



Recent mixed U.S. economic data triggered a decline in risk appetite, as lower-than-forecasted growth in service industries and employment raised concerns over the strength of the overall economic recovery. Trading of U.S. stocks and commodities turned volatile, as investors flocked to the safety of U.S. Government debt, spurring a sharp rally in high-quality bonds since early April.

Overview

- Concerns over future economic growth bolstered high quality bonds overall, with high quality municipals experiencing a significant rally during the month of April.
- The municipal market continued to benefit from a number of favorable underlying trends, most notably of which continues to be light primary municipal new issuance.
- Industry participants are gradually moving to a more neutral/slightly bullish outlook on municipals as opposed to the more recent bearish standpoint, as a lack of high profile defaults continues to cast doubt on the highly publicized forecasts of an imminent collapse of the municipal market.

New Issue Scarcity and Absence of Predicted “Billions in Defaults” Fuel Municipal Rally

The municipal market continues to benefit from the current short-term technical supply/demand imbalance, a dearth of primary new issuance, and a gradual increase in retail investor demand. As of April 27, year-to-date issuance has reached just over \$60 billion, marking a year-over-year decline of roughly 50%. Many market analysts expect issuance to remain low through the end of the year, with total 2011 new-issue volume estimated to be less than half of last year’s record \$430 billion.

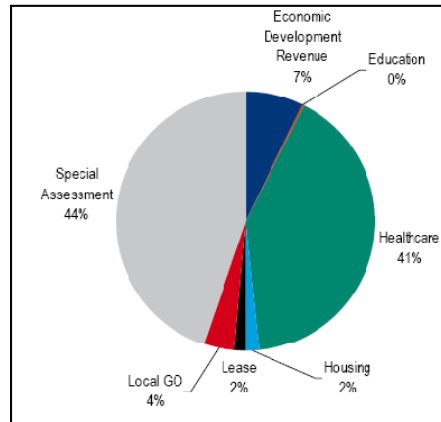
Despite ongoing negative media coverage on rising unfunded pension liabilities and continuing outflows from municipal mutual funds, tax-exempt municipal debt posted the highest monthly returns since August 2010. After a somewhat lackluster month in March and early April, the market experienced a sharp rally beginning on April 11, as demand gradually began to pick up following the end of tax season. According to a recent BofA Merrill Lynch report, municipals in the 7-12 year range and AAA-rated munis have been the best performers by maturity and credit, respectively, year-to-date.

April Performance		
	Merrill Lynch Municipal Index	U.S. Corporate Index
AAA	1.43%	1.28%
AA	1.93%	1.53%
A	2.15%	1.70%

YTD 2011 Performance		
	Merrill Lynch Municipal Index	U.S. Corporate Index
AAA	2.50%	1.48%
AA	2.30%	1.82%
A	2.45%	2.57%

Source: Bloomberg

Retail buyers and institutional investors drove the rally, as fears of widespread municipal defaults waned in the absence of any major crisis. In fact, municipal bond defaults seem to be on track to decline for the third consecutive year in 2011. According to Reuters, only nine small issues totaling \$245 million defaulted during the first quarter of 2011, down from more than \$1 billion over the same period last year. The default rate has declined by 59% year-over-year, and municipal defaults represented around 0.54% of new issuance for the quarter, compared with 1% of new issuance at the same point last year. The chart below illustrates 1Q11 defaults by sector; approximately 96% of the defaults were revenue bonds and none of the issues were rated by S&P.



Source: BofA Merrill Lynch Global Research

Retail investors, who have undoubtedly regained some comfort in the municipal market, appear to be focused on the short end of the curve. High-quality new money offerings have further benefited from scarcity of supply, with refunding issues accounting for approximately 37% of 2011 YTD issuance. The Merrill Lynch 1-12 Year Municipal Index returned 1.3% in April, with the 8-to 12-year sector experiencing the greatest appreciation in prices within the index.

AAA Municipal Yield Curve

	1 yr	2 yr	3 yr	5 yr	8 yr	10 yr	12 yr	15 yr	20 yr	30 yr
3/31/11	0.32	0.66	0.98	1.77	2.74	3.19	3.50	3.90	4.36	4.80
4/11/11	0.32	0.68	1.00	1.79	2.84	3.27	3.55	3.94	4.39	4.85
4/29/11	0.30	0.56	0.88	1.50	2.44	2.85	3.18	3.62	4.13	4.58
Change	-2	-10	-10	-27	-30	-34	-32	-28	-23	-22

Source: MMD

Concerns Over Future Economic Growth Strengthens Rally

Prices on high-quality bonds in general were bolstered by several recent weak economic indicators: subdued U.S. job growth, reduced inflationary risk due to slow GDP estimates, increased sovereign debt concerns in the E.U., and plummeting stock and commodity prices. According to the “advance” estimate released by the Bureau of Economic Analysis on April 28, gross domestic product (GDP) growth slowed in the first quarter of 2011. After increasing 3.1 percent in the fourth quarter of 2010, real GDP increased only 1.8% in the first quarter, falling short of the consensus forecast of 2.0%. Federal government spending was down 7.9% in 1Q11, accounting for a 0.68 percentage point reduction in growth. Furthermore, state and local government spending was down 3.3%, shaving an additional 0.41 percentage points from growth during Q1. Growth in the economy has also been hampered by reductions in the work forces of state and local governments, which have reduced the number of employees by 282,000 or -1.4% from March 2010 to March 2011. While these reductions may impede the overall growth of the economy, state and local governments currently facing sizeable budget gaps, must take these painstaking actions in order to reduce expenditures.

States continue to implement new revenue generating practices in order to successfully close current operating deficits, including the approval of various tax increases. According to a new report issued by the Nelson A. Rockefeller Institute of Government, state tax revenue grew by 7.8% in the fourth quarter of 2010, marking the fourth consecutive quarter of revenue growth. Moreover, preliminary results for January and February 2011 indicate continued growth, with 45 early-reporting states showing a 9.5% increase in revenue growth year-over-year.

One factor to watch during the next twelve months is the potential for significant tax reform. The tax-exempt status of municipal bonds has garnered much attention in Washington, with proposed legislation to eliminate or significantly reduce the tax-exemption for future municipal bond issuance. Legislation currently includes a grandfathering provision for existing municipals; therefore if such legislation were to gain traction in Congress, tax-exempt municipal bonds could become a scarce commodity causing prices to rise.

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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