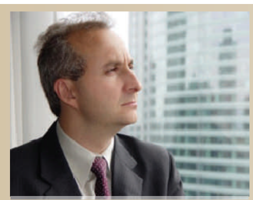
Redstone Advisors



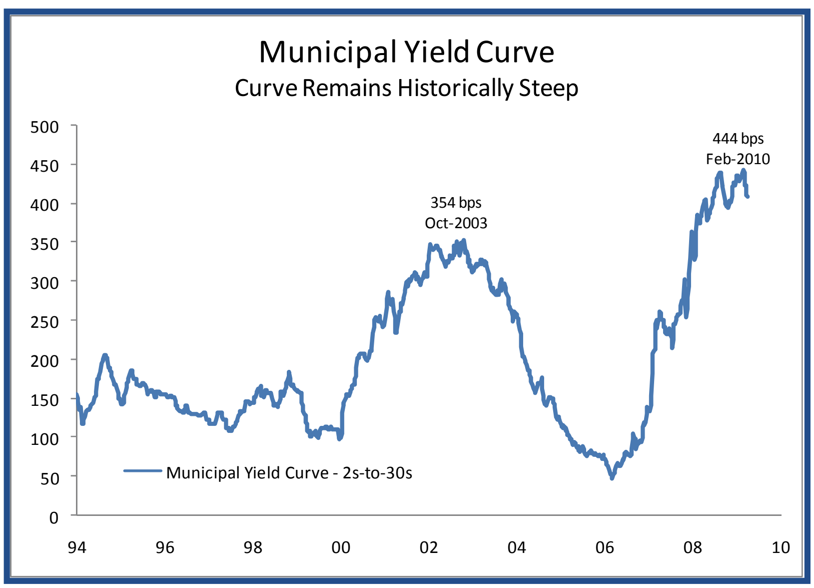
Municipal Market Review

First Quarter 2010

During the first quarter of 2010, short-and-intermediate municipal yields rose slightly while long-term yields (over 20-years) remained effectively unchanged. As a result, the municipal yield curve experienced a very modest **bearish flattening,** as short and intermediate yields rose between 25 and 15 basis points respectively. (See **Figure 4**) As a result, municipal market performance was weaker in the front end and in the belly of the yield curve versus the long end, resulting in quarterly returns that increased sequentially as maturities were extended. By way of illustration, the quarterly return on the short municipal index (1-5 Yrs) was 0.35%, the short-intermediate municipal index (1-10 Yrs) returned 0.77%, while the long municipal index (20+ Yrs) returned 1.49%. This return dispersion occurred as a result of the specific reshaping of the yield curve (a bearish flattening) coupled with the incremental yield earned by longer-dated bonds due to the steep slope of the municipal yield curve. As mentioned, long-term municipal yields were unchanged and remain anchored due the strong technical backdrop resulting from the creation of the Build America Bond program (BAB), with most of the new municipal issuance in the long-term maturity range coming as taxable BABs, effectively reducing the volume of new long-term issuance of tax-exempt municipals. Overall, a reduced supply of traditional tax-exempt municipal bonds due to the increase in taxable BAB issuance coupled with a increased demand for tax-exempt municipal bonds as investors have been forced out of money market funds into higher yielding assets by the Fed's decision to keep short-term rates low for an ***"extended period"***, continues to exert downward pressure on municipal yields.

Referring again to **Figure 4**, we can see that despite the modest bearish flattening that took place during the first quarter, the municipal yield curve remains **historically steep**. As measured by a 2s-to-30s yield spread of **410 basis points**, the current municipal yield curve is nearly **twice as steep** as the 10-year average yield curve spread of **207 basis points**. Referring to **Figure 1**, which graphs the 2s-to-30s municipal yield

Figure 1



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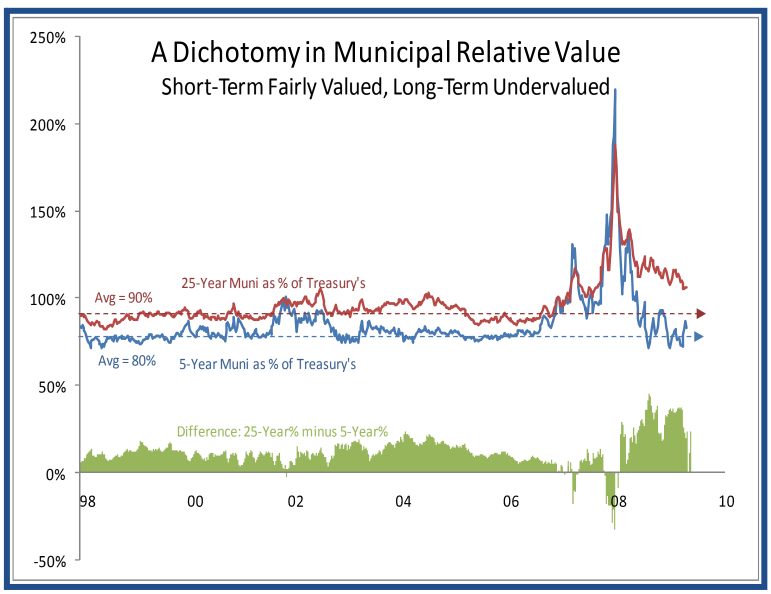
spread since 1994, we can see that due to the modest first quarter flattening, the quarter ending municipal yield curve spread, at 410 basis points, is just off the all-time high of **444 basis points** set in February of 2010. As we discuss in our taxable **Quarterly Review and Outlook**, the current investment environment is dominated by **uncertainty** due to the massive level of intervention in the financial markets by the stabilizers. However there is **one certainty** unique to the bond market that can provide investors an opportunity to increase total returns – **time**. As Einstein once observed, *"the only reason for time is so that everything doesn't happen at once",* and what doesn't happen at once to a bond is its' maturity. The combination of a bonds' fixed coupon and maturity date, along with a steep yield curve, provides opportunities for increasing return from the **passage of time** due to **yield curve roll**. Yield curve roll simply refers to the potential upward re-pricing of a fixed coupon bond as it rolls down a steep yield curve with the passage of time. For example, assuming a 5-year municipal bond and a 4-year municipal bond currently yield 2.20% and 1.80% respectively, then the 1-year **yield drop** is equal to **40 basis points** (2.20% minus 1.80%). If we purchase the 5-year bond and simply hold it to maturity, our total return on this bond will be very close to the purchased yield of 2.20%. However, assuming the yield curve remains essentially unchanged (steep) over the next year, an investor who sold that bond at the end of the first year would earn the same 2.20% income on the bond plus the capital gain from the yield curve roll which would equate to approximately **1.1%** in additional return, for a total realized return of **3.30%.** Referring again to **Figure 4**, we can see that currently the **3-to-7 year maturity area** of the municipal yield curve offers the most compelling curve roll return opportunities with annual yield drops of **36 to 41 basis points**. In addition, purchases that are positioned in short-to-intermediate maturities in order to benefit from curve roll also provide moderate protection against the risk of a price decline from an unexpected rise in interest rates because of the portfolios shorter duration. As such, we continue to view the steep municipal yield curve as a source for active managers to increase total returns over and above the historically low nominal purchase yields currently offered in the municipal market.

Referring to **Figure 5** we can see that owing to the modest bearish flattening in the municipal yield curve combined with a slight bullish steepening of the underlying Treasury yield curve, municipal yields as a **percentage of Treasury yields** (i.e., relative values) moved back above their long-term average across the entire municipal yield curve. Generally speaking, longer-term bonds appear to be more attractive from a relative valuation perspective, with **25 and 30-year** municipal yields currently at nearly **110 percent** of Treasury yields compared to their 10-year average of **90** and **91 percent** respectively. By contrast, **5-year** municipal yields are at **83 percent** of underlying Treasury yields versus their long-term average of **80 percent**. [Note: The extremely high relative value of municipals under 1-year is an anomaly created by the Fed's zero interest rate policy] **Figure 2** illustrates this dichotomy in relative value in municipal bonds by graphing 5-year (**blue line**) and 25-year (**red line**) municipal yields as a percentage of their respective Treasury yields across time. The **green bars** represent the difference

Figure 2



between the two series. As we can see, 5-year relative yields, at **83 percent** of Treasury's, have returned to their long-term average after falling from the extreme levels seen during 2008 in response to the events surrounding the credit crisis and Great Recession. However 25-year relative yields, while also retracing much of their crisis-induced rise, continue to trade at levels above their long-term average. The marked increase in the height of the **green bars** during 2009 and 2010 denotes the degree of divergence between the two relative values, with the current **pick-up** in relative value for extending maturity from 5-years out to 25-years exceeding **33 percent**, nearly three times the long-term average of just **12 percent**. As we reported last quarter, municipal bonds typically yield less than 100 percent of underlying Treasury's due to the value of the tax exemption. To the extent nominal municipal yields exceed 100 percent of Treasury yields, is a reflection of both the perceived **incremental credit risk** in municipals as well as market expectations regarding an **increase in marginal tax rates**. We continue to believe the current dichotomy between the relative valuation of short-term municipal bonds and long-term municipal bonds is a function of the sharp increase in demand for tax-exempt income due to heightened expectations of a **tax increase**, tempered by concerns over the **near-term fiscal problems** confronting many states. And while this trend is being exacerbated by the reduction in long-term tax exempt issuance in favor of taxable BAB issuance, investors are nevertheless, allocating more of their demand for tax-free income to shorter maturities because of their concerns surrounding the resolution of state fiscal issues.

Despite two consecutive quarters of positive GDP growth, state tax revenues are still falling. According to the State Revenue Report published by the Rockefeller Institute, the fourth quarter of 2009 marks the ***fifth consecutive quarter of declining state tax revenues***. To be sure, the rate of decline has clearly moderated, with the year-over-year decline for the fourth quarter 2009 coming in at down 4.2% versus its nadir of down 16.5% in the second quarter of 2009. Nevertheless, state tax revenues are still down over **8 percent** from levels of two years ago, with **forty-one states** reporting tax revenue declines, seven of which reported double-digit declines, versus only **nine states** reporting improvement in revenue collection relative to a year earlier. Prior to the current economic slowdown, state revenues grew at over **5% per annum for nearly two decades**, enabling budgets and entitlements to expand at an unsustainable pace. However, as we discussed in our last report, unlike the federal government, most states are constrained by law to balance their budgets. As a result, revenue shortfalls are being met with a combination of increased fees and taxes coupled with reductions in state services. In addition, tax revenue has held up much better at the **local leve**l, with local tax collections still growing at a positive rate of around **4.5%** in the fourth quarter of 2009. Most local governments rely heavily on **property taxes** which tend to be more stable, adjusting slowly to downturns in the housing market. And while we will continue to closely monitor these trends as they develop, it would appear that while we may still be far from the *"beginning of the end"* for state budget woes, we may, nevertheless, be approaching the *"end of the beginning."* As such, we would reiterate our assessment of last quarter:

> *"While we remain confident that with few exceptions, the **underlying credit quality** of general obligation and essential service state and local municipal debt remains **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."*

During the first quarter of 2010, both Moody's and Fitch announced that they will **recalibrate** their ratings of US municipal bonds and issuers to its global rating scale (in the case of Moody's) beginning sometime in mid-April. The stated purpose of the recalibration is to enhance the **comparability** of credit ratings across the agencies' rating universe, making municipal debt ratings more compatible with those of corporate debt. This recalibration will affect ratings on state and local governments, tax-supported debt, water and sewer issues, public power distribution and public higher education bonds. The overall effect of the recalibration will be an **upward revision** to most all municipal issues. And while we expect the ultimate impact of these expected ratings changes on yields and credit spreads to be relatively modest, it seems likely that the ratings upgrades will have a **negative impact** on monoline insurers by further dampening demand for bond insurance.

Despite the current low nominal yield environment, we remain committed to our belief in the **strong value proposition** of tax exempt municipal bonds for taxable investors. This belief is founded on 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, the historically steep municipal yield curve, and the continuation of strong demand for tax-exempt income due to an expected tax increase (Bush tax cuts will sunset at end of 2010) and the *"encouragement"* provided to investors to ***move out on the yield curve*** by the stabilizers' commitment to zero interest rates for an *extended period*. Referring to **Figure 3**, we can see that current nominal yield levels on Aa GO municipal bonds exceeds those of taxable Treasury yields on a **before-tax-basis** in the 18-year and longer maturity area. This opportunity to increase yield on a before-tax basis with little to no diminution in credit quality, enhances the attractiveness of tax-exempt municipals to **cross-over** taxable investors. However, it is with taxable investors who can benefit from tax-exempt income that the real value proposition lays. As illustrated in **Figure 3**, we can see that even at current yield levels, municipal bonds offer individual investors yields nearly twice that of Treasury yields on a **tax-equivalent basis**. This is particularly true for mid and long-term maturities. The value of the tax-exemption is underscored by a comparison to what current tax-equivalent yields on municipal bonds *would be* if they were trading at their **historical relationship to Treasury's**, i.e., at lower relative valuation levels. When we factor in today's higher relative valuation of municipals as measured by municipal yields as a percentage of Treasury yields, the exceptional value of current after-tax yields available to investors in the municipal market becomes apparent. As such, we continue to believe tax-exempt municipals are well positioned relative to other fixed income alternatives, given the positive supply environment coupled with the attractiveness of their tax preference amid the likelihood of higher taxes

Figure 3

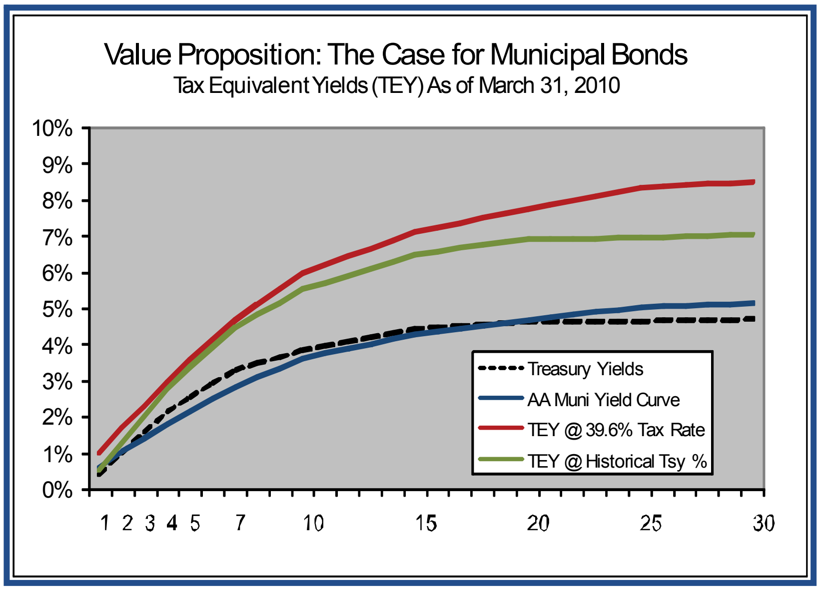


Figure 4

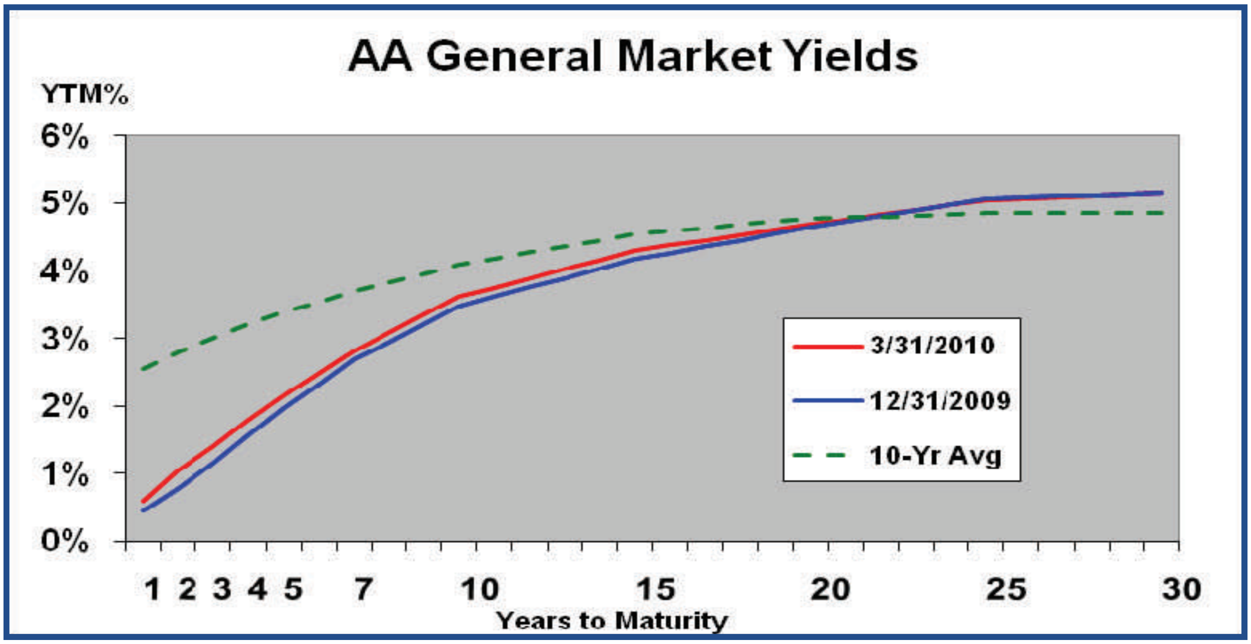
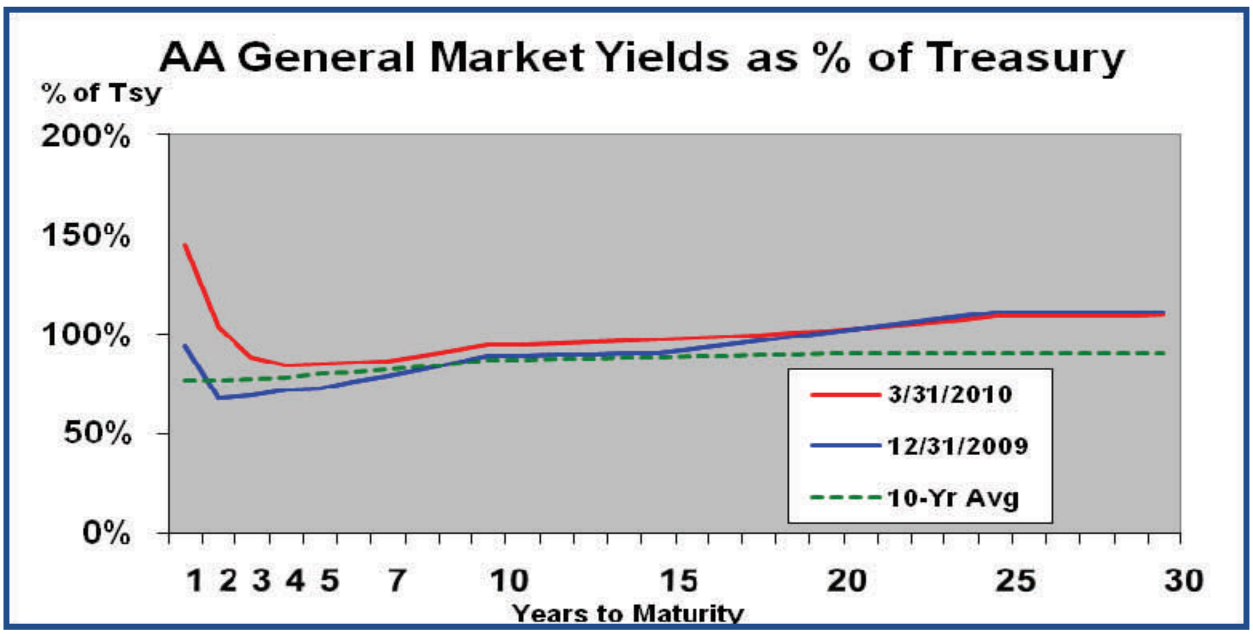


Figure 5



	10 Yr Avg	10/31/2009	3/31/2010
2-Year AA Municipal	77%	68%	104%
5-Year AA Municipal	80%	73%	83%
10-Year AA Municipal	87%	89%	94%
25-Year AA Municipal	90%	110%	109%