



MARKET COMMENTARY

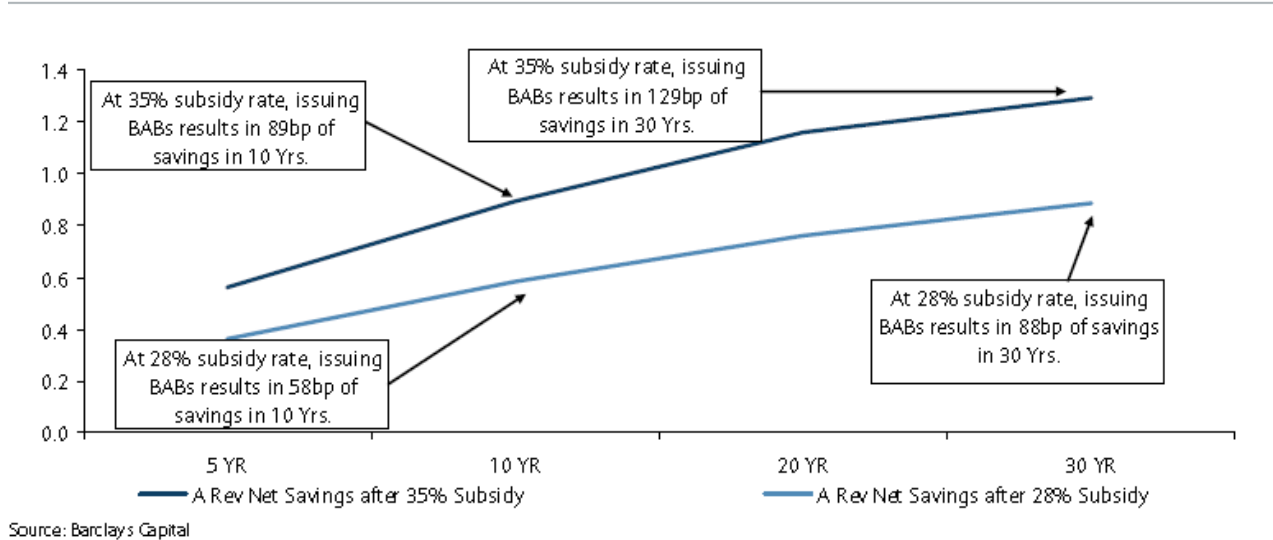
February 2010

Stronger than expected 4Q 2009 GDP growth of 5.7% may give way to more modest growth in 1Q 2010, since much of the growth was driven by replenishing depleted inventories. The pace of the economy is expected to slow to 3.0%-3.5%, while the Federal Reserve Bank may start raising interest rates during 4Q 2010...

Overview

- New issue tax-exempt volume will likely be below traditional levels, due to increases in taxable municipal supply resulting from the extension of the BAB legislation.
- Net inflows to tax-exempt funds continue at a slower pace, following the pattern of flows during the last quarter of 2009. However, strong demand for tax-exempt municipals is likely to grow again due to the expected increase of the top federal income tax rate to 39.5%.
- The Administration is looking to permanently extend the BAB program with a 28% subsidy rate from the current rate of 35%.
- As the graph below indicates, if the BAB proposal is enacted, the vast majority of A-rated deals that currently issued as BABs would continue to be more cost effective as taxables vs. tax-exempts after applying the 28% subsidy.

Figure 4: Cost-effectiveness of issuing A rev BABs (Non Call) with 35% rebate vs 28% across maturities (February 3, 2010)





The Municipal Market

Market analysts expect the taxable municipal supply to reach \$150 billion in 2010 versus tax-exempt supply of \$285-\$300 billion. Tax-exempt issuance in this range would be around 20% lower than the average over the past five years of \$368 billion and approximately \$20-\$40 billion below 2009 issuance. As a result, the 10-year and longer portion of the tax-exempt market is expected to outperform Treasuries in a stable or rising interest rate environment. In addition, the prospect of lower new issue volume comes when rising tax rates and few tax shelters could serve to make tax-exempt bonds more valuable. The budget proposal allows for an increase in the top Federal tax bracket from the current 35% to 39.6%. Moreover, the plan calls for restrictions on deductions such as a cap on itemized deductions for high wage earners. These tax increases, as well as the Administration's more aggressive policy regarding assets held in off shore accounts, would likely be supportive of tax-free municipal bonds.

The Municipal Yield Curve

The municipal high grade curve steepened during January. The 2-30 year spread widened by 18 basis points to 362 bps as long-term rates rose. The 10-30 year high grade spread widened 9 bps to 124 bps. The Treasury curve steepened in January. The 2-30 year Treasury spread widened by 17 bps to 368 bps, as 2-year yields fell by 32 bps and the 30-year yield by 15 bps. The 5-year and 10-year spots also saw rates go down by 36 bps and 25 bps, respectively. Historically, the municipal 2-30 year spread has experienced only two sustained periods of 300 bps or more: October 1981-November 1985 and June 2002-August 2004. The average daily spread of the current run from November 2008 through January 2010 is 358 bps. As the economic outlook becomes brighter and Treasury yields start to reflect sustained growth, the curve will likely flatten in the future.

State Budgetary Pressures will Likely Remain During 2010-2011.

The fiscal conditions of states have deteriorated over the past two years and large budgetary shortfalls are projected for 2010-2011. Also, previous downturns have proven that the worst budget years for a state are the two years after the national recession is declared over. In addition, state recoveries from the current recession may be even more prolonged as the national economy is struggling to recover due to high unemployment rates. Total shortfalls are over \$194 billion or 28% of state budgets consisting of the largest gaps on record.



The New Proposal on BABs Program and its Implications on the Municipal Market

The Administration is looking to permanently extend the Build America Bond program originally announced in the American Recovery and Reinvestment Act. The proposed legislation includes:

- The subsidy rate would be reduced from 35% to 28%, effective 01/01/2011.
- Non-profit entities including hospitals and universities.
- BABs could be used for current refundings of prior tax-exempt public capital projects and for short-term working capital for governmental operating expenses.

The market will not have certainty over the BAB legislation as the budget process will likely play out over most of 2010. Market participants expect that the proposal, if enacted, will likely result in profound and lasting changes to the municipal market affecting the relative value of tax-exempt and taxable municipals as well as the amount of issuance in 2010 and beyond. Specifically:

- Making the program permanent would bring additional investors into the sector who were concerned that issuance in the sector would fade after 2010. The municipal sector might be established as a source of spread product for taxable fixed-income investors.
- The reduction in the subsidy to 28% would push the break-even point at which BABs financing is more attractive to state and local issuers substantially further out along the yield curve (17-18 years on high grade issues).
- The proposed legislation could increase the volume of taxable municipals in 2010 as issuers have a strong incentive to bring BAB bonds to market this year while the subsidy is 35% versus the proposed 28% subsidy in 2011. In 2010, taxable municipal issuance could reach \$150 billion.
- Most Institutional investors have been reluctant to add municipal credit analysts to their staffs due to perceived short term need for their expertise relevant to the additional personnel cost. The BAB program was designed to run from April 2009 to December 2010. However, if the proposed legislation passes, the increased demand for taxable municipals will increase, justifying the need for dedicated analysts in this area.



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APA's Strategy

We continue to focus on high quality general obligation and essential service revenue bonds from larger and established issuers. We prefer bonds with clearly identifiable sources of revenue backing their payments.

At APA, our main strategy can be summarized as follows:

1. For new portfolios, we continue to employ a "barbell" strategy by investing into both the short end of the curve (1-3 yr) and the longer end (7-13 yr) to maximize yield and take advantage of the steep municipal yield curve. In addition, we do not see a threat from significantly higher inflation any time soon. Our overall duration target remains within the 4-5 year range, with a bias towards the lower end of the range.
2. While geographic exposure weightings will vary from state to state based on the investor's tax profile and state of residence we recommend investors in high tax states diversify among issuers within their state of residence, while those in lower tax states may look for greater diversification in out-of-state issues.
3. We believe we are well positioned to capture remaining market dislocations including high quality, essential service revenue bonds. Examples include water & sewer bonds and public school district debt in states that offer an intercept program that may bolster diversification and price stability in our portfolios.

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