longer-term issues than the immediate budgetary pressures discussed on *60 Minutes*. As such, while we believe that investor caution is certainly warranted, underscoring the value of an experienced municipal market professional, opportunities do exist in the municipal market. We live in a 15-second sound bite world for which media-enabled **"chicken little's"** are perfectly suited. As Bloomberg commentator Joe Mysak recently observed; *"The market is awash right now in inexpert testimony, the opinions of analysts who may know how to analyze stocks, but who are confounded by munis. It's a big mistake to think about municipals in terms of equities, and to talk about them that way as well."* Now regarding Ms. Whitney's **"black swan"** call for ***"hundreds of billions of dollars"*** in municipal debt defaults? We would remind our readers that Ms. Whitney's claim to fame was her fortuitous October 2007 call on Citibank's capital inadequacy. Since that time, she has also made other ***"sensationalistic prognostications"*** including her December 2008 call that ***"consumer credit is doomed"***, her May 2009 call that ***"credit cards are the next credit crunch"***, and her December 2009 proclamation that ***"government is out of bullets."*** The paradox of predicting black swans is that in order to be credible, **they must be rare**. If you doubt this, just ask Abbey Joseph Cohen, if you can find her.

Figure 4

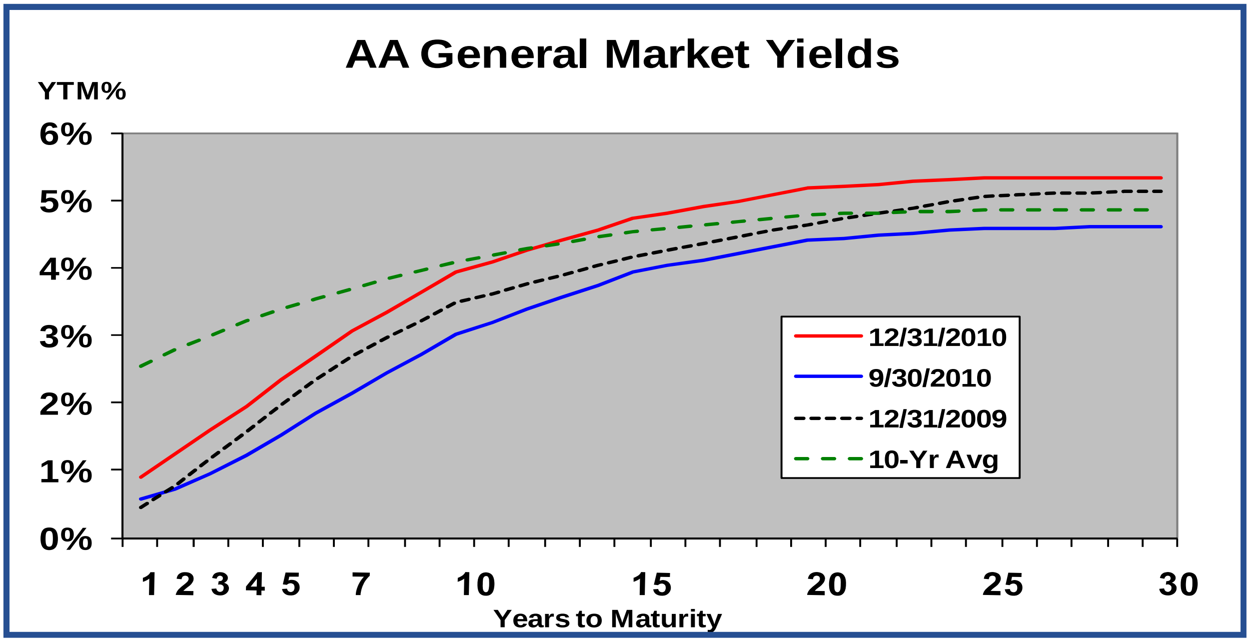
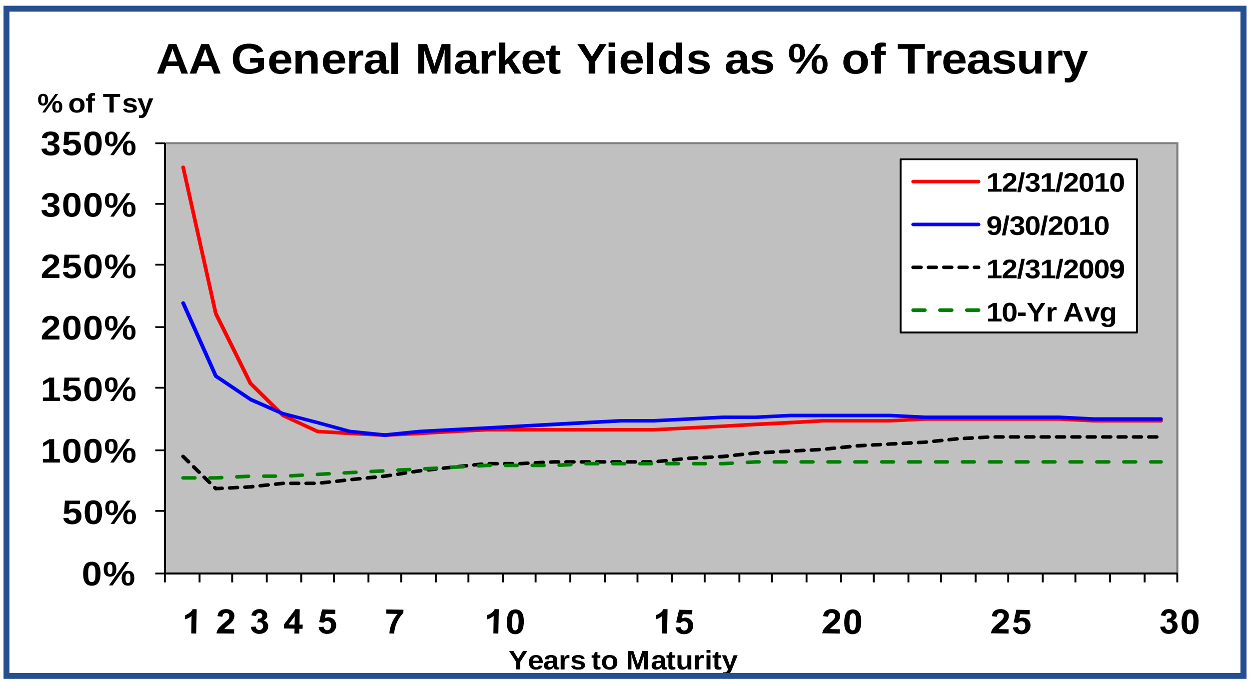


Figure 5



	10 Yr Avg	9/30/2010	12/31/2010
2-Year AA Municipal	77%	160%	210%
5-Year AA Municipal	80%	121%	115%
10-Year AA Municipal	87%	118%	116%
25-Year AA Municipal	90%	126%	125%