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Monthly Commentary

New attempts to stabilize financial systems by central banks and governments around the world in the past week has not been sufficient yet to halt the erosion in key sectors of the economic activity at a time when the recession seems to be intensifying...

- The municipal bond market is suffering through the most severe lack of liquidity in recent history.
- Yields in the municipal bond market continued to trend higher last week and reached all-time records as a percentage of Treasury in almost all maturities.
- High municipal yields do not necessarily reflect primarily fears of credit erosion, but rather a supply/demand imbalance.
- Even the very best quality municipal paper can trade at sharply higher yields in absolute basis as well as in comparison with Treasuries.
- The nearly illiquid municipal market will likely take some time to recapitalize with liquidity emerging first for the higher quality, more liquid issuers and later for the lower rated credits.
- We believe that municipal valuations are attractive currently and the collapse of Treasury yields and equity markets should ultimately make municipal bonds an even more attractive alternative over time (see graph):

Figure 1. 30-Year Munis as a Percentage of 30-Year LIBOR and 30-Year Munis as a Percentage of 30-Year Treasuries, Jan 02 - Present



Source: CRI



Lack of Liquidity Pressures the Municipal Market

The municipal market liquidity has experienced some damage in the aftermath of recent events on Wall Street. Most traditional sources of capital have dried up, as property and casualty insurance, mutual fund, and leverage buyers (TOB) have already lost capital or are accumulating cash in anticipation of future funding needs due to redemptions or other liabilities. Retail investors seem to be the only consistent source of capital for the market. A return to more orderly markets depends, we believe, on restoring confidence in the broader capital markets and funding in the investment community. In our opinion, the recent government policy actions are a necessary initial step in the long-term process of restoring typical market functions, including traditional banking, brokerage and insurance activity. A return to tax-exempt yields that are more consistent with historical norms will take some time, as there is considerable inventory of new issue supply, increasing redemptions in mutual funds and selling in the insurance portfolios, hedge funds and dealer community.

Limited Credit Concerns

Most market participants do not expect a significant increase in municipal bonds defaults. Even though state and local government credit quality can erode over time when pressures deepen on the revenue/expenses balance, municipal bonds are not likely to suddenly erode into default. For instance, many better-quality revenue bonds have one year of debt service in a reserve which covers far more than a single year of payments in the event of a revenue shortfall. In most states payment of debt service on state General Obligation (GOs) issues has a first claim on state revenues and there is a constitutional requirement for a balanced budget. The difference between municipal and corporate credits is significant because states are, in effect, natural monopolies, not subject to being pushed out of existence by another competitor. So, the first response to a revenue/expenditure imbalance is usually a round of high profile and often painful spending cuts and/or tax hikes. Only over an extended period of budgetary imbalance does it become more likely that such an imbalance will lead to bankruptcy. States and local governments generally cannot function without access to the municipal bond market for needed capital projects. Therefore, they simply cannot permit budgetary pressures, no matter how severe, turn into full blown credit crises. Even with the limited number of sizeable municipal issues that have reached default status, the default has generally included remedies with full payment back to the investor.

The Municipal Yield Curve

The 2s-30s tax-exempt and Treasury spreads increased during September. At the end of the month, 2s-30s tax-exempt spread increased 8 bps, to 276 bps, while the Treasury spread increased 26 bps, to 231 bps. Since the end of last year, the tax-exempt and Treasury spreads have increased by 141 bps and 92 bps respectively. In the tax-exempt world, the municipal curve shifted up by 46 bps in the 2-year sector and 54 bps in the 30-year of the curve. The Treasury curve displayed different dynamic as the 2-year moved 37 bps down and the 30-year sector dropped by 10 bps. Going forward, the massive financial rescue plan is expected to put upward pressure on interest rates, as the new longer dated issuance should increase yields. Short-term yields may fall, as measures undertaken by the Federal Reserve Bank



should ease liquidity and a decrease in a benchmark interest rate is likely because of the slowdown of the U.S. economy. In the short-term tax-exempt spreads may go higher. The worsening of state fiscal conditions could increase new municipal supply and consequently lift long-term yields. This steepening effect could be moderated by further reductions in inflation expectations, as well as an increase in the short-term yields owing to new issuance.

The Municipal Bond Supply

September supply of \$20.3 billion was lower by 38% than last year of \$32.8 billion. Issuance during the first few weeks of the month was in line with last year's, but the capital market turmoil and illiquidity in the municipal market drove yields higher. Issuance during the past week virtually stopped as institutional demand weakened significantly. Year-to-date long-term bond supply is \$318 billion, or 2% lower than the \$325 billion last year. Refunding at \$92.8 billion is 46.7% higher than last year at \$63.2 billion largely due to the auction rate securities conversion. From a sector perspective, the environmental facilities sector had the largest year-to-date increase (66% or \$4.0 billion) in bond issuance. The healthcare sector has the largest dollar amount increase (\$10.8 billion). Year-to-date California has issued \$48.2 billion of bonds, the largest state issuer and 8% lower than the same period last year. Texas has issued \$33.7 billion of bonds year-to-date, ranking second on the list. Its bond issuance increased 2% from last year.

APA's Strategy

In our opinion, the municipal market is quite attractive currently. Yields, as a percentage of Treasuries, have reached all-time historical highs. Even though the tax-exempt market is not likely to recover as quickly as it did during previous periods of turmoil in August 2007, November 2007 and late February 2008 given the continued illiquidity, we believe that municipal bonds are unsustainably undervalued in comparison with Treasuries. It is unlikely that the current pressure on yields reflect fears of credit erosion. The evidence indicates that municipal yields are at historically high levels even for the strongest quality issues. Therefore, it is likely a supply/demand imbalance due to the reasons described previously that causes a dysfunctional municipal bond market. At APA, we believe, investors will be attracted eventually by the unusually high absolute yields especially once they recognize that this surge in yields is not due to a credit crisis. Consequently, we expect these high yields to drop significantly over time, providing the potential for capital gains as well as an attractive tax-free coupon yield. In addition, individual investors are likely to continue pulling away from other investment alternatives as a result of the fallout in the equity market.

Finally, at APA, we continue to focus on high quality paper and take advantage of the value offered in issues insured by FSA, Assured Guaranty and Berkshire Hathaway with solid underlying credit. Our main duration range remains at 4.50-5.00 years since it should provide a large pick-up in yield over cash with moderate market risk, however, we also buy selectively issues with around 15 years of maturity in an attempt to capture the high yield advantage in terms of slope relative to maturity/duration.

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