

Harrisburg PA's filing for bankruptcy clouds an otherwise strong muni market as the large numbers of defaults predicted earlier in 2011 have yet to materialize. Debt issuance has increased the past few weeks as issuers take advantage of low rates. Volatility and investor uncertainty in the financial markets continues. Interest rates are not expected to increase anytime in the near term. Many investors are waiting on the sidelines with cash as they are concerned with the ongoing economic and political developments in the U.S. and abroad.

Overview

- APA believes that Harrisburg PA's filing for Chapter 9 bankruptcy protection on October 11th is not reflective of the municipal market as a whole and it has had little effect on the trading of municipal bonds.
- The "billions in default" have yet to materialize. According to the Distressed Debt Securities Newsletter, defaults in the muni market this year are approximately \$1 billion, compared to \$3.6 billion for all of 2010.
- Increased issuance in the tax-exempt municipal market, modest demand for municipal debt, the continued volatility in the U.S. stock market and foreign markets, and risk aversion from investors continues the flight to quality in U.S. fixed income markets.
- In the past few weeks, inflows of funds to the muni market have improved.
- Despite some improvement, the national economy continues to sputter along at a frustratingly slow pace with regards to housing, employment, and consumer confidence.
- Volatility in the stock market may give rise to attractive buying opportunities in the municipal market, particularly in essential service revenue bonds (water/sewer), health care, and in particular on the short to medium end of the curve.

Harrisburg Petition for Chapter 9 bankruptcy highlights Muni Market in October

APA believes that despite Harrisburg PA's filing for Chapter 9 bankruptcy protection on October 11th, the situation is not reflective of the municipal market as a whole and that it has had little effect on the trading of municipal bonds. Harrisburg, like Jefferson County, is a unique case and was years in the making. We at APA were not surprised with the filing.

In short, the bulk of Harrisburg's troubles can be attributed to debt issued for improvements that were made to the city's trash incinerator plant, which had been a source of financial problems since it opened in the 1970s. The plant was profitable until 1990 and was originally designed to burn garbage to produce steam. However, Dauphin County adopted a solid waste disposal plan that rerouted the garbage produced outside Harrisburg to various other landfills, which was less expensive than paying the incinerator plant to take and burn the waste. The plant began to lose money, and in 1993 the City sold the incinerator to the Harrisburg Authority, the city's public utility. In 2003, the incinerator was closed due to cost issues and not being in compliance with Federal Clean Air Act regulations. But instead of demolishing the plant, city officials decided to rebuild, and issued additional debt to support the project. The project was completed in April 2006 after major cost overruns, but the City discovered that there were major problems with the plant's ash-handling systems and that a third boiler was not entirely finished. Without the third boiler, the plant would be able to generate sufficient revenue to make the required debt service payments as well as offset operating expenses. The city did everything that it could to make the plant profitable, including reducing staff, increasing property taxes, and increasing waste charges. Despite these efforts, the city has been unable to make debt service payments. As a result, the city filed for Chapter 9 bankruptcy, and the State may take over the facility. The case is currently being handled by the US Federal bankruptcy Court for the Middle District of PA in Harrisburg.

Current Market Conditions Still Favorable to Tax-Exempt Municipal Bonds

An increase issuance in the tax-exempt municipal market, modest demand for municipal debt, the continued volatility in the U.S. stock market volatility, and risk aversion from investors continues the flight to quality in U.S. fixed income markets. Municipal yields across the curve have flattened in conjunction with rally in U.S. Treasuries. Treasury yields rallied with 2-year Treasury yields at 0.27% as of October 17th. The benchmark 10-year note's yield hit 2.17% on October 17th, 2011, an increase from the 1.98% in the previous month. Accordingly, investors continue to extend their purchases as long as 30 years in an attempt to pick up additional yield.

AAA Municipal Yield Curve

	1 yr	2 yr	3 yr	5 yr	8 yr	10 yr	12 yr	15 yr	20 yr	30 yr
7/1/11	0.23	0.42	0.69	1.28	2.34	2.76	3.11	3.52	3.94	4.36
8/1/11	0.20	0.40	0.63	1.16	2.23	2.67	3.05	3.40	3.86	4.35
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
Change, July to Oct 2011	+2	+3	+1	+7	-12	-18	-27	-35	-35	-61

Source: MMD

While issuance through October 12th of \$10.6 billion was still down from \$14.2 billion for the same time period last year, supply in the tax-exempt muni market has improved in the last few weeks. J.P. Morgan reports that there was nearly \$7 billion in new issuance the week of October 10th and over the past six weeks, tax-exempt volume increased to \$7.5 billion a week in new issuance. This is higher than the \$3.8 billion weekly tax-exempt supply for the first eight months of 2011 and is \$1 billion higher than the 5-year average supply for post-labor day periods, J.P. Morgan reports.

Short-Duration Funds See Inflow of Funds

In the past few weeks, inflows of funds to the muni market have improved. According to Bank of America/Merrill Lynch, municipal funds received \$1.6 billion since August 31st, 2011, with short-duration muni funds have taken in nearly 70% of the total funds. High yield funds have also benefitted, with investors, who may not want to take duration risk, be more willing to take some credit risk under current market conditions, according to BofA/Merrill Lynch.

National Economy Continues Slow Growth

The national economy continues to sputter at a frustratingly slow pace in the key areas of housing, jobs, and consumer confidence. Additional evidence of a challenged economy is seen in the unemployment rate in September that remained unchanged from the previous month's level of 9.1%. Moreover, the Conference Board Consumer Confidence score remained nearly the same in September 2011 at 45.4%, an increase from the 44.5% in August from 59.2% in July 2011. This reading shows that consumers continue to be a little less pessimistic about the economy. This was one of the lowest score in two years, with a score above 90 indicating that the economy is on solid footing and a score above 100 signals strong growth. This is a strong leading indicator of the national economy as consumer spending accounts for 70% of U.S. economic activity.

APA's Strategy

At APA, our main 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. 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 the tax on out-of-state bonds by extending maturity just a year or two on 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, 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.

Disclosures:

Past performance is not indicative of future results. This material is not financial advice or an offer to sell any product. The actual characteristics with respect to any particular client account will vary based on a number of factors including but not limited to: (i) the size of the account; (ii) investment restrictions applicable to the account, if any; and (iii) market exigencies at the time of investment. Asset Preservation Advisors, Inc. reserves the right to modify its current investment strategies and techniques based on changing market dynamics or client needs. There is no assurance that any securities discussed herein will remain in an account's portfolio at the time you receive this report or that securities sold have not been repurchased. The securities discussed may not represent an account's entire portfolio and in the aggregate may represent only a small percentage of an account's portfolio holdings. It should not be assumed that any of the securities transactions, holdings or sectors discussed were or will prove to be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance of the securities discussed herein.

APA is a registered investment advisor. More information about the advisor including its investment strategies and objectives can be obtained by visiting www.assetpreservationadvisors.com. A copy of APA's disclosure statement (Part 2 of Form ADV) is available without charge upon request. Our Form ADV contains information regarding our Firm's business practices and the backgrounds of our key personnel. Please contact APA at 404-261-1333 if you would like to receive this information.

APA-11-177