



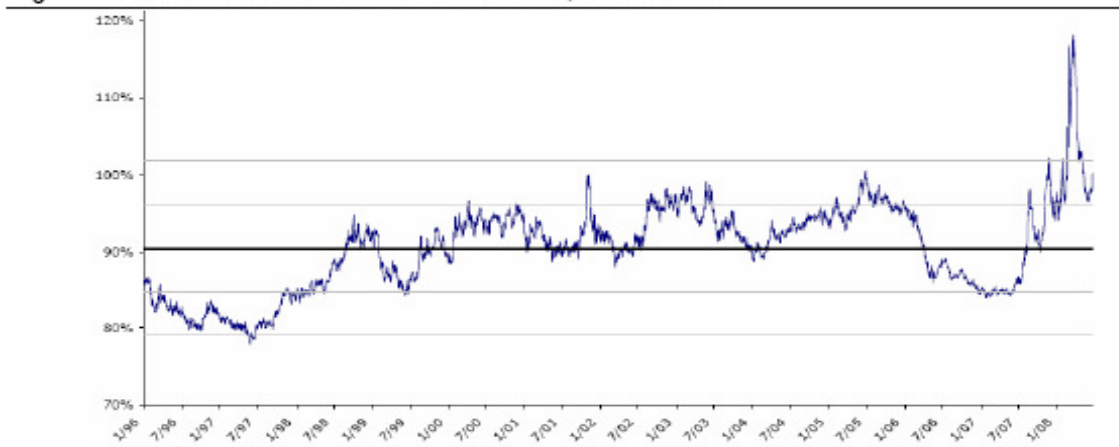
AUGUST 2008

Monthly Commentary

The Federal Reserve Bank held interest rates steady for the second consecutive meeting amid uncertain judgments about the risks to growth and inflation. Most market participants believe the Federal Reserve Bank will remain on hold through year-end...

- The Fed appears to be keeping its options open in regard to future policy decisions. Uncertainties on both sides of the growth and inflation debate still dominate but one of the more encouraging developments – such as recently-retreating oil prices-has seemed to ease concerns somewhat on both counts. The statement following the August FOMC meeting shifted to a more balanced tone and noted that downside risks remain and that the inflation outlook is “highly uncertain.”
- In our view, municipals continue to represent a compelling longer term opportunity. The following graph summarizes the periods of elevated municipal-to Treasury ratio (95% or higher) and the length of the reversion periods to more subdued levels (90%). As it can be seen, there have been four periods when the M/T ratio hovered around or above 100%. The longest period was from October 2002 to March 2003. On average, the market reverted from 100% to 95% in about two months. The period when the reversion took the longest is from July 2005 to January 2006.

Figure 4. 30-Year Munis as a Pct of 30-Year Treasuries, Jan 96-Jul 08



Sources: Yield Book ®, Thomson Financial/MMD and Citi.



ASSET
PRESERVATION
ADVISORS

The Economy

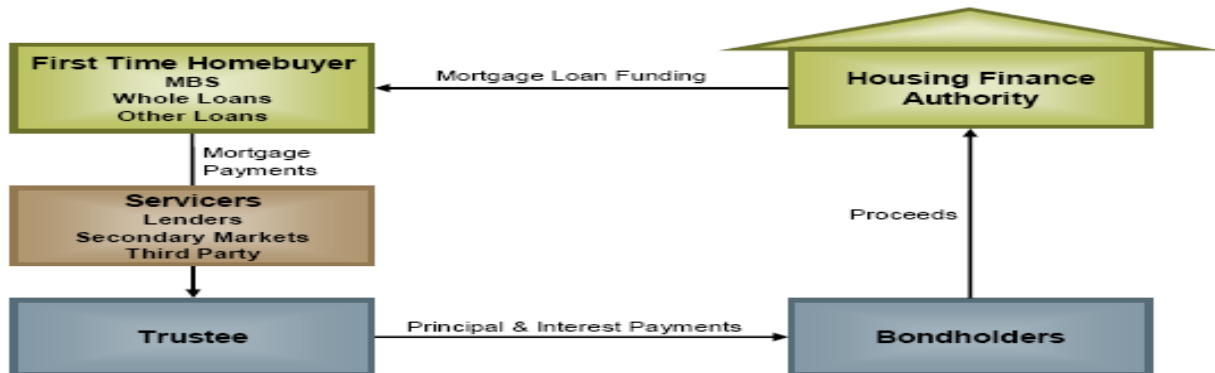
The second quarter GDP report showed overall growth at a 1.9% annual rate, below the 2.3% consensus forecast. The report also showed sharp declines in inventory investment, with strong sales growth of 3.9% for the quarter. Housing investment declined by 15.6% for the quarter, subtracting 0.6% from overall GDP growth. Net exports surged, adding 2.4% to GDP growth in the quarter. Inflation remained elevated as the total PCE (Personal Consumption Expenditure) deflator rose 4.2%, with the core up 2.1%. Consumers seemed to respond cautiously when tax-rebates came through earlier this summer in light of sharply higher prices for necessities, growing job worries and declining wealth. The business response appeared even more restrained as firms ran down inventories at a fast rate, typical of recessions. The labor market continued to weaken in July as non-farm payrolls fell by 51,000. The net declines in payrolls have been less severe than in previous downturns, in part because industries did not seem to be vastly overemployed heading into it. Nonetheless, the unemployment rate continues to increase, now up 1.3 percentage points to 5.7%, as prospective workers may confront limited job availability.

The Municipal Yield Curve

Both the 2s-30s tax-exempt and taxable spreads increased during July. At the end of the month the 2s-30s tax-exempt spread increased 47 basis points, reaching 260 bps, while the Treasury spread rose 17 bps, reaching 206 bps. Since the end of last year, the tax-exempt and Treasury spreads have increased by 123 bps and 68 bps respectively. In the tax-exempt world, the municipal curve shifted down by 46 bps in the 2-year sector, while the 30-year sector increased slightly (+1 bps). The Treasury curve displayed a similar dynamic as the 2-year moved 10 bps down and the 30-year sector moved up by 7 bps.

Housing and Economic Recovery Act of 2008

The Housing and Economic Recovery Act of 2008 was signed into law on July 30, 2008. The Act aims to stem foreclosures, stimulate new housing demand and support Fannie Mae and Freddie Mac. It also provides for several tax-exempt housing bond simplifications and an increase in issuance capacity. Under current law, there is a national limit on the annual amount of tax-exempt housing bonds that each state may issue and many states have reached that limit. The bill increases the states' cap on the total amount of tax-exempt bonds they can issue as additional \$11 billion tax-exempt bonds may be sold to provide loans for first-time home buyers and to finance the construction of low-income rental housing. Furthermore, under the Act, interest earned on newly-issued state and local housing bonds will not be subject to the AMT, likely resulting in lower yields than similar bonds that are not subject to the AMT. Market participants estimate that yield on AMT may be 50 bps lower when compared to similar AMT bonds. The flow of funds for a single family housing bond (HFA) is detailed below:



Source: RBC Capital Markets

In terms of credit quality, housing bonds are usually “overcollateralized” meaning that they have more in assets (mortgages, reserves, cash and other short-term investments) than they do in bonds outstanding. Because of over-collateralization, reserve funds, primary and pool mortgage insurance, the high quality of the mortgage collateral, sound management practices and/or use of mortgage securitization, virtually all state mortgage revenue issues are rated in “AA” or “AAA” categories by rating agencies. In addition, while single family housing mortgages are made to first time homebuyers, the borrowers are not usually considered “subprime” borrowers. Unlike any of the bankrupt mortgage originators who many think are responsible for the subprime crisis, HFA loan underwriting standards remain high and often times contain a requirement for homebuyer counseling prior to purchase. Finally, in order to comply with federal law, all HFA single family mortgages must be for owner-occupied residences and be fully documented as to income.

APA’s Strategy

Expanding Treasury funding needs will likely result in greater dependence on long-term borrowing by the Treasury. For instance, for August, the Treasury plans to increase 10-year auctions by \$1 billion, to \$10 billion and 30-year auctions by \$2 billion, to \$17 billion. As a result, the Treasury curve will likely get steeper. On the municipal market, the elevated medium and long-term supply is expected to increase the long-term yields. Therefore, we believe the steepening in the Treasury market coupled with the supply outlook in the municipal market should drive the municipal 2s-30s spread higher. At APA, our main focus remains on the short-to-intermediate sector (5 years) along with strong credit quality since that segment typically offers good value for both income and return oriented investors while limiting interest rate risk. We have also found good value in insured, now downgraded, high quality issues for yield and prerefunded bonds for liquidity and performance. Finally, longer intermediate good quality paper yielding close to 5% would seem to fit our strategy for incremental return.

Costas Kalaitzidis, CFA

Disclosure:

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. The information provided in this report should not be considered a recommendation to purchase or sell any particular security. 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. All recommendations within preceding 12 months or applicable period are available upon request.

Asset Preservation Advisors, Inc. is a registered investment advisor. More information about the about the advisor including its investment strategies and objectives can be obtained by visiting www.assetpreservationadvisors.com.