MARKET COMMENTARY

December 2011

While there was not a unanimous vote on the new Euro Union accord there was sufficient agreement to stem the flight from related Euro Zone sovereign debt and delay an S&P threat to downgrade the ratings on key Euro member nations. The global bond markets reacted cautiously to the European Union's accord through Monday's open with most players focused on the politics of Great Britain, Germany, and France. Stateside, election year politics centered on tax increases on the wealthy. In two key electoral states, New York and California, agreement was close or complete on proposals to raise taxes on the wealthy to close budget gaps. These measures may have an impact on the municipal market should they come to fruition.

Overview

- A bankruptcy filing by American Airlines parent AMR may have only a limited impact on Municipals. We believe the most significant impact will be on the "special facility" muni bonds backed by AMR for airport improvements.
- A year after the now famous prediction of "hundreds of billions of dollars" in municipal defaults, the total of EMMA-filed notices of defaults shows 96 issuers with outstanding bonded debt of $2.5 billion. This amount, however, does not include the $3.1 billion of Jefferson County Alabama debt nor the $3.3 billion of AMR backed debt, which, technically, has not defaulted but via the filing has put into question repayments to investors.
- Fewer than predicted defaults and volatility in the equity markets led to higher inflows into Municipal Funds through November. Investors added an average of $148 million a week in the 3-10 year intermediate sector while commitments to tax-exempt funds reached $1 billion in the week ending December 7th.
- Demand for municipals was evident in the 4th quarter as issuance exceeded earlier 2011 expectations. Through November, total annual muni deal issuance was $264 billion with levels in the first three months ending in November at $96 billion – the highest offering level since the three month period ending June 2009.
- Consistent with investor uncertainty and flight to quality, Treasury yields remained low with two-year yields hovering around 25 basis points and the benchmark 10-year yield going above and then below 2 percent through the weeks leading to the Euro Zone Summit last week.
- On the economic front, slight improvement in job demand led to a decline in the unemployment rate to

8.6% in November.

- The National Conference of State Legislatures reported progress in States' efforts to close budget gaps in 2012. Through proposed tax increases this year in New York and California and Illinois last year, there is a cautious optimism that municipalities are positively addressing their fiscal condition following the 2008 financial crisis.

AMR Bankruptcy filing's impact on Market

APA believes that the American Airlines (AMR) bankruptcy filing should have a limited impact on the overall municipal market. However, there has been a slight but noticeable impact on bonds backed by AMR through the so-called special facility bonds. There may also be some effect on other airport bonds where American is the dominant carrier. AMR has $3.2 billion of debt backing facilities that were issued as tax-exempt bonds by airports and municipal authorities to pay for gates and maintenance in cities like New York, Los Angles, and Dallas. The pricing of these special bonds was affected by Bloomberg reporting, for example, that a NYC Industrial Development Bond maturing in August 2031 and sold for American in 2005 fell 16% after AMR's filing to 75.9 cents on the dollar from 94 cents on October 27th. In addition to price decline, Bondholders face uncertainty if AMR were to miss bond payments pending a decision on the future of the facilities financed and utilized by AMR.

The AMR filing coupled with Jefferson Co. Alabama and Harrisburg, Pennsylvania increased the dollar amount of municipal defaults to near term highs but they are still nowhere near the "hundreds of billions" predicted a year ago. The Distressed Debt Securities newsletter reported 110 municipal bond defaults totaling $5.2 billion in 2011. This amount does not include the $3.1 billion of Jefferson County debt nor $3.3 billion of AMR backed debt. The record year for defaults was 2008 when the market witnessed $8.5 billion in defaults.

Municipal Bonds Remain A Sound Investment Allocation

Despite these recent headlines, APA believes that municipals remain a sound investment, notably when investors take into account increasing risks associated with other investments and the tax implications of these other investments. For example, Municipal Market Advisors (MMA) reported in their November 2011 Overview that an investor holding a 10-year State of Georgia Bond, rated AAA by all three rating agencies, has a tax-exempt yield of 2.24%. Taking into account another tax-equivalent investment for someone in the 35% tax bracket, the investor would have to have an investment yield of 3.45% to match the tax-exempt yield.

An indication of investor demand in the muni-market was the average of $148 million a week in fund inflows to intermediate duration funds (3-to-10 year maturities) since October 5th, according to Lipper's US Fund Flow data. Additionally, tax-exempt funds received some $1 billion in inflows in the week ending December 7th as a result of higher tax levies proposed in Congress and large states such as California and New York. State lawmakers in New York approved Governor Cuomo's plan to raise tax rates on the wealthiest residents to reduce a budget gap projected to be $3.5 billion. Likewise, California's Governor Brown would like voters to approve similar tax increases in order to close a $13 billion budget gap. The secondary result of proposals like these is demand from investors that has driven down yields on top-rated 10-year maturities to 2.19%, or 1.72 percentage points below the 30-year rate.

Tax Exempt vs. Taxable Yields

Date of Pricing	Major Loans/Issuer/Ratings	10-year Yields	
		Tax Exempt	Tax Equivalent
10/31/2011	MMA 5% AAA Median	2.45	3.77
11/1/2011	GA GO Aaa/AAA/AAA	2.24	3.45
11/8/2011	MA Water Aa1/AA+/AA+	2.54	3.91
11/8/2011	Philadelphia PA A1/A/A+	3.20	4.92
11/15/2011	Baltimore Co. MA Aaa/AAA/AAA	2.23	3.43
11/17/2011	Westchester Co. NY Aaa/AAA/AAA	2.21	3.40
11/21/2011	Westchester Co. Health NY A3/BBB/NR	3.98	6.12
11/30/2011	CT Special Tax Aa3/AA/AA	2.60	4.00
11/30/2011	PR Sales Tax Aa2/AA-/AA-	3.22	4.95
11/30/2011	MMA 5% AAA Median	2.29	3.52
Source: MMA Monthly Overview, page 2			35% Federal tax bracket

Municipal Supply Increases Amid Growing Demand

November brought another increase in issuance in the tax-exempt municipal market along with an increase in demand for municipal debt. Municipal issuance in November was slightly more than the $34 billion issued in October, according to MMA. Total issuance for the three months (September-November) of $96 billion was the largest amount of debt issued since the April to June period of 2009. The total debt issuance year-to-date increased to $264 billion from $204 billion as of October 31st, which was slightly above annual issuance average. APA believes that issuance could reach $300 billion by the end of the year and predictions for 2012 show issuance to be in the $250-$310 billion range.

Treasury yields increased slightly with 2-year Treasuries at 0.25% on December 8th, compared to 0.24% on November 8th. The benchmark 10-year note yield hit 2.05% on December 8th, a small increase from the 2.04% on November 8th. The yield was 1.98% in August 2011.

AAA Municipal Yield Curve

	1 yr	2 yr	3 yr	5 yr	8 yr	10 yr	12 yr	15 yr	20 yr	30 yr
9/12/11	0.22	0.30	0.38	0.87	1.67	2.07	2.43	2.89	3.38	3.66
10/13/11	0.25	0.45	0.70	1.35	2.22	2.58	2.84	3.17	3.59	3.75
11/8/11	0.25	0.42	0.64	1.19	1.90	2.30	2.59	2.97	3.42	3.70
12/8/11	0.25	0.36	0.58	0.97	1.57	2.00	2.35	2.80	3.32	3.70
Change, Sept to Dec 2011	+3	+6	+20	+10	-10	-7	-8	-9	-6	+4

Source: MMD

Fewer States Expect Budget Gaps in 2012; State Revenues Increasing

States appear to have rebounded notably from the effects of the financial crisis. According to the National Conference of State legislatures, fewer states expect budget gaps in 2012. The report stated that only 4 states (California, Missouri, New York, and Washington) faced combined deficits of $4.4 billion for 2012, substantially less (83%) than the $26.7 billion in deficits facing 15 states this fiscal year. State revenues are projected to increase 1.9% in the next year. Collections in most states have either stabilized or increased, and personal income tax collections have met or outperformed forecasts in 33 states. Sales taxes have increased in 35 states.

National Unemployment Rate Declined in November

The national economy is showing some signs of improvement as evidenced by a lower unemployment rate, reduced jobless claims and an increase in the key consumer confidence measure. The housing market, however, continues to struggle. The November 2011 unemployment rate declined to 8.6%, which was below the October rate of 9% and the September level of 9.1%. Including individuals who would like to work but are not actively job searching and part-time workers who would rather be working full-time, the unemployment rate for this category also fell in November to 15.6% from 16.2% in October, according to RDQ Economics.

The Labor Department showed jobless claims falling by 23,000 to 381,000 in the week ending December 3rd. This represented the fewest jobless claims since February 2011.

Moreover, the Conference Board's Consumer Confidence score improved to 56% in November from a very low 39.8% in October, which was the lowest reported level since the depths of the fiscal crisis in March of 2009. Still, the lower confidence reading underscores the concern consumers have regarding their future economic prospects. A score above 90 indicates that the economy is on solid footing and a score above 100 signals strong growth. The Consumer Confidence Survey is a strong leading indicator of the national economy as consumer spending accounts for 70% of U.S. GDP. Another sign that consumers are feeling slightly more optimistic is that the "Present Situation Index", which measures consumers feeling about their current economic situation, increased to 38.3% from 27.1% as did the Future Expectations Index to 67.8% from 50%.

The Federal Reserve reported that U.S. mortgage debt, which previously was a major source of consumer spending and spurred growth in the national economy, may see a fourth year of decline. The volume of outstanding home mortgages was $9.93 trillion at the end of the second quarter, and peaked at $10.6 trillion in early 2008. Lending for new home purchases is expected to decline to $80 billion in the fourth quarter of 2011, the lowest since 1991 and one-fifth the volume of the record high in mid-2005, according to the Mortgage Bankers Association.

APA's Strategy

APA's continuing strategic direction may be summarized as follows:

1. For new portfolios, given that the municipal yield curve has flattened yet is still steeper than in the beginning of 2011, we are recommending a ladder strategy by targeting bonds with maturities 10 years and shorter. We believe that the barbell structure has outperformed until now so we recommend shortening the gap to bonds 10 years and shorter.

   In addition, we do not see any significant long-term threat from inflation. Our investment committee feels that the current moderate uptick in inflation is mostly driven by the cyclical and transitional nature of commodities such as food and fuels. Moreover, we do not see pressure in the near-term, as prolonged high unemployment rates and a depressed housing market continue to suppress labor costs. Our overall duration target is in the 4 year range, down somewhat from 4.5 years.

2. We recommend investors allocate a portion of their portfolios to out-of-state bonds, even in high-tax states, in order to increase geographical diversification and help mitigate concentration risk. Currently, investors can take advantage of the slightly flatter though still overall steep municipal yield curve to make up for the tax on out-of-state bonds by extending maturities just a year or two on out-of-state issues.
3. Further, we believe that we are well positioned to capture additional yield by investing in market sectors where credit spreads remain wider than historical averages. For example, water & sewer bonds, highly rated hospital bonds, public power authorities and public school district debt in states that offer an intercept program can strategically bolster diversification and price stability in APA's portfolios.

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