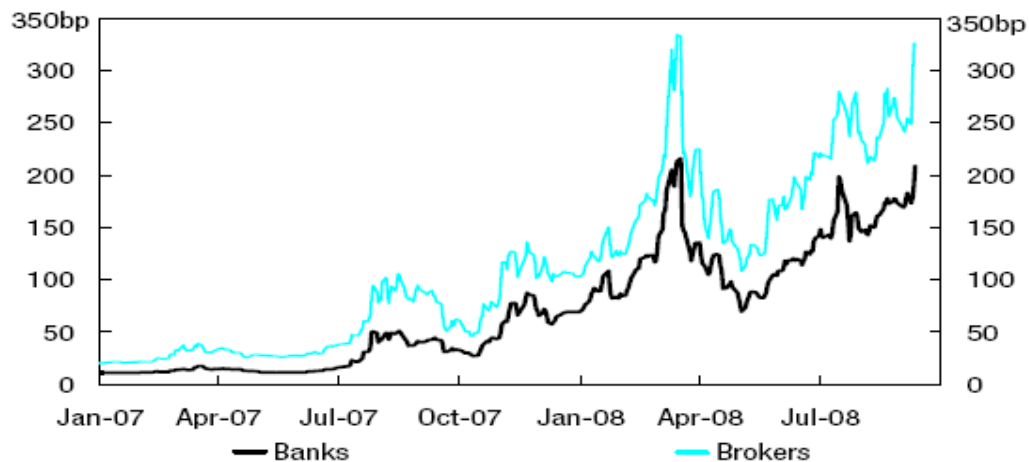


Monthly Commentary

Financial conditions continue to deteriorate potentially leaving the economy exposed to rising unemployment, weak demand and faltering income growth while the Federal Reserve officials left interest rates unchanged at 2%...

- The credit crisis remains a high hurdle for economic growth as credit spreads, and share prices of some financial firms have deteriorated dramatically. Concerns about the health and viability of banks and brokerages continue to balloon the cost of default insurance (see graph below) and keep funding costs high. Consumers' incomes have slowed and have been squeezed by elevated food and fuel bills while household net worth appears to have been battered by the combination of falling home values and equity prices.
- The municipal market is in the midst of several important events such as rating changes, on-going monoline insurance concerns, lack of liquidity, auction rate security settlements, stressed local government budgets and some highly publicized defaults. However, the municipal bond market has been primarily stable despite the ongoing capital market malaise in recent weeks. The main reason for this relative stability has to do with the continuous flight to quality, albeit not to the same degree as Treasuries. In addition, direct retail buying has remained solid, as many individuals have retreated to only the most stable investment sectors in the face of the high volatility experienced in other sectors.

Figure 1. Credit Default Swaps for Large Banks and Brokers (Basis Points), 2007-11 Sep 08



Source: Citi.



The Economy

Second quarter GDP growth was revised aggressively higher, to 3.3% from a previously estimated 1.9%. The bulk of the additional stimulus was driven by a sharply improved trade balance. On the other hand, consumer spending has tapered off as falling home prices, rising unemployment, still high commodity prices, and poor financial asset performance dampen consumption. The labor market continued to contract in August, as non-farm payrolls fell by 84,000. The unemployment rate hit a five year high of 6.1% and several market participants expect the unemployment rate to rise further, peaking at 6.3% during the second quarter of 2009. The emergence of weaker employment data should have a definitive effect on growth and consumption over the next two quarters.

The Municipal Yield Curve

The 2s-30s tax-exempt spread increased during August, while the Treasury spread slightly decreased. At the end of August, 2s-30s tax-exempt spread increased 10 bps, to 268 bps, while the Treasury spread dropped 2 bps, to 205 bps. Since the end of last year, the tax-exempt and Treasury spreads have increased by 133 bps and 66 bps respectively. In the tax-exempt world, the municipal curve shifted down by 14 bps in the 2-year sector and 4 bps in the 30-year of the curve. The Treasury curve displayed a similar dynamic as the 2-year moved 17 bps down and the 30-year sector dropped by 19 bps.

The Municipal Bond Supply

August supply of \$29.8 billion was 2.07% higher than last year's of \$29.2 billion. Continued refinancing of auction rate securities, variable rate demand notes and higher levels of housing issuance would likely keep 2008 issuance levels on record pace. From a sector perspective, the environmental facilities sector had the largest year-to-date increase (148% or \$3.0 billion) in bond issuance. The transportation sector had the largest dollar amount increase of \$15.1 billion. Year-to-date, California has issued \$45.2 billion of bonds, the largest state issuer. This is 9.0% lower than the same period last year. Texas has issued \$31.6 billion of bonds year-to-date, ranking second on the list.

Short-Term Tax Exempt Securities

At the beginning of September, cash flows that caused rates to drop initially lasted only a few days and dealers subsequently raised rates to pare down their inventories. The SIFMA index, which is comprised of hundreds of general market Variable Rate Demand Notes, was higher by 16 basis points and now is set at 1.79% (see table on next page). Market participants expect rates to climb above 2.00% the following weeks as a lack of cash is expected to persist until the end of the quarter. Dealer inventories are high and general market daily floaters that were being reset as low as 1.25% earlier this month are now being reset at 2.50% as dealers seem to be pricing their products at taxable levels to attract buyers.

Figure 9. Variable-Rate Demand Notes and Tax-Exempt Commercial Paper

BMA Index 1.79 +16bp		Non-AMT	AMT
Daily Floaters		2.50%	2.62
Weekly Floaters-National		1.80	1.90
California		1.55	1.77
New York		1.67	1.77
Taxable 7-day VRDNs		2.55	
30 Days	60 Days	90 Days	120 Days
1.75	1.75	1.70	1.75

Source: Citi.

APA's Strategy

In light of some highly publicized defaults in the municipal market (e.g. Jefferson County, AL) we would like to remind our clients of our primary policy in regard to credit quality. At APA we are actively monitoring the credit quality of our portfolios. Credit ratings are changing all the time and passively managed municipal portfolios would be exposed to high credit risk due to downgrades or even defaults. Instead, we are continually reviewing financial statements from municipalities, educational entities, hospitals, etc, to assess their financial health and make necessary adjustments if warranted. In addition, should we have any concern with a credit that we own and we cannot get financial information, or the municipality/entity will not disclose critical information, then we would likely sell the bond and reinvest funds in issues that are meeting our high credit criteria. Finally, we will not sacrifice credit quality in return for higher yield since one of our most valuable principles is the preservation of our clients' investment capital.

With all of the uncertainty and volatility, the municipal market has remained relatively stable when compared to other asset classes and is providing attractive values in certain sectors, states and maturities. Over the past 10 years municipals have produced strong taxable-equivalent returns despite high levels of supply and low absolute yields. More importantly, these returns often came with low volatility and low default ratio. At APA, we continue to believe that elevated medium and long-term supply will lead to higher long-term yields. Given that the current depressed market conditions are mainly the result of liquidity than credit quality concerns, a rising yield environment would also provide the impetus for the market to trade at levels that are more consistent with taxable benchmarks. Higher yields would motivate increased retail participation. In fact, individual demand for high quality municipal bonds increases dramatically when these securities can potentially yield 4.0%+ in 10-years and 5.0%+ in the longer portion of the curve.

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Disclosure:

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