



If enacted, APA believes that the President's American Jobs Act of 2011 would dramatically affect the municipal market. In addition, investor fears stemming from the sluggish U.S. economy, fiscal issues in Greece and other countries, all-time low treasury yields and limited supply continue to drive the municipal market. The large numbers of defaults predicted earlier in 2011 have yet to materialize. APA expects continued volatility as financial markets react to ongoing economic and political developments and heightened risk aversion among investors.

Overview

- The President's *American Jobs Act of 2011* limiting tax-exemption for muni bonds could have a negative impact on the municipal market and we feel it is unlikely to pass Congress.
- Increased stock market volatility and risk aversion continue, with investors continuing a flight to quality in U.S. fixed income markets.
- Limited supply of bonds in both the primary and secondary municipal market continues to be the principal driving force behind the positive performance of tax-exempt municipals in 2011 and APA expects this trend to continue for the remainder of 2011.
- The "billions of dollars" in defaults predicted in late 2010 have not materialized. The Distressed Debt Securities Newsletter data shows that the dollar amount of defaults totaled \$946 million through August 2011, compared with \$3.6 billion for all of 2010.
- Despite some improvement in GDP growth, the national economy continues to sputter along at a frustratingly slow pace with regards to housing, employment, and consumer confidence.
- Recent and past downgrades of tobacco bonds coupled with declining revenues shows inherent risk in this sector.
- APA still believes several positive technical and fundamental factors that have supported the municipal market in 2011 will likely continue through the end of the year.
- Recent volatility may give rise to attractive buying opportunities in the municipal market.

President's Jobs Act Limiting Tax-Exemption for Muni Bonds could have negative impact on muni market. Unlikely to Pass in Congress

In an attempt to stimulate the sluggish economy, President Obama announced the \$447 billion *American Jobs Act of 2011 (The Act)*. The Act is designed to provide funding for highway repair and construction, schools, and other infrastructure projects. There are various provisions in the Act that would help pay for the jobs program which include a reduction in eligible mortgage expenses along with limiting state income and local property taxes deductions and charitable donations. Citigroup reports that the Act would also create a new "American Infrastructure Financing Authority" with the capacity to provide direct loans and loan guarantees to aid in infrastructure investment.

One key provision in the Act that could have a direct impact on the municipal market and could severely impair the tax exempt muni market is the limiting of tax deductions from income earned on existing and new tax-exempt bonds. The provision in the Act would apply to individuals with income over \$200,000 and families over \$250,000 by limiting muni tax deductions to 28% of their income starting January 1st, 2013. Citigroup reports that 45% of muni interest payments is received by individuals with adjusted gross incomes of \$250,000 or more and 49% is received by individuals exceeding \$200,000.

Reuters reports that this limitation may cause yields on tax-exempt bonds to increase in order to attract investors, which APA believes would greatly increase borrowing costs for states, cities, schools and others in the municipal bond market. This proposal comes at a time when many state and local governments are facing reductions in key revenue sources such as personal income taxes, sales taxes, and property taxes. The Obama Jobs Plan relies on increased spending for school construction and transportation related projects in order to create jobs. If passed, APA believes the Act would have a significant negative effect on muni issuance and could lead to a flight from muni-bond funds. However, APA and other muni industry professionals believe this provision is highly unlikely to pass Congress.

Current Market Conditions Continue to Support the Tax-Exempt Muni

Increased stock market volatility and risk aversion continues the flight to quality in U.S. fixed income markets. Municipal yields across the curve have flattened in conjunction with a sharp rally in U.S.

Treasuries. Treasury yields are still at all-time lows with 2-year Treasury yields at 0.20% as of September 13th. However, this was an increase from the previous month's record breaking 0.157%. The benchmark 10-year note's yield hit 1.98% on September 13th, 2011, down from the 2.033% in the previous month. Accordingly, investors have been willing 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
9/1/11	0.22	0.30	0.38	0.89	1.80	2.25	2.65	3.07	3.56	3.89
9/12/11	0.22	0.30	0.38	0.87	1.67	2.07	2.43	2.89	3.38	3.66
Change, July to Sept 2011	-1	-12	-31	-41	-67	-69	-68	-63	-56	-70

Source: MMD

Limited supply in both the primary and secondary market continues to be the principal driving force behind the positive performance of tax-exempt municipals in 2011. We expect this trend to continue for the remainder of this year. August issuance declined 26.8% year-over-year to \$21.7 billion and volume for the first eight months of the year declined 37.6% to \$164.6 billion versus the same period last year. This follows a decline of 13.2% in July of 2011 and a 2.8% decline in June according to data from *The Bond Buyer*. All sectors have seen reduced issuance, with the largest declines coming in the electric power sector (down 75% year-to-date), environmental facilities (down 74%), transportation (down 54%), general purpose bonds (down 46%) and health care facilities (down 40%). Only one sector saw an increase in issuance in 2011, that being housing, which increased 18%.

Municipal defaults continue to decline

The "billions of dollars" in defaults predicted in late 2010 have not materialized. The Distressed Debt Securities Newsletter data shows that the dollar amount of defaults totaled \$946 million through August 2011, compared with \$3.6 billion for all of 2010. The reasons they believe that the number of defaults has declined is the result of cities and other governmental entities reducing spending to balance budgets and that state lawmakers stepped in to protect against insolvency and local bankruptcies. The majority of these defaults have been in either originally non-rated and/or land secured deals, often referred to as

dirt bonds, sectors in which APA has traditionally stayed away from purchasing.

National Economy Continues to Sputter

Despite some improvement in GDP growth, the national economy continues to sputter at a frustratingly slow pace in the key areas of housing, jobs, and consumer confidence. Data from the Bureau of Economic Analysis (BEA) shows U.S. real GDP increased at an annual rate of 1% in 2Q11, following downwardly revised growth of 0.4% in 1Q11. BEA attributes the modest growth to increases in nonresidential fixed investment, exports, personal consumption expenditures, and federal spending. The increases offset the declines in state and local government spending and private inventory investment. The national housing market has not dramatically improved despite historically low mortgage rates.

Additional evidence of a challenged economy is seen in the unemployment rate in August that remained unchanged from the previous month's level of 9.1%. Remarkably, U.S. companies added no new jobs in August. Moreover, the Conference Board Consumer Confidence score fell dramatically to 44.5% in August from 59.2% in July 2011. This reading shows that consumers continue to be pessimistic about the economy. This was 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.

Tobacco bonds downgraded

In a low yield environment, many fixed income investors have questioned whether tobacco bonds are a good investment choice. Yields on tobacco bonds are in the 8% range and they compare favorably to other taxable muni's and similarly rated corporate bonds, an argument has been made that tobacco bonds are an attractive option. However, APA continues to believe that these bonds carry an unwarranted level of risk and has avoided the sector over the years due to structural weaknesses and reliance on cigarette consumption. Recent declines in revenues and a Moody's downgrade of \$17 billion of tobacco bonds, including CA Golden States and OH Buckeyes, strengthens our resolve in avoiding these bonds. The downgrade brought the ratings to below investment grade, and currently the issues carry no investment grade rating from any major agency.

Tobacco bonds are backed by payments resulting from a 1998 health-care settlement. The payments are

based on cigarette shipments and the underlying rate of inflation with a floor of 3%. Payments due under the Master Settlement Agreement (MSA) show revenues declining 5.6% as of April 2011. Reasons for the decline are a 6.4% drop in cigarette consumption along with Philip Morris's decision this year to withhold entirely its part of the disputed payments. Revenues have grown only 0.11% on a compounded annual basis since the first full year of payments in 2000. The declines in cigarette sales in 2009 and 2010 are due to many local ordinances banning smoking. Since 1998, when the MSA was signed, cigarette consumption has generally trended down, with payments tied to overall sales volume not industry profit. Tobacco bonds are highly sensitive to declines in revenues, with a potential for default, repayment extensions, and reduced returns in the future. Add to this the FDA's brand new anti-smoking campaign and APA expects further reductions in consumption and thus revenue decline.

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:

50% of total holdings allocated to 1-3 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 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.

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