



# MARKET COMMENTARY

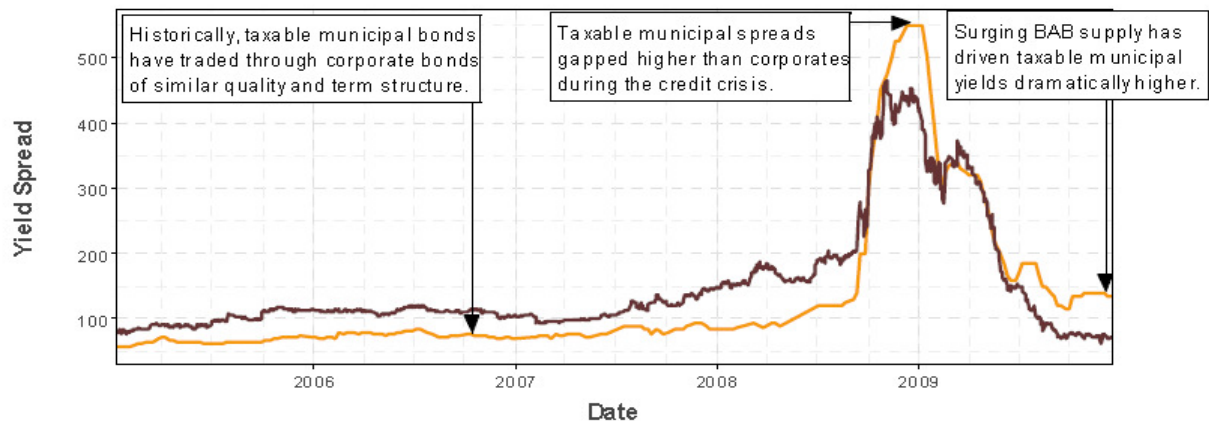
January 2010

*Economists expect GDP growth of 4.0%-5.0% in 4Q 2009 and 1Q 2010, as relatively stronger growth has led to income gains at the consumer level. Experts believe such income gains coupled with higher asset values and a stable housing market will ultimately encourage increased consumer spending. The increase in spending will likely boost employment and hiring on a more sustained basis....*

## Overview

- The long-term muni market has resisted increases in yields on Treasuries, particularly since the beginning of December 2009.
- Tax-exempt municipal issuance continues to trend lower as taxable bond supply surges. Ongoing strong demand from bond fund investors, large amounts of individual investor cash-on-hand and painfully low-yielding short term instruments have created a significant demand/supply imbalance and a shortage of available tax-exempt product.
- As the graph below indicates, we think taxable municipal bonds show compelling spreads over corporate bonds of similar quality and term structure; with spreads continuing to lag since the October 2009 surge in BAB supply. Spreads will likely tighten over time as a result of the scarcity of longer-dated, high quality taxable issuance.

Figure 10: Spread of 30y Taxable Municipals and Corporates to Treasuries



Key	Axis	Name	Last	Minimum	Maximum	Mean	SD	SD Change
Blue	Left	30 Yr AA Tax Muni (Sprd to Treas)	135.000	57.000	550.000	133.682	114.710	13.752
Red	Left	30 Yr AA Corp. Curve Spread	72.481	63.549	466.094	150.163	88.992	5.542

Source: Barclays Capital



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## The Municipal Market

The municipal market spent the early part of 2009 recovering from the crisis that occurred late in 2008, but then went on to continue to perform impressively for the remainder of the year. As the following table indicates, long-term municipal bonds continued this performance through December 2009, with yields continuing to decline. Conversely, Treasury yields moved substantially higher towards year-end, with intermediate municipal yields following to a degree.

### AAA GENERAL OBLIGATION YIELDS

	1-yr	3-yr	5-yr	7-yr	10-yr	12-yr	15-yr	20-yr	30-yr
<b>12/31/2008</b>	0.85	2.03	2.47	2.85	3.52	4.02	4.42	4.80	4.99
<b>11/30/2009</b>	0.30	0.85	1.50	2.12	2.78	3.09	3.31	3.73	4.13
<b>12/31/2009</b>	0.28	0.85	1.57	2.37	3.00	3.14	3.34	3.70	4.05

Source: Thomson Reuters MMD

Treasury yields increased sharply throughout 2009 (see table below) with the yield on 5, 10 and 30-year issues up 107 basis points, 160 basis points and 200 basis points, respectively. This pattern represents the assuaging of late 2008 panic, when investors wanted virtually nothing but Treasuries, and also reflects the more recent recognition that the economy appears back on track toward a moderate growth rate, which will require higher yields due to the large federal deficit. This pattern also played out in December, with 5, 10 and 30-year yields up 68, 64 and 43 basis points, respectively.

### TREASURY YIELD CURVE

	1-yr	2-yr	3-yr	5-yr	7-yr	10-yr	20-yr	30-yr
<b>12/31/2008</b>	0.37	0.76	1.00	1.55	1.87	2.25	3.05	2.69
<b>11/30/2009</b>	0.27	0.67	1.12	2.01	2.69	3.21	4.07	4.20
<b>12/31/2009</b>	0.47	1.14	1.70	2.69	3.39	3.85	4.58	4.63

Source: Thomson Reuters MMD

One main reason for this powerful relative performance of municipals versus Treasuries can be attributed to the issuance of taxable Build America Bonds as a substitute for tax-exempt municipals.



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The Bond Buyer estimates that \$64.1 billion BABs were issued in 2009, accounting for roughly 20% of total municipal supply. In our view, the impact on the municipal market proved to be much greater, as BAB issuance has significantly reduced the availability of long-term tax-exempt supply. Since the municipal yield curve is still dramatically steeper than the corporate bond curve, the vast majority of the issuance in BABs has been in 12-year and longer maturities, thus dramatically shortening the average maturity of the remaining tax-exempt issuance. That means that only few sectors still issue long-term tax-exempt munis; those that do not qualify to be issued as BABs. Consequently, for the vast majority of issuers that can use BABs, long-term tax-exempt new issuance has virtually disappeared.

### What to expect in 2010

Many of the factors that impacted the municipal market last year appear well-positioned to endure in 2010. The two most visible are lower yields following the impressive 2009 price rally, and the ongoing shadow of credit concerns over many of the nation's states and local governments. Meanwhile, the prospect of higher marginal tax rates for most municipal buyers moves closer to reality with the Bush tax cuts set to expire at the end of 2010, resulting in the top federal tax rate reverting back to 39.6%. Therefore, demand for tax-exempt income will likely remain strong during 2010 and beyond. We believe the following reasons could enable municipal bonds to outperform, and thus mitigate rising Treasury yields:

1. The impact of the federally taxable BABs program, which diverts supply that would otherwise be tax-exempt issuance, thus supporting the market prices of the tax-exempt sector.
2. A very strong history of debt repayment and low defaults by investment grade-rated municipal issuers.
3. Remaining dislocations in moderate to low investment grade issues. For instance, according to the Municipal Market Data Co., both A-rated and BBB-rated yield spreads stand at almost 2.5 times their respective long term averages.

In regards to credit quality, there is no question that several states and local governments throughout the nation are under fiscal pressure. In fact, market participants expect the credit picture for municipalities in general to remain challenged for at least the next 18 months, with negative headline pressure continuing to impact the market during that period. While we believe many of the concerns



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are exaggerated or simply misplaced, areas of the municipal market exist where such concerns are warranted, including lower-rated debt, very small issuers who may lack market access and flexibility, and issuers with narrow revenue sources. However, as the headlines roll and many media articles focus on budget woes at the state level, it is also important for investors to maintain a long-term perspective and recall that states have an impressive record spanning decades for successfully closing budget gaps through a combination of reserve draw-downs, spending cuts and tax increases where necessary.

### **APA's Strategy**

In 2010, we will continue to focus on high quality general obligation and essential service revenue bonds from larger and established issuers. In addition, we prefer premium-priced securities, due to their defensive nature over par or discount-priced bonds. We view pre-refunded municipal bonds as fully priced in the current market environment, but still a potential consideration for those interested in ultra-high credit quality.

#### **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 (10-12 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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**Disclosure:**

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