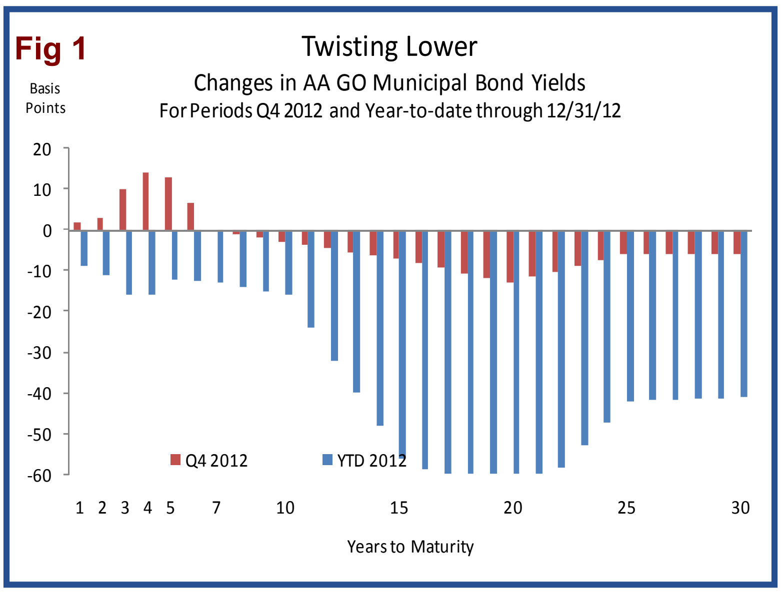
Redstone Advisors

Municipal Market Review

Fourth Quarter 2012

Municipal bonds posted yet another very good year in 2012, wrapping up a second consecutive year of outstanding performance. Despite the banner year, municipal bonds gave back some of their gains during the final month. Owing to the uncertainty surrounding the Fiscal Cliff negotiations, investors increased their normal year-end harvesting of capital gains in anticipation of tax increases in 2013 coupled with concerns about the possible loss of the tax exempt status of municipal bond interest, causing municipal yields to back-up sharply during the month of December. So while municipal bond yields did rally during the fourth quarter of 2012, bringing the total number of consecutive quarters in which municipal yields have declined to **eight**, it wasn't an **"all-in rally"** as bonds maturing in 5-years or less **rose modestly** during the quarter. Looking at **Figure 7**, we can see that except for these shorter-maturities, yields declined all across the yield curve. The reshaping of the yield curve is better reflected in **Figure 1** which graphs the changes in municipal yields across the curve for both the fourth quarter and for the year-to-date period through December 31, 2012. As we can see in **Figure 1**, for both periods under review, the municipal yield curve underwent a **"non-parallel** [uneven] **downward shift"** in yields, resulting in a modest bullish flattening of the yield curve. Specifically for the year-to-date period ending December 31, 2012, the 2s-to10s segment of the yield curve flattened by **5 basis points**, while the 10s-to-30s segment flattened by **25 basis points**. Despite the overall bullish flattening of the municipal yield curve of **30 basis points**, the municipal yield curve, as measured by the 2s-to-30s segment, remains historically steep at a level of **352 basis points**. For the entire year of 2012, **municipal yields stand lower across the entire yield curve**, with long-term yields declining over four-times as much as short and intermediate yields. Against this favorable backdrop of declining yields, municipal bonds as a sector, again performed very well in 2012, particularly as compared to the Treasury's, with longer-maturity municipal bonds outperforming shorter-maturity municipal bonds. However, while municipal bond yields rallied across the entire curve, with shorter yields declining more than longer yields, with the exception of a modest rally in the 5-to-10-year area, Treasury yields ended 2012 effectively unchanged. The effect of the combined reshaping of the municipal and Treasury yield curves on relative value ratios is reflected in **Figure 8**, where we can see that **municipal relative value ratios** were unchanged for all maturities under 10-years and only modestly lower for maturities over 10-years. Despite the modest decline in longer-maturities, municipal bonds continue to be quite attractive as relative value ratios **remain above 100 percent for all bond maturities.**

Fig 1

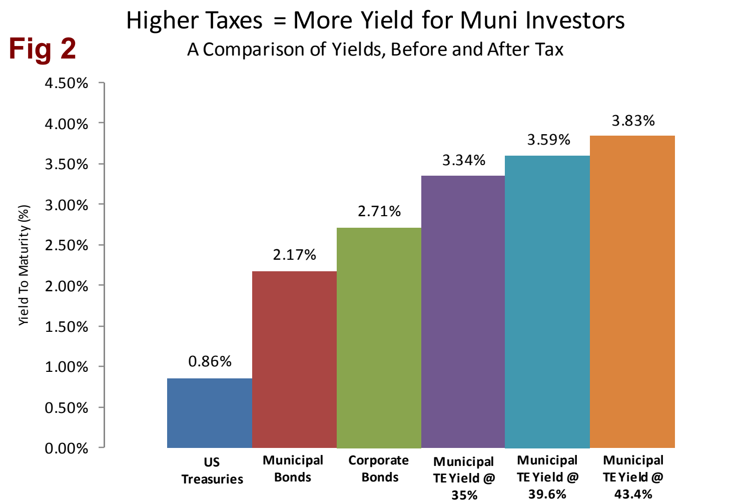


(316) 687-2143 jyeskie@redstoneadv.com

The big story of course, are the recent tax changes coming out of the year end "cliff" negotiations. Regarding the recent tax legislation, it is the ***'Tale of Two Investors';*** *It was the best of times, it was the worst of times*. It is *the worst of times* in that **taxes are indeed going up**. In fact, as of January 1st, most people have already experienced an increase in their taxes as the two-year, 2-percent "payroll holiday" is now over. As the clock struck midnight and the curtain came down on the drama that was the "fiscal cliff" negotiations, the American Taxpayer Relief Act of 2012 was passed. Relief! Never was a bill more misnamed unless the **"relief"** referred to is *relief* from the uncertainty about your taxes going up. Truly, German Chancellor Otto von Bismark spoke well when he said, *"laws are like sausages, it is better not to see them being made"*, for we as a nation would have been immensely gratified not to have witnessed this lesson in sophomoric partisan behavior.

Nevertheless, it is equally *the best of times* since municipal bonds offer investors an excellent way to keep more of what you earn. In addition to the increase in payroll tax withholding, the top marginal income tax rate increased from **35 percent** to **39.6 percent** for families with taxable income over $450,000 and single filers over $400,000. As a side effect, Congress also created a new bracket for taxable incomes between $380,00 and the new thresholds of $400,000 or $450,000. This "new" bracket will be taxed at 35 percent. This was done so that those in this "new" bracket would not be taxed at 33 percent, a rate lower than the 35 percent rate they paid previously. As we have stated previously, as marginal tax rates increase, so too does the **value of the tax exemption** of municipal bonds. This increased value can been seen in **Figure 2** where we make a simple comparison of the yield-to-maturity between Treasury corporate and municipal bonds. The yield-to-maturities for each sector were taken from their respective Barclays Master Indices as of December 31, 2012. By applying the tax exemption to municipal yields, the increasing value of the municipal bond tax exemption becomes quite apparent. We illustrate this using the previous top rate of 35 percent, the new top tax rate of 39.6 and 43.4 percent. The 43.4 percent tax rate includes a new mandated **3.8 percent Affordable Care healthcare surtax** from which municipal bond income will be exempt. While on a **nominal basis**, municipal bonds offer a markedly higher yield than Treasuries, they only offer 80-percent of the yield of corporate bonds. However when we take the tax-exemption into consideration, we can see that municipal bonds have the unique advantage of being able to help investors keep more of what they earn as tax-equivalent yields for municipals currently offer income yields of 130 to 140 percent of corporate yields. In addition, due to the phase out of itemized deductions for singles making over $250,000 and couples making over $300,00, people in lower tax brackets will see their **effective tax rate rise** as they are allowed fewer deductions, increasing their level of taxable income. This means that for these people, even though their marginal tax rates did not go up, the actual amount of taxes they pay will. And because

Fig 2



Source: Barclays Global Family of Indices as of 12/31/12. Barclays Treasury Index = US Treasuries Yield; Barclays Municipal Index = Municipal Yield; Barclays Corporate Index = Corporate Yield municipal bonds are not affected by this phase out of deductions, municipal bonds can help these investors keep more of their income.

In addition to higher marginal tax rates, the **"Relief"** bill also ***relieves*** investors of more of their income by raising the tax rate on capital gains and dividends from **15 percent** to **20 percent** for those in the new top tax bracket. Importantly however, the Affordable Care healthcare (ObamaCare) surtax of **3.8 percent** will also apply to capital gains, and will be levied on capital gains and dividends for those with incomes greater than $250,000 for families and $200,000 for individuals. Therefore, families with incomes between $250,000 and $450,000 ($200,000 and $400,000 for individuals), will pay a combined capital gains tax rate of 18.8 percent, and for those in the top marginal tax bracket, it rises from 15 percent to 23.8 percent, an increase of **59 percent**. This will clearly have an impact on an investor's decision regarding their choice of an income source as dividend income has just become significantly more expensive on an after-tax basis, particularly as compared to tax-exempt municipal bond income.

A final provision of the "Relief" bill, as it relates to municipal bonds, did, in fact, provide some relief, at least from uncertainty. The minimum income levels subject to the dreaded **Alternative Minimum Tax**, or AMT, have been permanently increased and indexed to inflation. As a resut, the uncertainty surrounding *"who will pay this tax"* has been greatly reduced. Unfortunately, in keeping with our primary theme as it relates to the "Relief" bill and municipal bonds, it remains a 'Tale of Two Investors'. For the big winners in this 'fix' to the AMT will be those whose incomes are in the $45,000 to $105,000 bracket as they will be able to use tax credits to lower their income and keep them out of the AMT *by-path meadow*. Unfortunately the losers will be high-income Americans, more of which will likely continue to be affected by AMT due to the phase-out in itemized deductions for singles making over $250,000 and couples making over $300,00 as mentioned earlier. As such, those in the over $450,000 bracket (4400,00 for individuals), will be hit the hardest.

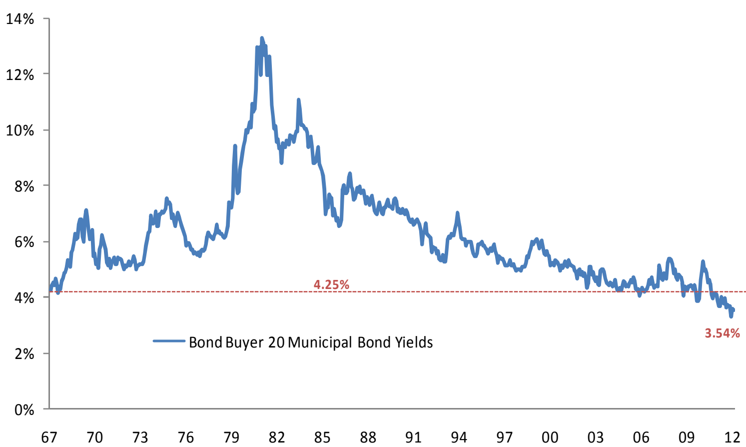
On a final note regarding the recent tax changes and their impact on municipal bonds, there was one important area of uncertainty that was not "relieved" by the tax bill and that is the continuing status of the tax exemption for municipal bonds. While there were purportedly discussions about capping or abolishing this exemption, we have never believed that it was a serious consideration. In particular, we do not believe that there is any danger of the exemption being eliminated entirely. For one thing, we do not believe that such a change could be applied retroactively to outstanding municipal issues. Aside from potential legal issues surrounding certain **"taxability call provisions"** in many municipal issues, particularly private activity bonds, the potential for both market disruption and wealth destruction are incalculable. The vast majority of outstanding municipal debt is currently priced at a significant premium due to historically low nominal market rates. If these bonds were called at par, investors would sustain significant capital losses. On the flip side, the loss of the municipal tax exemption would markedly increase the cost of capital to states and municipalities at a time when state and local budgets are still dealing with the strain of the loss of revenues brought about by the Great Recession. In light of these very substantial impacts, such a move would be both highly unpopular and effectively impossible for our **"divided house"** of policymakers to pass, particularly in light of the already passed higher marginal tax rates on the wealthy. If the recent "fiscal cliff" brawl taught us anything it is that compromise is nowhere to be found in the lexicon of this Congress. As another commentator wrly observed, *"as veteran market watchers know, challenging the tax treatment of munis -- like challenging the home mortgage deduction -- is a frequent gambit when Washington finds itself scrambling for higher tax revenues."* And we all know what happens when you wake that sleeping giant.

So in summary, the Relief Act is a 'Tale of Two Investors', the municipal investor and the non-municipal investor. As municipal bonds are one of the only tax-advantaged asset classes available to investors, the outcome was **largely positive**. First, the higher marginal tax rates for high-income earners, particularly when we include the impact of the Obamacare 3.8 percent surtax, are unambiguously favorable for municipal bonds, directly enhancing the **value of their tax exemption**, a return advantage that as we have pointed out many times, continues to compound across time. Second, to the extent that other investment assets are "disadvantaged" by the changes to the tax law, including higher capital gain and dividend tax rates for those same earners, indirectly, this too is a positive for municipal bonds as it enhances their relative value as an asset class to investors. And finally, the phase-out of itemized deductions for high-income earners, also increases the relative value of municipals by allowing investors to keep more of their own income.

Quickly, as we consider the prospects for municipal bonds in 2013, we continue to believe that municipal bonds are uniquely qualified to provide investors with both an excellent source of wealth preservation and high-quality income in the stabilizers' *'Brave New World'* of high volatility and low nominal yields, coupled with excellent relative value in a world of higher absolute tax rates. Having said that, we believe that after two very good years in which capital gains amounted to nearly 50 percent of total returns, return expectations for 2013 should be focused primarily on income. Even with the stabilizers publicly committed to keeping interest rates low *for an extended period of time* (2015), with yields at historically low levels, realistically, rates have a limited amount of room to move lower, and by extension, price increases are limited also. This is highlighted by **Figure 3** which graphs the yield on the Bond Buyer 20 Municipal Bond Index. Driven by the increased demand for **high quality income**, nominal municipal yields are at levels not seen in 45 years. Clearly this does not preclude the possibility of rates moving lower, as at a minimum, bonds will benefit from the passage of time as they **"roll down"** a steep yield curve. Nevertheless it does suggest that investors should not expect the same level of contribution to total return from capital gains as they saw in 2011 and 2012.

Fig 3 **Generational Lows**

Demand for High Quality income in an Increasingly Low Quality World Drives Municipal Yields to 45-Year Lows



The **relative value** of municipal bonds remains historically high. Referring to **Figure 4**, we can see that with the loss of the monoline insurers, the **era of credit discovery** in municipals began. Prior to this time, over **one-half** of all muni bonds were insured. After the loss of the insurance **"fig leaf"**, the process of evaluating the differences in the credit profiles of the nearly 100,000 non-homogenous municipal issuers began in earnest. As a result, municipal and Treasury yields **traded places** with municipal yields exceeding Treasury yields, resulting in relative value ratios **above 100 percent**. This market action may also be seen in **Figure 5** which graphs the **credit spread** between AAA GO and BBB Revenue debt. Again with the loss of the insurers, credit spreads spiked from an average of **61 basis points** to over **350 basis points**. Since reaching its high, this credit spread has retraced nearly one-half of its' increase. And while this reflects both the reduction of the **"monoline premium"** and the improvement of state and local finances, we continue to recommend caution regarding reaching for yield by going down in quality. Referring to **Figure 6**, we can see that although state revenues have recovered from their lows, on an **inflation-adjusted basis**, state revenues are still **5 percent** below their prior peak and their current trend remains below the previous trend line. All in all, in a year which will feature both higher tax rates and higher volatility, we recommend investors remain focused on municipal bonds for their high-quality, tax-exempt income, the very traits that have been the long-time hallmark of the municipal market.

Fig 4 Despite "Cliff-Diving" in December "Credit Discovery Premium" Keeps Relative Value Above 100%

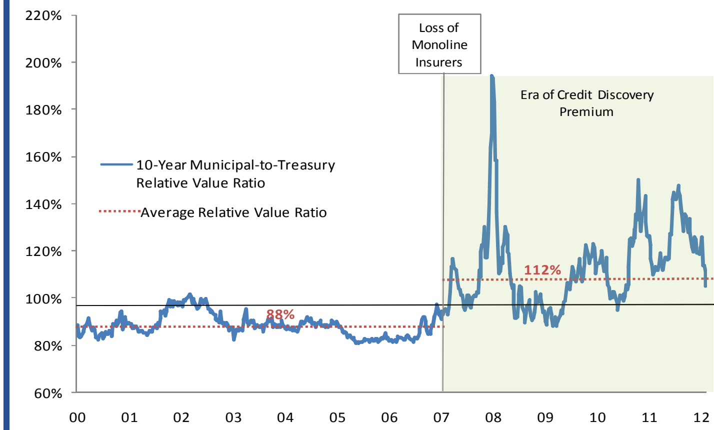


Fig 5 Municipal Credit Spreads Have Fallen Markedly as Process of "Credit Discovery" Matures in Insurance-*Less* Muni Market
The Difference Between 10-Year AAA GO and BBB Rev Muni Yields

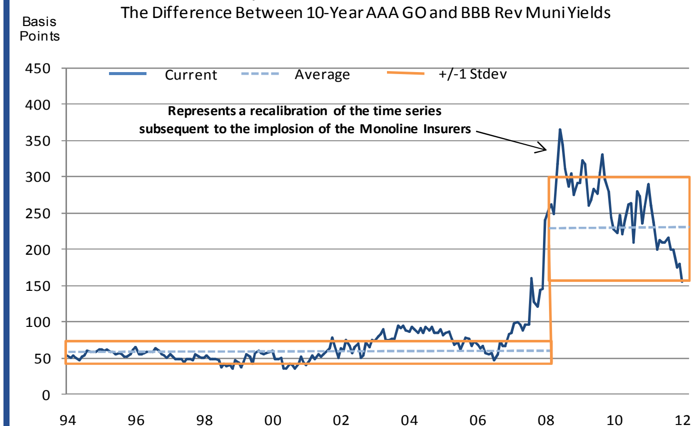


Fig 6 Nominal State Revenues Recover From Recession Lows
Rolling Annual State Tax Revenues Through 9/30/12

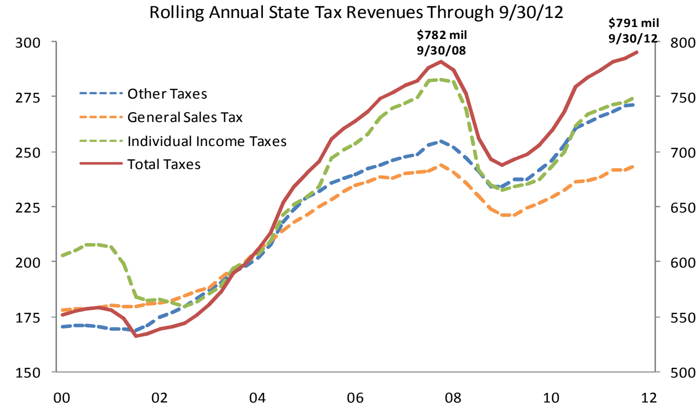


Fig 7

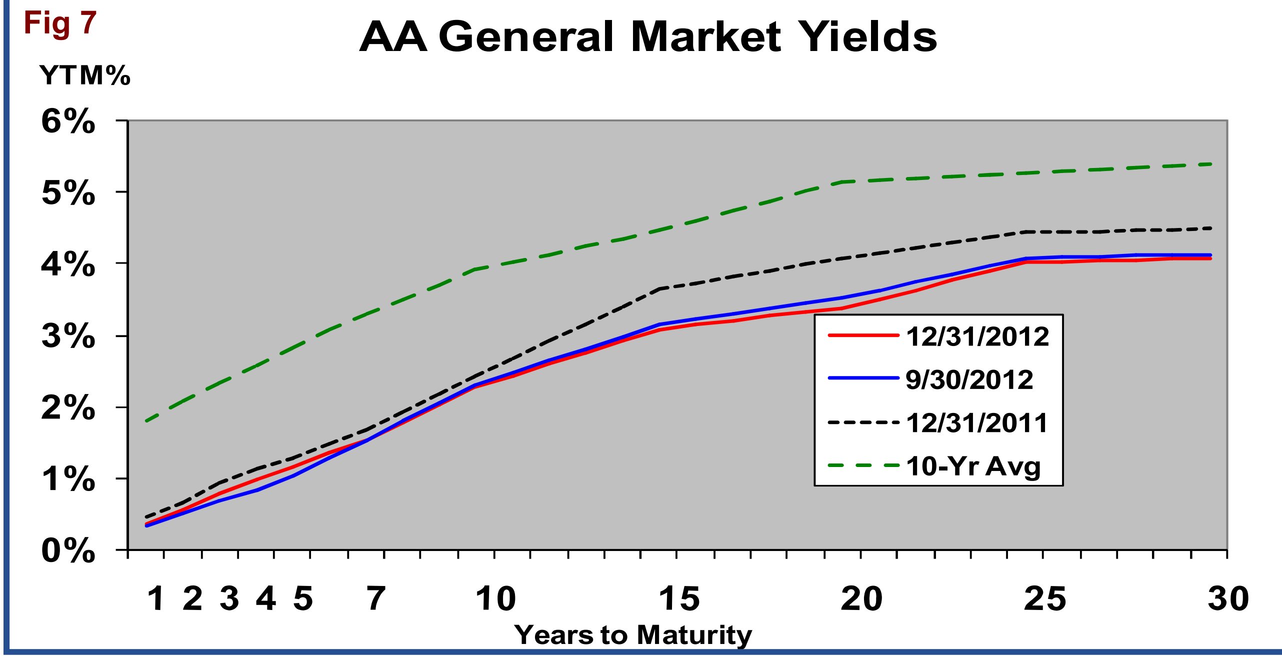
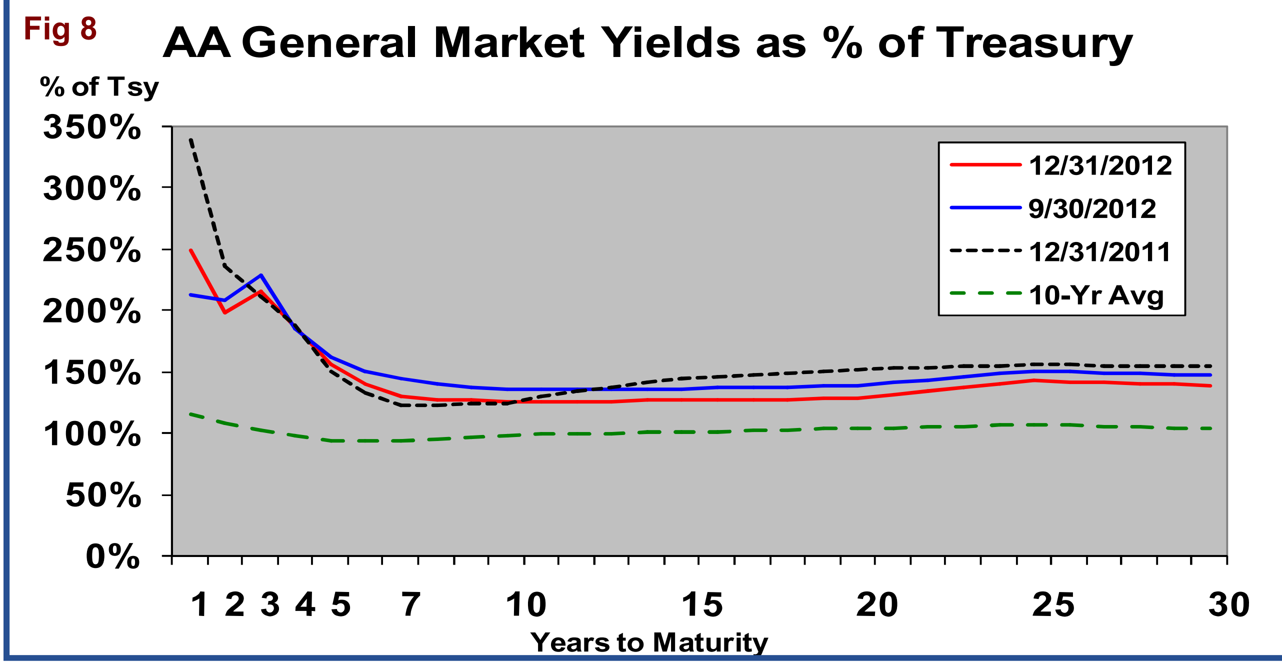


Fig 8



	10 Yr Avg	9/30/2012	12/31/2012
2-Year AA Municipal	107%	208%	198%
5-Year AA Municipal	93%	161%	156%
10-Year AA Municipal	97%	135%	125%
25-Year AA Municipal	106%	150%	142%