

*Jefferson County Alabama's filing for Chapter 9 bankruptcy protection on November 9<sup>th</sup> followed Harrisburg, Pennsylvania's Chapter 9 filing in October. And though Jefferson County's filing was the largest in municipal market history, it had been largely discounted by investors given the three year saga involving indictments, convictions and the never-ending (failed) negotiations with the County's creditors. The two filings came against a just released study by S&P that, ironically, highlighted a significant decline in 2011 of municipal defaults that spiked in 2010/09 following the 2008 financial markets crisis. Accordingly, the 10-year treasury yield again dipped below the 2% threshold in reaction to the Euro Zone crisis and a resulting flight to safety. In total, the muni-market reacted in concert with the U.S. treasury market and investors flight to safety.*

### Overview

- Despite Jefferson County, AL and Harrisburg PA's filings for Chapter 9 bankruptcy protection in November and October (that were both years in the making) and the default headlines of Central Falls (RI) and Moberly (MO), an S&P report just released showed 2011 defaults down 69% from the same period in 2010. The Distressed Debt Newsletter reported similar findings, stating that U.S. municipal defaults fell in the 3rd quarter of 2011. There were 12 defaults in the quarter, totaling \$126 million, a decline from 18 in the same quarter of 2010 and 24 for the 3rd quarter of 2009.
- A substantial increase in issuance in the tax-exempt municipal market, coupled with an increase in demand for municipal debt as a result of continued volatility in the U.S. and foreign stock markets, had investors moving funds to quality and safety in U.S. fixed income markets.
- 2011 Treasury yields continued downward with 2-year Treasuries at 0.24% on November 8<sup>rd</sup>, compared to 0.45% on October 17<sup>th</sup>. The benchmark 10-year note's yield hit 2.04% on November 8<sup>th</sup> compared to 2.17% on October 17<sup>th</sup>, 2011. This compares to the 10-year level of 1.98% in August.
- The S&P report noted that the increase in defaults in '09 and '10 were largely the result of land deals in the boom years of 2005-2007 and that 2011 levels were more near historic norms.
- November is election month and in 2011 voters across the U.S. were to decide on \$16.5 billion of new bond issuance, a reflection of improving credit markets through 2011.
- State tax collections continued to grow for the seventh straight quarter according to the Nelson A. Rockefeller Institute of Government.

- However, state pension funds are still significantly underfunded, according to data supplied from Bloomberg and examined by APA. This concern was obvious in heated ballot debates on collective bargaining rights in key 2012 electoral states.
- While unemployment levels declined slightly to 9% in October, the Federal Reserve reported continued softness in the economy in their November meeting and kept open the option for further stimulus measures.

### **Municipal Defaults Still the Exception, Not the Rule**

APA believes that despite Jefferson County AL and Harrisburg PA's filings for Chapter 9 bankruptcy protection in November and October and the recent problems in Central Falls (RI) and Moberly (MO), these critical examples are not reflective of the municipal market as a whole and overall had little impact on the trading of municipal bonds. And, although significant, the two large filings still fall short of the "hundreds of billions in defaults" predicted by Meredith Whitney a year ago. In addition, while not indicative of future default filings, APA notes that the number of credit downgrades reported by Moody's and S&P did increase in the 3rd quarter of 2011.

On November 9<sup>th</sup>, 2011, Jefferson County Commissioners voted 4 to 1 to file for what will be the largest municipal bankruptcy in U.S. history, previously held by Orange County CA, which defaulted on \$2.2 billion in debt in 1994. The Chapter 9 bankruptcy protection vote comes nearly three years after the Alabama County was unable to meet creditor demands over restructuring \$3.14 billion of defaulted sewer debt. The filing did not come as a surprise to investors or the muni market. In 2008, the County threatened to file for bankruptcy after the variable and auction rate sewer bonds and their related swaps tanked following the subprime market meltdown.

Jefferson's bankruptcy was the result of a sewer project "funded and refunded" through fraud and related political corruption. In 2009, Jefferson's banker JP Morgan agreed to a \$722 settlement with the SEC regarding alleged payments made by their bankers to intermediaries with ties to county political figures in an attempt to gain business with the county.

Overtime the debt restructuring attempts failed. The most recent effort came in September 2011 when JP Morgan, the County's largest creditor, agreed to restructure \$750 million in debt and waive \$9 million in swap termination fees related to \$120 million of variable-rate general obligation warrants. The restructuring deal also called for annual sewer-rate increases of 8.2% over the first three years of the agreement. The proposal was not supported by local lawmakers who felt it would unfairly hurt the more poor residents of the County. On

November 1st the Birmingham City Council passed a resolution requesting the County to file for bankruptcy and then hired a retired federal judge to determine whether or not the sewer increases were “unjust”.

The County now must demonstrate to a federal judge that they are unable to pay their bills and come up with a plan for meeting their obligations. Positively, municipalities have more leeway with creditors under Chapter 9 when compared to corporate filings under Chapter 11. For example, creditors are unable to seize or sell off county assets. Nor may the court assign a trustee to take over county operations.

APA notes that Jefferson County, like the previous largest bankruptcy, Orange County CA, is a rarity. Bloomberg reports that over a period of sixty years (since 1937), there were fewer than 500 municipal bankruptcies. In addition, the Distressed Debt Newsletter reported that U.S. municipal defaults fell in the 3rd quarter of 2011. There were 12 defaults in the quarter, totaling \$126 million, a decline from 18 in the same quarter of 2010 and 24 for the 3rd quarter of 2009. S&P reported that muni defaults were down by 69% thus far in 2011 compared to 2010. Issuers have been more willing to reduce municipal expenses rather than risk default. Notably, much of the improvement results from the collapse of municipal bond backing for land developments. Land secured bonds are one of the sectors most likely to default as a result of the housing market bust. As the S&P report stated, 44% of land deals in their muni index showed defaults in 2011.

### **Downgrades Increased**

While a downgrade may not be indicative of a potential default, Moody's reported that downgrades outpaced upgrades in the 3rd quarter of 2011, with five downgrades for every one upgrade. This resulted in 163 downgrades to 31 upgrades, with more than 100 local governments and school districts having their ratings cut. School districts accounted for 41% of the Moodys downgrades. S&P reported similar findings, with 117 municipal downgrades compared to 95 downgrades in the 2nd quarter of 2011. The ratings firm upgraded only 95 issuers, down from 118 last quarter. They stated that the only sectors in which upgrades outpaced downgrades were in health care and revenue-secured utility related bonds.

### **Increase in Municipal Supply is Favorable for Tax-Exempt Municipal Bonds**

A substantial increase in issuance in the tax-exempt municipal market along with an increase in demand for municipal debt as a result of continued volatility in the U.S. and foreign stock markets and debt troubles in the Euro Zone have investors continuing their flight to quality in U.S. fixed income markets. Municipal issuance was over \$34 billion in October, the largest month of non-BAB issuance since June 2009, according to MMA. Total issuance for the year increased to \$204 billion as of October 31st, which was slightly above the annual issuance

average. 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. The reason for the increase in issuance is the result of a these factors: More investors willing to enter the muni market; issuers taking advantage of low interest rates for primary market deals; refunds in the secondary market and issuers issuing debt for projects that were put on hold following the financial crisis. As a result of increased supply, sellers of muni bonds have been compelled to offer lower prices in order to attract savvy investors.

Treasury yields decreased with 2-year Treasuries at 0.24% on November 8<sup>rd</sup>, compared to 0.45% on October 17<sup>th</sup>. The benchmark 10-year note yield hit 2.04% on November 8<sup>th</sup> compared to 2.17% on October 17<sup>th</sup>, 2011. Yet this was an increase from 1.98% in August. Indicating optimism among investors in the muni market, a net of \$851 million flowed into muni's the past eight weeks with an emphasis on municipal bonds maturing in three to ten years, according to Bloomberg. This represented the largest inflow into muni funds in the past 12 months.

#### 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>8/1/11</b>	0.20	0.40	0.63	1.16	2.23	2.67	3.05	3.40	3.86	4.35
<b>9/12/11</b>	0.22	0.30	0.38	0.87	1.67	2.07	2.43	2.89	3.38	3.66
<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>11/8/11</b>	0.25	0.42	0.64	1.19	1.90	2.30	2.59	2.97	3.42	3.70
<b>Change, Aug to Nov 2011</b>	-5	+2	+1	+3	-33	-38	-46	-43	-44	-65

Source: MMD

#### November 2011 Ballot Initiatives

November is election month and in 2011 voters across the U.S. voted on \$16.5 billion of new bond initiatives. There were only two states (Texas and Arkansas) with major state level bond measures. Texas voters approved an authorization for a maximum of \$6 billion in GO bonds for water and sewer projects and \$1.86 billion for student loans. Voters in Arkansas approved a bond program for renewal of a \$575 million bond program that will repair up to 400 miles of interstate highways. Other measures on statewide ballots included a measure in Ohio that would have allowed voters to either ratify or repeal a new bill passed by the state legislature that limited collective bargaining rights for public employees. Following intense lobbying and expensive campaigning by union supporters, the Ohio collective bargaining legislation was repealed by 61.8% of Ohio voters. In other

votes, Maine voters rejected an expansion of state gambling venues while early returns from New Jersey had residents approving a referendum that sought to give state residents the legal right to bet on sporting events. Aside from the Ohio vote, which could place additional financial pressure on that state in the form of higher wages for public employees going forward, APA believes that the various other approved measures are unlikely to affect credit quality or bond pricing.

The only statewide tax vote in the U.S., Proposition 103 in Colorado, was defeated by 64% of voters. The legislation would have increased personal and corporate income tax rates to 5% from 4.63% and increased the sales and use levy to 3% from 2.9%. If passed, the increases could have raised an additional \$2.9 billion for public education. This rejection follows a national trend against any government sponsored tax increases. Washington State voters rejected income and sales taxes increases in November of 2010. Bloomberg reported that the last successful statewide voter approved tax increase was in South Dakota in 2006.

### **State Revenues Increased**

U.S. State tax collections have grown for the seventh straight quarter, according to the Nelson A. Rockefeller Institute of Government. This news could not have come at a better time as states continue to be pressured by the weak housing market and low consumer confidence resulting in declining sales tax revenues. The institute found that collections increased 6.8% in July and August 2011 when compared to July and August, 2010. Revenue increased 10.8% in the second quarter of 2011. For the fiscal year ending June 30<sup>th</sup>, which 46 states use, revenues increased 8.4%, which was the largest increase since 2005. State collections of personal income taxes increased 16% in the second quarter of 2011 when compared to the second quarter of 2010. This was the third straight quarter of double digit growth. Yet projections overall are for weaker revenue growth going forward.

### **Underfunded State Pensions**

State pension funds are significantly underfunded, according to data supplied from Bloomberg and examined by APA. The median funding ratio in 2010 was 74.61%, a decrease from 82.78% in 2007. Only six states had funding ratios above 90% and only New York had a funded surplus of 101.5%. Wisconsin was near 100% with a 99.84% funding ratio. The other top three funded pension systems were North Carolina at 96.71%, South Dakota at 96.28% and Washington State at 92.24%. Illinois had the worst pension funding ratio at 45.43%. The other four worst funding ratios were Connecticut at 53.45%, Kentucky at 54.32%, Oklahoma at 55.87%, and Louisiana at 55.91%. While many states have taken action to aid their pension systems, low funding ratios are not likely to

improve any time soon as return estimates used to gauge funding levels are much higher than actual results and underperformance in these funds continues as the result of weak equity markets and low fixed income yields.

### **National Economy Continues on a Painfully Slow Growth Path**

The national economy continued to sputter along at a frustratingly slow pace in the key areas of housing, jobs and consumer confidence. APA expects the Fed fund rates of 0% to remain at that level well into 2012 and beyond. Additional evidence of a challenged economy is seen in the still high unemployment rate. In October, it declined slightly to 9% from the September 2011 level of 9.1%. Moreover, the Conference Board Consumer Confidence score declined to 39.8% in October from the September 2011 level of 45.4%. The October Confidence score was the lowest reported level since March of 2009. It was significantly higher at 59.2% in July 2011. This reading indicates consumers continue to be markedly pessimistic about their economic future. 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.

Other key economic data (Source MMA):

- Non-farm productivity increased 3.1%, meeting a 3<sup>rd</sup> quarter forecast of +3.0%. This compared favorably to a 2<sup>nd</sup> quarter of 2011 decline of 0.1%.
- Unit labor costs decreased more than expected in the 3<sup>rd</sup> quarter of 2011 by 2.4%. This compares to the 2<sup>nd</sup> quarter 2011 decrease of 2.8%.
- Initial jobless claims were slightly lower in October: 397,000 on October 29<sup>th</sup> compared to 406,000 on October 22<sup>nd</sup>. The forecast was for 400,000 claims.
- Continuing jobless claims were also lower at 3.645 million compared to 3.698 million in the same time period of 2010. That forecast was for 3.693 million.
- The ISM non-manufacturing composite declined in October to 52.9 compared to the September 2011 number of 53.0. This was below the forecasted amount of 53.5.
- Factory orders rose over expectations with September numbers up 0.3% compared to the August 2011 level of 0.1%. The forecast number was for a negative -0.2%.

## APA's Strategy

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

1. For new portfolios, given the steep municipal yield curve, we continue to implement a barbell strategy by targeting the following yield curve segments:
  - 60% of total holdings allocated to 0-3 years in maturity.
  - 40% 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 such as food and fuels. Moreover, we do not project further inflationary pressure in the near-term, as prolonged high unemployment rates and a depressed housing market continue to suppress labor costs. Our overall duration target remains within the 4.00 to 4.50 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 make up for the tax on out-of-state bonds by extending maturity 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. Examples include water & sewer bonds, highly rated hospital bonds, public power authorities and public school district debt in states that offer an intercept program. This strategy bolsters diversification and price stability in APA's portfolios.

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