Redstone Advisors

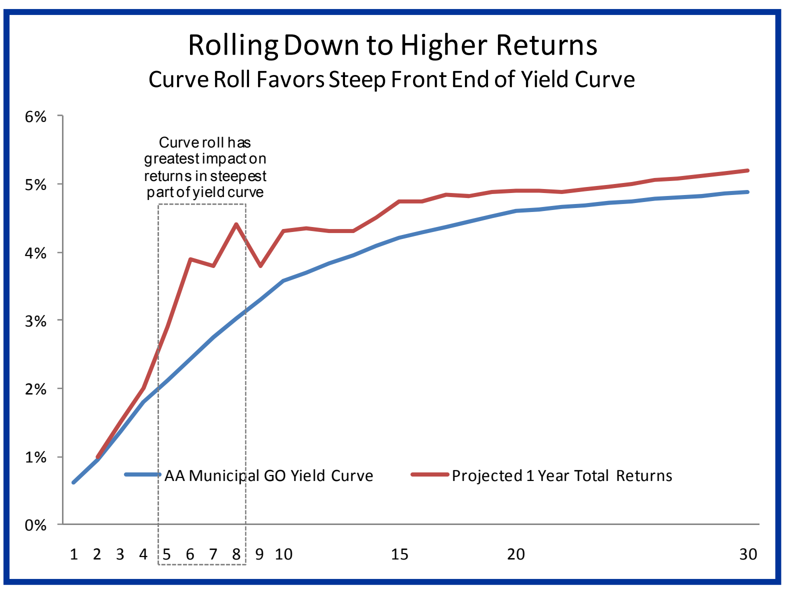
Municipal Market Review

Second Quarter 2010

Municipal yields ended the second quarter of 2010 largely where they began. Referring to **Figure 5**, we can see that yields on municipal bonds fell only slightly across the entire yield curve, with a more pronounced rally in yields on maturities greater than 20-years. As a result, the municipal yield curve underwent a very modest bullish flattening with long-term yields falling more than short and intermediate yields. This modest yield curve reshaping effectively negated the bearish flattening of the municipal yield curve which occurred during the first quarter. Consequently performance in the municipal market for the second quarter was more normative with intermediate and longer-dated maturities outperforming shorter maturities. While the overall shape of the municipal yield curve ended the quarter modestly flatter, the change in the shape of the yield curve was bifurcated with the municipal yield curve steepening marginally at the front end, while flattening modestly 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 261 basis points, 4 basis points steeper than the first quarter ending level of 257 basis points. Conversely, the long end of the municipal yield curve as measured by the 10s-to-30s spread, ended the second quarter at a level of 131 basis points, 22 basis points flatter than the first quarter yield spread of 153 basis points. As a result, the overall municipal yield curve as measured by the 2s-to-30s yield spread closed out the quarter 18 basis points flatter at an ending level of 392 basis points.

However, as we have discussed previously, despite the modest flattening of the yield curve, the current municipal yield curve, at 392 basis points, remains nearly twice as steep as the trailing 10-year average of 207

Figure 1



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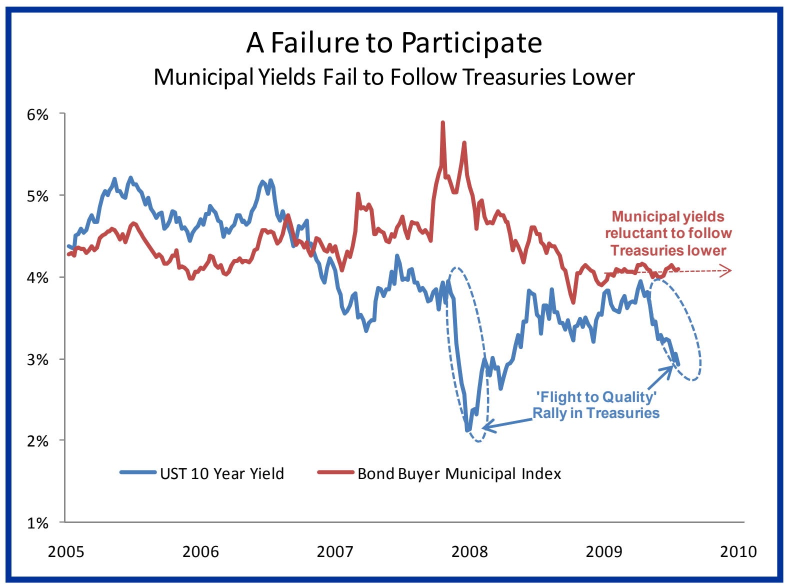
basis points, with the curve particularly steep at the front end. As such the short-to-intermediate area of the municipal yield curve continues to offer attractive **curve roll** opportunities. For this reason we continue to favor the 5-to-8 year area as this area offers the most compelling opportunities for curve roll with annual yield drops of between 38 to 40 basis points. **Figure 1**, which graphs the current AA municipal yield curve (blue line) against the **projected 1-year total return** for each maturity period (red line), illustrates the potential impact of curve roll on portfolio returns. By holding bond yields unchanged over a simulated 1-year holding period, we are able to isolate the potential increase in total returns attributable 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 black box. In addition, purchasing short-to-intermediate maturities to pursue curve roll also offers moderate protection against the risk of an **unexpected rise** in bond yields.

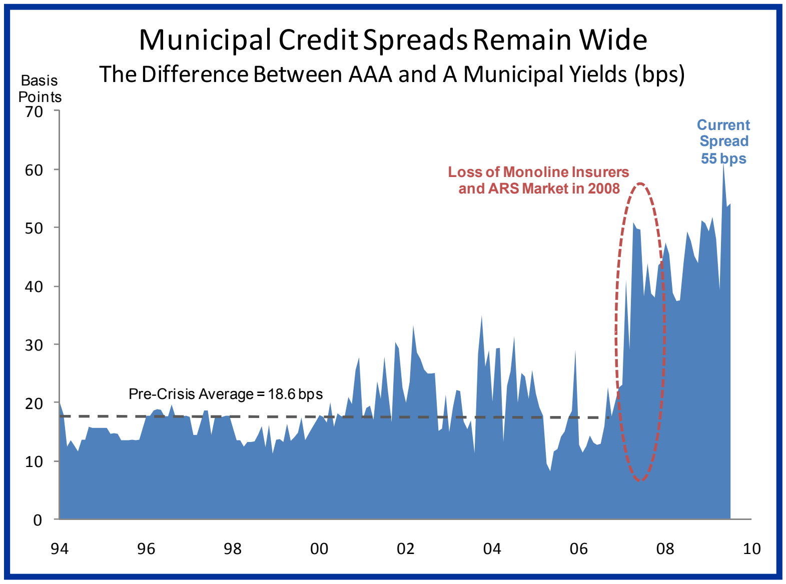
Even though absolute municipal yields remained effectively unchanged for the quarter, the relative value of municipal bonds did not. Instead it rose markedly during the second quarter due to the ongoing **'flight to quality'** rally in Treasury yields. Referring to **Figure 6**, we can see that municipal bond yields as a percentage of Treasury yields (red line), increased over both the first quarter 2010 (blue line) and year end 2009 levels (dotted black line). As such 2010 has been characterized by a dichotomy between **low absolute yields** and **high relative value**, and thus far, absolute yields have trumped relative value. The fact is, with absolute yields at such low levels, the market is experiencing a certain amount of **investor resistance**. Referring to **Figure 2**, we can see that similar to 2008, Treasury yields (blue line) have rallied markedly in 2010 as investors have sought the safety of Treasuries in response to the increased **uncertainty** arising from the banking crisis in Europe and concerns surrounding a possible "double-dip" recession in the economy. Under such conditions there has been a growing **reluctance** on the part of investors to participate at the increasingly **low absolute yield levels** for offer on municipal bonds. This is highlighted by the sideways trend in the Bond Buyer Municipal Index yield (red line) even as Treasury yields have plummeted. To date, this trend has not resulted in an increase in selling pressure, but has instead been reflected by a ***"failure to participate."***

Figure 2



Another factor that has contributed to the recent demand dislocation in the municipal market has been the on-going **transition** of the municipal bond market from a homogeneous, rate-sensitive, AAA-insured arena, to a heterogeneous, credit-sensitive market comparable to the corporate market. This transition began with the loss of the monoline insurers and the auction rate securities market in 2008 and has been accelerated with the recent recalibration of credit ratings for municipal issuers by the credit rating agencies, effectively making municipal debt ratings compatible with those of corporate debt. Thus far the overall impact of the ratings recalibration has been an upward revision for most municipal issues. Nevertheless, what was once a market dominated by the credit profiles of a few monoline insurers has been replaced by the idiosyncratic credit profiles of over 60,000 unique municipal issuers. The overall effect of this transition is reflected in **Figure 3** by the marked increase in credit spreads within the municipal market. Referring to **Figure 3** we can see that at **55 basis points**, the difference in yield between AAA-and-A municipal debt, or the credit spread, has increased nearly two-and-one-half times relative to its' **pre-crisis average** of around **20 basis points**. In our opinion, this widening in municipal credit spreads reflects the increased level of **uncertainty** associated with the market process of sorting out the particular ***"haves"*** and ***"have not's."***

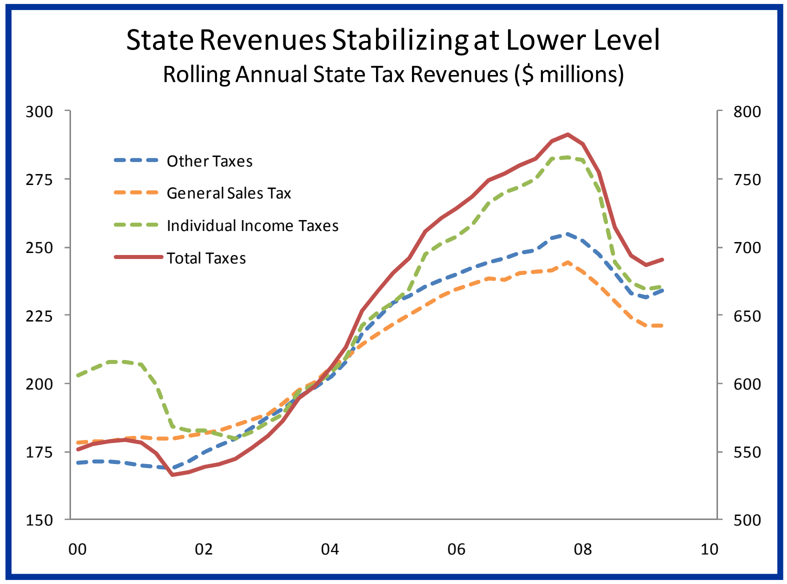
Figure 3



However, while low absolute yields and the ongoing anxiety over the ongoing separation of the *"sheep"* and the *"goats"* likely slowed demand, more problematic has been impact of the steady diet **negative headlines** regarding the financial condition of the states and by extension, municipal debt. Many municipal investors have been climbing the proverbial **wall of worry** in response to the spurious media comparisons made between *incontinent American states* and Greece. By way of example, recent headlines have included; "Municipal Bonds: The Next Financial Land Mine?", "Municipal Bond Market: Ticking Time Bomb", and "The Coming Collapse of the Municipal Bond Market". In our opinion, much of this reporting has been both **irresponsible** and **sensationalistic** in nature, clearly geared more toward increasing circulation than comprehension. Clearly states have continued to struggle with balancing budgets against a backdrop of the most severe contraction in tax revenues since the Great Depression. And while the magnitude of this contraction can be seen in

Figure 4, we can also see that state revenues have recently began to stabilize, albeit at lower levels. At the same time, expenditures, driven in part by the impact of **automatic stabilizer programs** such as unemployment insurance, have increased, thereby exacerbating the problem. Yet with the exception of Vermont, all states have constitutional amendments requiring their annual operating budgets to be balanced. And the simple fact is that state and local governments, coping with unprecedented revenue declines, ***are*** fulfilling their legal obligations to balance their budgets by reducing costs and raising taxes to protect a key constituency: **the owners of approximately $2.8 trillion of municipal bonds**. According to the National Association of State Budget Officers, states have cut spending by $74 billion since 2008 and more than half raised taxes and fees in 2009. We believe states are taking these difficult measures in order to honor their debt payments and so ensure continuing access to the capital markets. In our opinion, lawmakers will be more willing to risk angering voters with reduced services and higher taxes than they will be to spurn the favor of investors who purchase more than $400 billion of state and local debt each year, the proceeds of which finance critical **job-supporting** capital projects.

Figure 4



And in fact this has been aptly borne out by an unbiased reading of the history of municipal bond defaults, a history which reveals that **municipal defaults** are a **slender risk**. According to a report by Moody's, the cumulative 10-year default rate for investment grade municipal debt from 1970 through 2009 was just **0.03 percent**, compared with **2.32 percent** for corporate bonds. In addition Moody's also reported that on average, investors recovered 67 cents on the dollar on defaulted municipal debt compared with only 44 cents for corporate debt. Also, it is important to consider that while the cumulative default rate of 0.03 percent includes all investment grade municipal bonds, **the distribution of defaults is not symmetrical**. By far the fewest defaults occur within the lowest risk class -- general obligation (GO) bonds backed by the full faith and taxing power of the issuer, and revenue bonds issued by long-standing, essential purpose enterprises that are either natural monopolies or have strong protections against competition -- the very segment of the municipal market we favor almost to exclusion. By contrast, most municipal defaults occur within the highest risk class which includes enterprises that **compete against private-sector entities** and have

volatile revenue streams. These include industrial development bonds, multifamily housing, nursing homes, and tribal gaming bonds. Not surprisingly, these sectors have default risk characteristics similar to corporations.

According to James Spiotto, a partner with Chapman and Culter LLP, a Chicago law firm that specializes in municipal bankruptcies and workouts, the generally low credit risk of municipalities is in part a consequence of the **unique laws applicable to municipalities**. While corporations can file for bankruptcy under either Chapter 7 (liquidation) or Chapter 11 (reorganization), municipalities, when allowed by their governing state laws, file for bankruptcy under Chapter 9. Bankruptcies of municipalities under Chapter 9 differ from corporate bankruptcies in several important respects. First, involuntary bankruptcy filings are not permitted. Secondly, Chapter 9 provides only for an adjustment of the municipality's debts not its liquidation. And finally, the municipality's taxing powers are not affected by the filing. These bankruptcy differences specifically provide for a municipality to **continue its existence** during a bankruptcy, including maintaining its operations and revenue collections, thereby greatly increasing the opportunity for a potential recovery on its defaulted debt in the future.

Because of the stigma associated with bankruptcy and the increased difficulty and costs associated with raising capital subsequent to default, filing for Chapter 9 will continue to be a **last-resort solution** for most municipalities. We are equally confident that the balanced and responsible reporting by the media of late will continue to elicit **headline fear**. However, with revenues falling, legislators and governors are often unable or unwilling to agree on spending cuts or higher taxes to balance the budget. Under these circumstances, it will be important to distinguish between an *ability-to-pay issue* and a *willingness-to-pay issue*. And given the current underfunded status of most state and city pension funds, the **publicized threat** of bankruptcy may be more **political** than economic as municipalities try to renegotiate pension obligations and labor costs. So while we would not diminish the fact that there is a significant amount of fiscal pain within many municipalities, we remain confident that most states will take the necessary steps to **maintain access to capital markets**. And while there may be some isolated defaults, particularly within the higher risk class of securities, it is our opinion that there will not be **systemic defaults** or bankruptcies, **bonds will be paid**. And for headline fear as it pertains to municipal bonds, we would offer Mark Twain's sage advice*: "If you don't read the newspaper, you're uninformed. If you do read the newspaper, you're misinformed."*

Figure 5

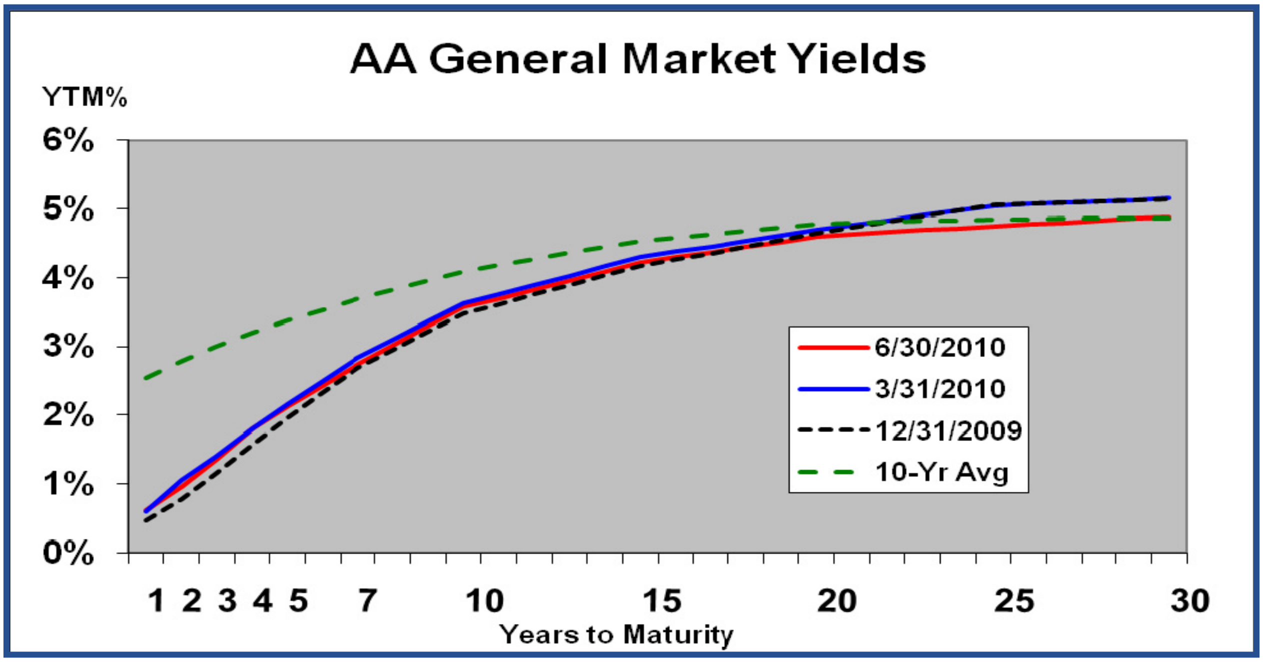
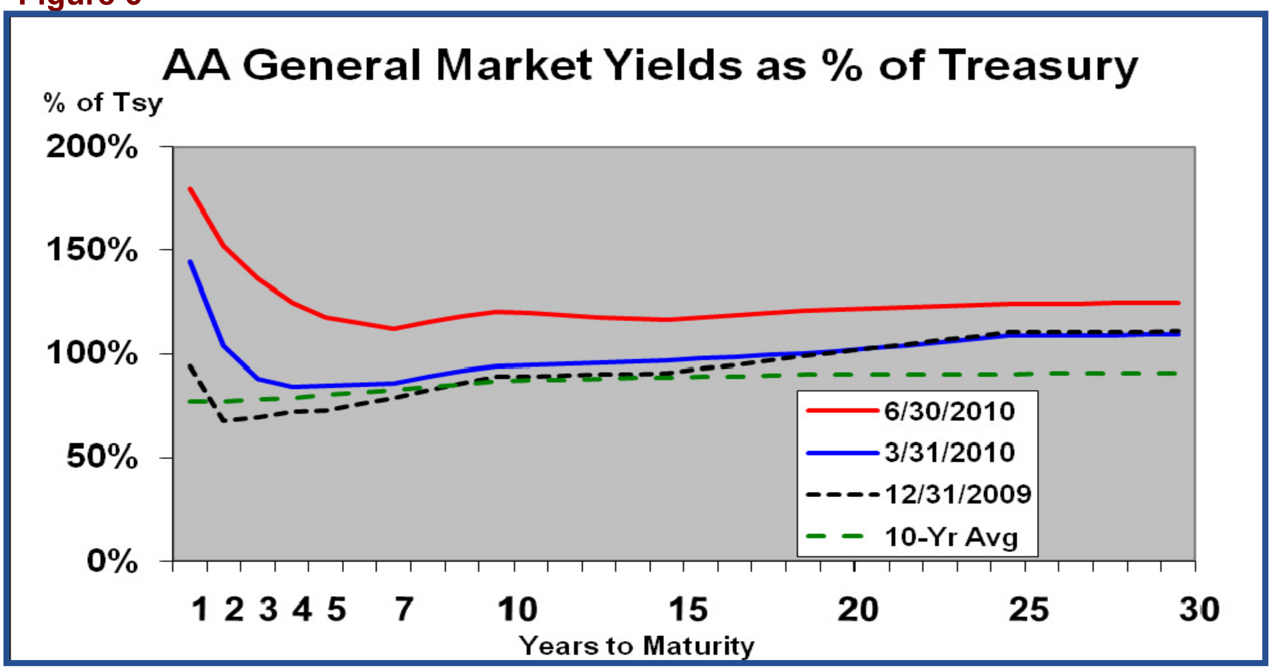


Figure 6



	10 Yr Avg	3/31/2010	6/30/2010
2-Year AA Municipal	77%	104%	152%
5-Year AA Municipal	80%	83%	118%
10-Year AA Municipal	87%	94%	121%
25-Year AA Municipal	90%	109%	124%