

*In this commentary we make note of a significant strategic change in APA's comprehensive investment approach. Due to the "Best in Asset Class" performance of Municipals in 2011, APA has noted certain pricing opportunities along the yield curve. We have also noted certain credit spread opportunities which led to duration and credit-based purchase changes in our investment strategies. Secondly, the much heralded predictions of massive Muni defaults last year failed to materialize despite historic headline defaults in the Municipal market. Precisely because of rapid swings in investor sentiment in 2011 – in both equity and fixed income markets – there was a supply imbalance in Municipals which produced attractive secondary market opportunities leading to the "Best Asset Class" returns in 2011.*

### Overview

- 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 118 issuers with outstanding bonded debt of \$12.8 billion. This amount includes the \$3.1 billion of Jefferson County Alabama debt and the \$3.3 billion of American Airlines backed muni-related debt.
- According to Barclays Capital and other financial news reports, debt issued by municipalities such as local governments and school districts outperformed all other asset classes in 2011.
- In spite of strong investor demand, issuance of municipal debt declined to a ten-year low of \$295 billion in 2011. This represented a 32% decrease from 2010 when \$433 billion was marketed, a year of heavy issuance of Build America Bonds (BABs).
- Treasury yields increased slightly with 2-year Treasuries at 0.38% on January 6th, compared to 0.25% on December 8<sup>th</sup>. Ten-year benchmark Treasury yields continued to see-saw around the 2% mark but registered an historic low of 1.9% in the January 11<sup>th</sup> auction.
- According to the Census Bureau, State and local governments had tax revenue increases, on average, of 4.1% in the 3<sup>rd</sup> quarter of 2011. This trend was expected to continue for the 4th quarter of 2011.
- On the economic front, the national economy appears to be once again showing some signs of improvement as evidenced by a lower unemployment rate for December, related reduced jobless claims and an increase in a key consumer confidence measure.
- The Conference Board's Consumer Confidence score improved to 64.5% in December, a notable increase from 56% in November.

- The housing market showed slight signs of improvement as well with an increase in November housing starts. According to the Commerce Department, housing starts were up 9.3% in November.

### **Predictions of “hundreds of billions” in defaults never materialized in 2011**

Despite dire predictions by analyst Meredith Whitney of “hundreds of billions of dollars” of defaults and the high profile bankruptcy filings by American Airlines, Jefferson County (AL) and Harrisburg (PA), the Whitney prediction fell notoriously short. For the most part, States and localities have been able to withstand the worst economic downturn since the 1930s. According to MMA, there was a total of \$12.8B of outstanding Muni issues with missed interest or principal payments in 2011. This was an increase of \$3.9B from 2010 but represents a mere fraction of the \$3.7 trillion in muni bond debt. And a large percentage of the non-payments (27%) can be attributed to American Airlines-secured special facility bonds included in the company’s Chapter 11 filing in December. Importantly, defaults in the muni market were heavily concentrated in high-risk sectors such as land secured deals, Industrial Development Bonds, retirement homes, multifamily housing, and TIF/TABs. These sectors, often unrated and which APA avoids, accounted for 86% of ongoing payment defaults. Accordingly, 83 of the 104 (non-AMR) newly defaulted debt was issued without ratings. Investment grade debt, favored by APA’s investment mandate, is in sectors such as water/sewer, GO, health care and education. These sectors had very few defaults in 2011.

### **Municipal Bonds: The Strongest of Asset Classes in 2011**

And despite these headlines early in the year and accompanying first quarter fund outflows, APA continued to believe that municipals remained a sound investment throughout 2011, especially when investors took into account the increasing risks associated with other investment classes and the tax implications related to other asset classes. According to Barclays Capital, debt issued by municipalities like local governments and school districts outperformed all other asset classes in 2011. Facing predictions of defaults in the early months of 2011, investors pulled \$35B from municipal-bond funds over 29 consecutive weeks, according to Lipper FMI. Further, issuance was scaled back due to expiration of the BABs Program and municipal officials concerns with taxpayer resistance and greater rating agencies concern with new local indebtedness. Prices on muni bonds fell and yields increased early in the year. Merrill Lynch Research reported that return coefficients between the S&P 500 Index and the muni markets showed a very low 0.17%, underscoring the attraction of diversity offered through Muni Bond portfolios during volatile equity market periods.

## Municipal Supply Improves Amid Increased Investor Demand in the Second Half of 2011

In spite of an increase in investor demand, issuance in municipal debt declined in 2011 to a ten-year low of \$295 billion. This was a 32% decrease from 2010 when \$433 billion was issued. Supply was down in each quarter, with the first quarter of 2011 down 54% from the first quarter of 2010 while second quarter issuance declined 30% year over year. With lower borrowing costs and reduced headline risk, issuers returned to the markets in the second half of 2011. Third quarter issuance was down by only 19% followed by fourth quarter declines of 25%. APA believes that 2012 issuance may be in the \$250-\$310 billion range. Negotiated issues had the largest decrease, down 36% from 2010. Competitive issuance was also down but by a lower 19%. General purpose or GO debt, the largest muni sector, was down 29% and education, the second largest sector, was down 25%, according to Bloomberg.

Treasury yields increased slightly with 2-year Treasuries at 0.38% on January 6th, compared to 0.25% on December 8<sup>th</sup>. The benchmark 10-year note yield hit an historic low of 1.9% in the Treasury auction of January 11<sup>th</sup>. This represented a significant decrease of 8% from the 2.05% level one month earlier. The yield was 1.98% in August 2011. Concerns with the slow economic pace in the United States and EU contributed to the record low Treasury yields.

### AAA Municipal Yield Curve

	1 yr	2 yr	3 yr	5 yr	8 yr	10 yr	12 yr	15 yr	20 yr	30 yr
<b>10/13/11</b>	0.25	0.45	0.70	1.35	2.22	2.58	2.84	3.17	3.59	3.75
<b>11/08/11</b>	0.25	0.42	0.64	1.19	1.90	2.30	2.59	2.97	3.42	3.70
<b>12/08/11</b>	0.25	0.36	0.58	0.97	1.57	2.00	2.35	2.80	3.32	3.70
<b>01/06/12</b>	0.20	0.42	0.60	0.87	1.44	1.87	2.24	2.71	3.20	3.54
<b>Change, Oct to Jan 2012</b>	-5	-3	-10	-48	-78	-71	-60	-46	-39	-21

Source: MMD

## State and Local Government Tax Revenues Increase

State and local governments have seen improvement in key tax revenue sources such as property, personal income, and sales taxes. According to the Census Bureau, States and local governments had tax revenue increases on average of 4.1% in the 3<sup>rd</sup> quarter of 2011. Collections increased to a combined \$292 billion from \$280.5 billion. This was the eighth straight quarter of increases and represented the longest stretch of increases since 2008. Tax revenues increased in 48 states for the third quarter of 2011 while declining in only

two (Wisconsin and Delaware). Perhaps surprisingly, the troubled state of Michigan, following many years of fiscal imbalances, is expected to finish fiscal year 2011 with a \$735 million surplus. And fewer states encountered budget deficits this fiscal year, with only New York, California, Illinois, Missouri and Washington reporting deficits. This compares favorably to the 15 states that were expecting deficits just one year ago. This improvement in state and local government revenues is one reason why municipal bonds outperformed every asset class in 2011, with muni returns besting Equities, U.S. Treasuries, and Commodities.

### **National Economy is Showing Signs of Improvement**

The national economy appears to be on the rebound again showing muted signs of improvement as evidenced by a lower unemployment rate in December, reduced weekly jobless claims and an increase in a key consumer confidence measure. The housing market is showing some signs of improvement as well. The December 2011 unemployment rate of 8.5% matched its lowest rate since the depths of the financial crisis in February 2009. This was the fourth straight month of declines, as evidenced by a November 2011 unemployment rate of 8.6%, which in turn was below an October rate of 9% and the September level of 9.1%. The Labor Department stated that employers added a net 200,000 jobs in December and stretched the six-month run in which the U.S. economy added 100,000 jobs or more in each month. Hiring was strong across all sectors in December, including manufacturing which added 23,000 jobs; warehousing with 50,000 jobs; and retailers added 28,000. Even the troubled construction sector added 17,000 positions. For all of 2011, 1.6 million jobs were added, an improvement over the 940,000 jobs added in 2010. The average unemployment rate of 8.9% in 2011 was better than the 9.6% registered in 2010.

Moreover, the Conference Board's Consumer Confidence score improved to 64.5% in December, another month of increase from 56% in November. This was close to the 66% rating in April 2011 and was a significant improvement from the yearly low of 39.8% in October 2011. Still, a 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 46.7% in December from 38.3% in November as did the Future Expectations Index to 76.4% from 67.8% in the same period.

The housing market improvement was evident with the increase in November housing starts. According to the Commerce Department, housing starts increased in November by 9.3%. The increase was largely spurred by an increase in multifamily construction. This sector increase represented the largest for the housing sector

at any time in the last 19 months. Building permits also increased. Construction on multifamily units increased 14% as more individuals were looking for rental units and moving away from single-family home purchases made difficult by tighter mortgage underwriting. Single family construction increased 1.6%.

### **APA's New Year Strategic Direction**

Following significant gains in the Municipal Market Asset Class in 2011, APA believes a strategic modification is warranted in the coming months of the New Year.

In short, we are reducing our duration target to 3.5 years to 4 years from 4.5 years. The change, which culminated after hours of Investment Committee analysis and dialogue, comes about as the result of yield curve changes, supply/demand issues and pricing opportunities along certain yield curve segments.

Although the strategic direction may be characterized as a "modified ladder" approach verses our previous "barbell" strategy, APA's Investment Committee believes the best strategy currently is to emphasize bonds in the 1 to 10 year maturity from the previous range of 1 to 15 years. Additionally, APA will increase our purchase of "A" rated bonds to approximately 30% of the total portfolio from 10% of the total previously recommended. This modification reflects both credit and pricing factors, as stated above, and is the result of APA's Investment Committee's consensus change in strategy.

1. For investors with a lower risk tolerance, APA recommends a Short-Term Strategy. With a lower duration and high credit quality, this strategy offers clients a defensive position against rising interest rates. We recommend this strategy to investors seeking protection of principal in a rising rate environment while looking for generally higher returns compared to traditional money market funds. APA will tailor this portfolio for each client based on their individual liquidity and tax needs.
2. For new portfolios, or for investors seeking slightly higher yields at lower risk than longer duration bonds, APA recommends an Intermediate Strategy. With a slightly longer duration than APA's Short-Term Strategy, we recommend bonds selected utilizing a "laddered" investment approach targeting bonds with 1 to 10 year maturities. We are also increasing our A-rated bond holdings from 10% to closer to 30% in this strategy.

Because APA does not see any significant near-term threat from inflation, the Investment Committee believes that current muted improvements in the economy could benefit investors buying along this curve. Our overall duration target is now in the 3.5 to 4 year range, down from 4.5 years. The top five Municipal Bond sectors in our composite Intermediate Strategy portfolio includes

Local General Obligation (GOs), Higher Education, “Other Revenue”, State GOs, and Utility Bonds.

3. For investors with a higher risk tolerance seeking higher yields and attractive after tax returns, APA recommends our High Income Strategy. This strategy provides investors with higher current income while maintaining exemptions from federal income taxes. The bonds purchased in these portfolios have a slightly longer duration, lower credit ratings and longer maturities. The top five bonds in these portfolios typically are in the following sectors: hospitals, life care, other revenues, higher education, and local GOs.
4. For all of the strategies detailed above, APA recommends 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 may take advantage of a slightly flatter but still overall steep municipal yield curve to lessen the tax effect on out-of-state bonds by extending maturities a year or two out.
5. Further, we believe that APA is well positioned to capture additional yield by investing in market sectors where credit spreads remain wider than historical averages. For example, we emphasize purchases of single A-rated issuers, water & sewer bonds, highly rated hospital bonds, public power authorities and public school district debt in states offering an “intercept” program which can strategically bolster diversification and price stability.

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