



Recent disappointing economic data on U.S. housing, job growth and consumer confidence raised concerns over a slowing economic recovery and led many economists to lower projections of U.S. GDP growth for 2011. A flight to quality spurred a rally in Treasuries and helped stabilize retail investor demand in the municipal market.

Overview

- Tax-exempt municipal bonds performed strongly in May as new supply remained low with year-to-date issuance down 51% through May 2011 versus the same period last year.
- Contrast to highly publicized predictions, the default rate for municipal bonds in 2011 is on track to be the lowest since the recession began in 2008.
- State tax revenues continue to rebound in 2011, with first quarter collections marking the fifth consecutive quarter of growth.
- As local governments face a difficult year of reduced state aid and deficient tax revenues, many states are providing assistance through various state credit enhancement programs.

Tax-exempt municipal bonds have outperformed strongly over the past two months, with investment grade bonds posting solid gains across the curve. As indicated in the charts below, A and AA credits had the best returns last month and have outperformed their corporate counter parts year-to-date. Lower investment grade issues initially lagged behind the high-grade rally that began in April, but as fears of massive defaults continue to wane and total new issue supply remains low, weaker general obligation and essential service revenue bonds had excellent performance in May as credit spreads narrowed following a renewed confidence from retail investors.

May Performance		
	Merrill Lynch Municipal Index	U.S. Corporate Index
AAA	1.35%	1.41%
AA	1.90%	1.22%
A	2.37%	1.42%

YTD 2011 Performance		
	Merrill Lynch Municipal Index	U.S. Corporate Index
AAA	3.88%	2.92%
AA	4.24%	3.06%
A	4.88%	4.03%

Source: Bloomberg

Municipal yields across the curve have trended lower as a lack of primary supply continues to bolster the market. Through May 2011, \$84 billion in new issuance has come to the municipal market year-to-date, marking a year-over-year decrease of 51%. It also marks the first time since 2000 that year-to-date issuance through May has not reached \$100 billion. 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 feel the 5 to 10 year curve is currently the richest part of the curve and therefore does not offer the best value on a relative basis. With short-term rates anchored at current lows, investors seeking yield are beginning to move further out on the curve in search of better value. Yields on AAA 10 year tax-exempt bonds reached a six month low this month, dropping to 2.59% on May 18th. On an after-tax basis, however, these bonds remain attractive relative to Treasuries and offer an additional 50 basis points in yield over a taxable alternative. We currently see value in solid A and AA credits and seek to take advantage of current attractive yields, as we feel spreads will continue to tighten in the near-term.

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
5/31/11	0.25	0.44	0.74	1.23	2.22	2.65	2.98	3.43	3.89	4.30
Change	-12	-30	-37	-65	-71	-81	-87	-89	-100	-78

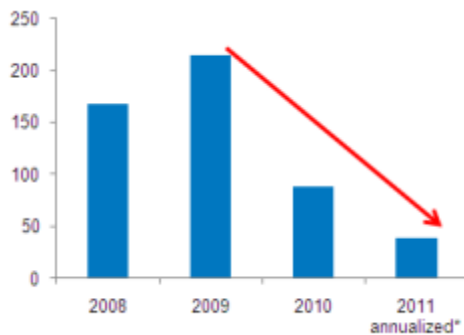
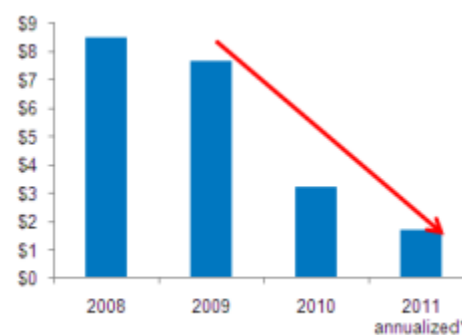
Source: MMD

Defaults Continue to Trend Downward as State Fiscal Conditions Improve

Although low volume continues to be the main catalyst behind the current municipal market, there has also been a renewed interest from retail investors in recent months as dire predictions of massive high-profile defaults prove to be unfounded. According to Reuters, only nine small issues totaling \$245 million defaulted during the first quarter of 2011, down from \$1 billion over the same time period in 2010. And keep in mind that 96% of these defaults were revenue bonds, with none of the defaulted bonds having a rating by S&P.

So far in 2011 (YTD), 16 municipal bond issues totaling \$642 million have defaulted, according to Richard Lehmann of the Distressed Debt Securities Newsletter. The record year for defaults was 2008, when \$8.5 billion in municipals went bust. Today's default level is significantly below the 43 issues and \$1.7 billion for the same period in 2010, and this year is on track to have the lowest number and aggregate

par amount of municipal defaults since the beginning of the recession in 2008. Furthermore, of the 269 government defaults in the past three years, 68% or 184 were housing related community development district (CDD) bonds that were mostly concentrated in Florida. Richard Lehmann predicts that we will most likely see further Florida CDDs defaults this year, as projects started roughly five years ago hit their completion dates and must begin making assessment payments. Seeing as the remaining 85 government defaults that occurred over the past three years amount to a total of \$5.8 billion, we find predictions of “hundreds of billions” in defaults completely irrational, especially as our economy continues to strengthen.

Aggregate Number of Defaults

Aggregate Par Value of Defaults (Billions)


Sources for charts: ISA and DWS Investments, as of 5/11/2011.

Reduced State Aid and Constrained Revenues Challenge Local Governments

Facing cost pressures and reductions in revenues brought on by the recession, states have taken various cost reduction measures and initiatives to address expenses such as pension and OPEB liabilities along with healthcare. Examples include: increasing employee contributions to pensions and healthcare, decreasing education spending and funding to higher education, increasing taxes and privatizing government services. States will be further pressured by the loss of federal stimulus aid in fiscal 2012, which will most likely have a significant impact on local governments which, collectively, derive nearly one-third of their revenues from state aid. In addition to a decline in state aid, many local governments will most likely face declines in property tax collections in the upcoming years as property tax assessments are updated to reflect lower housing market values. Although we do not predict a drastic increase in local government defaults, we continue to actively monitor these credits and look for signs of financial stress. One sign of fiscal trouble for state and local borrowers is increasing reliance on the issuance of short-term debt. Municipalities will issue short-term debt during periods of cash flow shortages, when revenue collections are low or do not coincide with expenditure payments. Therefore,

increasing reliance on this type of issuance in order to balance budgets may indicate an ongoing operating deficit problem.

States are working to assist local governments by implementing a number of enhancement programs in order to help mitigate credit risk during this period of financial strain. According to a recent report entitled “Small-Issuer Focus”, Natalie Cohen of Wells Fargo Securities highlights several of the enhancement programs available to local governments which include: state aid intercept (both pre- and post-missed debt payment programs exist), appropriations, and guarantee programs. As Cohen aptly points out, “between a local government in trouble and debt default are many scenarios.”

State Revenues Bounce Back, But Further Spending Cuts Necessary

After two years of declines, state tax revenue appear to have rebounded with 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, several states have reported better-than-expected tax collections into the second quarter: California increased its estimate of expected revenues for the current and upcoming fiscal years by a total of \$6.6 billion; New Jersey increased its estimate for the same period by \$0.5 billion, and Texas increased its estimate by \$1.2 billion for the next two years. While tax revenue collections have increased, they are still roughly 3.1% lower than prerecession levels, and state and local governments must continue to cut spending in order to balance their budgets. Along with a significant amount of state employee layoffs, 23 states made mid-year general expenditure cuts in fiscal 2011 that targeted K-12 and higher education. To eliminate fiscal 2012 budget gaps, 18 states have employed across the board cuts, another 18 reduced aid to localities, while 9 other states made use of their “rainy day” funds.

We must continue to stress, however, that the current fiscal pressures facing many state and local governments do not constitute a debt crisis, but rather stem from decades of financial irresponsibility, reckless spending and unsustainable benefit packages for public employees. Debt service accounts for a mere 5% of state and local annual budgets on average. Furthermore, most outstanding debt is self-amortizing with level debt service payments that are often tied to the useful life of projects or infrastructure improvements. Therefore, states are never faced with large looming debt service payments. They also have the ability to delay or reduce issuance in times of fiscal austerity, with very little debt issued for the purpose of closing operating budgets.

Slowing Recovery, Divided Congress Thwart U.S. Economic Growth

The economy continues to struggle with regards to housing, employment, and consumer confidence. There are many issues in the housing market that continue to drag down the economy: a large number of foreclosures, oversupply, home buyers facing strict credit conditions despite historically low mortgage rates, and declining home prices. On the job front, the U.S. economy gained only 54,000 jobs in May 2011, a significant slowdown from the 232,000 added in April, according to the Commerce Department. Evidencing the challenged economy, the unemployment rate increased slightly in May to 9.1% from 9% in April. Confidence among U.S. consumers is also down. The Thomson Reuters/University of Michigan preliminary index of consumer sentiment decreased to 71.8 from 74.3 in May. Economists initially forecasted a reading of 74, according to the median estimate in a Bloomberg News survey.

The U.S. Government nears an August 2nd deadline for increasing the debt ceiling. The Federal 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 or spending cuts enacted, the U.S. Government runs the risk of losing its AAA rating or possibly default on its debt, which has never happened in U.S. history. With Treasuries held by many countries around the world, a U.S. default could create economic difficulties on a global scale. Congress has raised the debt ceiling ten times in the past decade, according to National Journal, and we believe it is in our nation's best interest to once again raise the debt ceiling, while simultaneously implementing major cost cutting measures. Vice President Joe Biden is head of a team of bipartisan negotiators that are currently working to reach consensus on a large-scale debt-reduction plan. The key issues currently dividing the two parties are taxes and cuts in entitlements. As the Greek government continues its struggle to win support for extra austerity measures in a dire effort to avert default, the U.S. Federal Government must come to an agreement in order to avoid Greece's fate.

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 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 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, 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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