



Fears generated from media reports concerning major defaults have not materialized, and with limited supply and positive performance for the third straight month we see improving investor demand in the municipal market. However, continued underperformance in the housing sector with further declines predicted, a slight increase in the June 2011 unemployment rate to 9.2%, and continuing weakening consumer confidence continue to raise concerns over the limited economic recovery.

Overview

- In our view, lack of supply continues to be the major issue in the muni market as new issue supply remained low with year-to-date issuance down 44% through June 2011 versus the same period last year.
- Tax-exempt municipal bonds once again had positive returns in June.
- Build America Bonds showed strong returns for the first six months of 2011, due to expiration of the program at year end 2010 and limited supply in the muni market.
- Contrary to early 2011 media reports predicting large numbers of defaults from muni issuers, the default rate for municipal bonds this year is still on track to be the lowest since the recession began in 2008. We expect this trend to continue in the second half of 2011.
- Investment fund inflows have returned to the muni market.
- State tax revenues rebounded in 2011, with 48 of 50 states reporting total tax revenue growth for the 1Q2011. Preliminary reports for April and May show similar results, with 45 states showing growth of 12.5% compared to the same months of 2010.
- Local government tax revenues, however, declined for the second consecutive quarter, dropping 0.6% relative to a year earlier. Fundamental credit analysis remains key to our security selection.
- State and local governments spending declined at a 3.3% annual pace for the first three months of 2011, showing that municipals continue to tighten their belts.
- The national economy continues to sputter along amid fears regarding an increase in the U.S. Debt ceiling.

- APA continues to focus on the 0 to 3 year and 8-12 year part of the curve.

Lack of Supply

We think the major issue in municipals in 2011 continues to be the limited supply in the primary markets. Through June 2011, \$113 billion in new issuance has come to the municipal market year-to-date, marking a year-over-year decrease of 44%. Municipals appear the most attractive relative to Treasuries on the short 1 to 3 year end of the curve and the longer 20 to 30 year end of the curve. We believe that the 4 to 8 year segment of the curve is currently the richest part of the curve and therefore does not offer the best value on a relative basis. Yields on AAA 10 year tax-exempt bonds were 2.63% as of June 17th, 2011. On an after-tax basis, however, we believe these bonds remain attractive relative to Treasuries and offer an additional 77 basis points in yield over a taxable alternative.

AAA Municipal Yield Curve

	1 yr	2 yr	3 yr	5 yr	8 yr	10 yr	12 yr	15 yr	20 yr	30 yr
1/18/11	0.37	0.74	1.11	1.88	2.93	3.46	3.85	4.32	4.89	5.08
4/29/11	0.30	0.56	0.88	1.50	2.44	2.85	3.18	3.62	4.13	4.58
5/18/11	0.26	0.44	0.74	1.19	2.16	2.59	2.94	3.41	3.87	4.31
06/17/11	0.23	0.42	0.69	1.20	2.21	2.63	2.97	3.39	3.84	4.23
Change from January 2011	-14	-32	-42	-68	-72	-83	-88	-93	-105	-85

Source: MMD

Tax-exempt municipal bonds continued to perform strongly in 2Q11, with investment grade bonds posting another month of positive returns. As indicated in the charts below, A and AA credits had the best returns in June and they continue to outperform their corporate counterparts year-to-date. Media reports of massive defaults have not materialized and total new issue supply remains low, resulting in another month of excellent performance. Build American Bonds have also showed strong returns in the first six months of 2011 due to Congressional refusal to renew the popular program and limited traditional supply in the muni market.

June Performance		
	Merrill Lynch Municipal Index	U.S. Corporate Index
AAA	0.087%	-0.498%
AA	0.317%	-0.730%
A	0.614%	-0.912%

YTD 2011 Performance		
	Merrill Lynch Municipal Index	U.S. Corporate Index
AAA	3.97%	2.41%
AA	4.57%	2.31%
A	5.52%	3.09%

Large Numbers of Defaults Have Not Materialized

Despite early media attention to predictions of a significant number of defaults, both in terms of absolute number and dollar value, the reverse has actually occurred. Thus far in the first five months of 2011, 24 municipal bond issues totaling \$746 million have defaulted, according to Bloomberg. This is down from 60 defaults or \$2.29 billion over the same time period in 2010. This is also a significant reversal in defaults from the 144 in the first six months of 2009 totaling \$4.89 billion. The record year for defaults was 2008, when \$8.5 billion in municipals went bust. Defaults continue to be concentrated in real estate development issues or non-rated issues.

Inflows to Municipals

Investors may have put their fears to rest in 2Q11 as inflows in the municipal market were greater than outflows, a sign that perhaps investor confidence in the sector has returned. The BGOV Barometer shows that inflows into municipal bond funds have exceeded withdrawals by \$498 million since June 8th. The positive inflows of funds into the municipal market followed 29 consecutive weeks of withdrawals according to the Lipper US Fund Flows. Investors fled municipals late last year in 2011 due to headlines depicting significant default risk.

State Revenues Continue to Rebound. Local Governments, Not As Much

After two years of declines, state tax revenues appear to have rebounded in 1Q11, marking the fifth consecutive quarter of growth. U.S. state tax collections rose 9.1% year over year in the first quarter of 2011 according to data from the Nelson A. Rockefeller Institute of Government. Furthermore, preliminary estimates for April and May show continued growth in state revenues. The Rockefeller Institute also reports that State and Local gambling revenues from lotteries, casinos, racinos, and pari-mutual wagering increased 2% in FY2010, yet still a modest 0.5% lower than collections in FY08. This can be attributed to 10 states having enacted measures to expand gambling in order to boost revenues. On a positive note, State and local governments spending declined at a 3.3% annual pace for the first three months of 2011, showing that these entities are tightening their belts and have initiated fiscal diets. One positive for the long term fiscal health of states is that a July 2011 report by the Urban Institute shows that national health reform will result in savings for state and local governments. They estimate that total state savings will exceed states' new costs and that federal dollars will substitute for the projected

state and local reform costs.

The same increase in revenues taking place at the state levels has not trickled down to local governments. The Rockefeller Institute reports that real year-over-year declines in local taxes of 0.6% during the last four quarters compares to a 0.4% decline for the preceding year and 3% growth during the two previous years. The primary reason is that the impact of falling home prices on property tax collections tend to lag 18-24 months. Additionally, a decline in revenues from State Government causes many localities to find additional sources of revenue while reducing expenses. At APA, fundamental credit analysis is key in making local government investment decisions.

National Economy Continues to Sputter Along

The national economy continues at a frustrating slow pace with regards to housing, employment, and consumer confidence. Gary Shilling believes that another 20% drop in housing prices may come sometime in 2012 due to “the depressing effect of 2 million to 2.5 million excess inventories” or homes for sale or in foreclosure. In his view, this could increase the number of underwater mortgages from 23% to 40% of the total, which can depress consumer spending and cause another recession. Evidence of the challenged economy, the unemployment rate increased slightly in June to 9.2% from 9.1% in May, with U.S. companies adding only 18,000 new jobs in June. Confidence among U.S. consumers is also down. The Thomson Reuters/University of Michigan preliminary index of consumer sentiment decreased to 71.5 in June 2011 from 74.3 in May 2011. Their index of consumer expectations also declined to 64.8 from 69.5 during the same time period. Thomson Reuters/University of Michigan also reports half of all households cited price increases or income decreases in June, with a majority interviewed expecting no increases in income to in the 2nd half of the year.

The U.S. Government is coming close to an August 2nd deadline for increasing the Federal debt ceiling. The current U.S. debt level is capped at \$14.3 trillion, and Congress must either increase the ceiling or be forced to reduce spending by approximately 40%; raise taxes by a comparable amount, or enact some combination of spending reductions and tax increases. If the ceiling is not raised and a technical default results, the U.S. Government runs the risk of losing its AAA rating. This has never happened in the history of the United States. Moody’s recently released a report stating that some 7,000 top-rated issuers could be affected if the debt ceiling is not raised. J.P. Morgan believes that a default is extremely unlikely, yet they believe any delay in making a coupon or principal payment could affect the long-term reputation of Treasury finances and the U.S. economy. The threat of default also brings in the risk of a

flight to liquidity from government money funds while foreign investment demand could also be impacted, potentially increasing U.S. borrowing costs.

APA's Strategy

At APA, our main strategic direction may be summarized as follows:

1. For new portfolios, given a steep municipal yield curve, we continue to implement a barbell strategy targeting the following yield curve segments:

50% of total holdings allocated to 0-3 years in maturity.
50% of total holdings allocated to 8-12 years in maturity.

In addition, we do not see a long-term threat from significantly higher inflation. We feel that the current moderate uptick in inflation is mostly driven by the cyclical and transitional nature of commodities. Moreover, we do not project further inflationary pressure in the near-term, as prolonged high unemployment and a depressed housing market continue to suppress labor costs. Our overall duration target remains within the 4.0 to 4.5 year range.
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 steep municipal yield curve to offset the higher tax on out-of-state bonds by extending maturity a year or two on those out-of-state issues.
3. We believe that we are well positioned to capture additional yield by investing in market sectors where credit spreads remain wider than historical averages. Examples include water & sewer bonds, highly rated hospital bonds, state housing authorities, public power authorities and public school district debt in states that offer an intercept program which should bolster diversification and price stability in our portfolios.

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