MARKET COMMENTARY

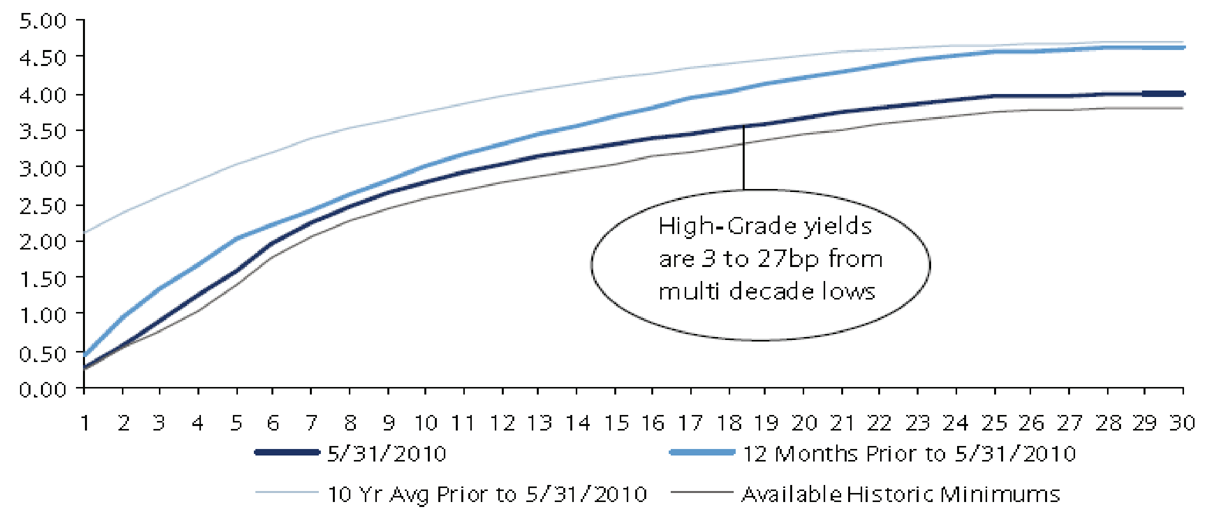
June 2010

Economists are projecting a stronger second half of the year, based on continued business investment and surging consumer confidence that continues to improve despite the debt crisis in Europe...

Overview

- Tax-exempt yields will likely lag Treasury yield movements in both up and down markets as strong municipal market technicals are offset by low yield levels across the curve.
- Net tax-exempt supply in the municipal market is trending increasingly negative as taxable issuance has been consistently over 30% of total supply since the beginning of the year.
- Inflows to municipal mutual funds have slowed considerably, but remain positive over the past three months as compared with the record inflows of last year.
- Taxable municipal spreads have been less volatile than their corporate counterparts during the recent market turmoil.
- As the graph below indicates, yields throughout the tax-exempt market are from 3bps (in the 1-2 year part of the curve) to 27 bps (in the 14-15 year part of the curve) from their lows based on data back to the 1970s.

Figure 2: High Grade Curve – May 31, 2010



Source: Barclays Capital

The Municipal Market

As the following table shows, the municipal market rallied during May, but not nearly as much as Treasuries. The flight to quality rally in Treasuries, resulting from renewed global economic fears, left virtually all other sectors lagging far behind. High grade municipal yields were down 1 to 12 bps along the yield curve, with the most dramatic drop in yield occurring in the short to intermediate part of the yield curve.

AAA GENERAL OBLIGATION YIELDS

Date	1-yr	3-yr	5-yr	7-yr	10-yr	12-yr	15-yr	20-yr	30-yr
05/06/2010	0.39	1.03	1.72	2.42	2.93	3.10	3.34	3.72	3.99
05/20/2010	0.30	0.92	1.62	2.30	2.83	3.05	3.30	3.68	3.98
Change in bps	-9	-11	-10	-12	-10	-5	-4	-4	-1

Source: Thomson Reuters MMD

This scenario is not particularly unusual. When economic or credit fears grip global markets, as they do currently, Treasuries are usually the primary beneficiary. Despite the underperformance relative to Treasuries, the municipal market experienced a very solid month that resulted in yields throughout the tax-exempt market to approach their multi decade lows, based on data back to 1970s. Tax-exempt market price movement has been relatively stable, despite broad market volatility. Investment grade tax-exempt valuations have remained range bound in contrast to the equity and taxable fixed-income markets that have declined considerably. This price stability has persisted despite uncertainty about the U.S. recovery, concerns over longer-dated liabilities and negative headlines. Supply/demand dynamics, resulting from the increase in taxable bond issuance, continues to drive performance in the tax-exempt market.

Negative Headlines: Reality versus Perception

Articles with negative headlines regarding municipal credit quality continued to appear during May and will likely resurface every time a domestic or global financial concern emerges. At APA, we do not concur with the conclusions reached in these articles for the following reasons:

- These articles tend to collect data from the same very small number of actual bond defaults on investment grade municipals and extrapolate this data to suggest that the pattern will become far more widespread. We believe this pattern is unlikely.

- We believe these articles confuse the severe long-term pressures related to pension funds and retiree healthcare with near-term credit risks. Even though pension and healthcare obligations will require significant adjustment over time, many state and local governments are already taking action and are moving to a less generous formula for new hires and in collective bargaining with unions.
- These articles seem to ignore distinctions between corporate budgetary crises and those of state and local governments. Corporations simply cease to exist if the budgetary crises are too severe while municipalities do not.

The Municipal Yield Curve

The municipal high grade spread (2-30 year) widened 6bps during May to 342 bps, as short-term yields fell more compared to the long portion of the curve. Yields were lower by 11 bps in the 2-year maturity range, 5 bps in the 30-year and as much as 17 bps in the 10-year portion of the high grade curve. The Treasury curve flattened in May. The 2-30 year Treasury spread tightened 12 bps to 344 bps, as 2-year yields fell 19 bps and 30-year yields dropped 31 bps. The 5-year rate was 32 bps lower, while the 10-year declined 37 bps.

States Continue to Face Fiscal Distress

States continue to face budgetary stress, with 48 states having to address shortfalls totaling $200 billion in fiscal 2010, including both initial and mid-year shortfalls according to a report by the Center on Budget and Policy Priorities. At least 46 states continue to face shortfalls for the upcoming fiscal year, with budget gaps totaling $112 billion or 17% of total budgets in 46 states. State budget gaps for 2012 are estimated to total $120 billion, with the combined total budget shortfall for 2011 and 2012 reaching $260 billion. States could face further distress due to declines in federal funding. For fiscal 2011, only about $40 billion from the American Recovery and Reinvestment Act remains to help states with Medicaid funds that are scheduled to expire in December 2010. States have also been struggling to meet public pension funding costs, as the value of assets has declined during the economic downturn, while benefit payments to retirees continue to grow. To address these rising costs, more than twenty states have taken steps to reduce pension costs by enacting pension reform. Illinois raised the retirement age to 67 from 62 for new hires and Wyoming has asked current state workers to contribute to their retirement. Utah has closed its defined benefit plan to new workers in step with several other states that have closed traditional pension systems to new employees.

Although pension reform typically affects future employees, since pension obligations made to current employees must be fulfilled contractually under state law, some states are requiring current employees to contribute more money. Colorado, Iowa, Minnesota, Vermont and Wyoming have all raised contribution rates for some or all of their current employees. Colorado has gone one step further, overhauling its public retirement system after years of failing to meet required contributions by raising the minimum retirement age for new employees, as well as capping living adjustments for current and future retirees at a lower rate and freezing them for a year.

APA's Strategy

We continue to favor the intermediate part of the municipal bond yield curve (8-13 years) where the slope of the curve remains steep. Yields on shorter maturity bonds are too low while yields in the long end of the curve are depressed by the dominance of BABs in that maturity range.

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 (1-2 yr) and the longer end (8-13 yr) to maximize yield and take advantage of the steep municipal yield curve. We do not see an imminent threat from significantly higher inflation. Our overall duration target remains within the 4.50-5.50 year range.
2. While geographic exposure weightings 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. Currently, investors can take advantage of the steep slope of the municipal curve to make up the tax on out-of-state bonds by extending maturity just a year or two on the out-of-state paper.
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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Disclosure:

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