



MARKET COMMENTARY

March 2010

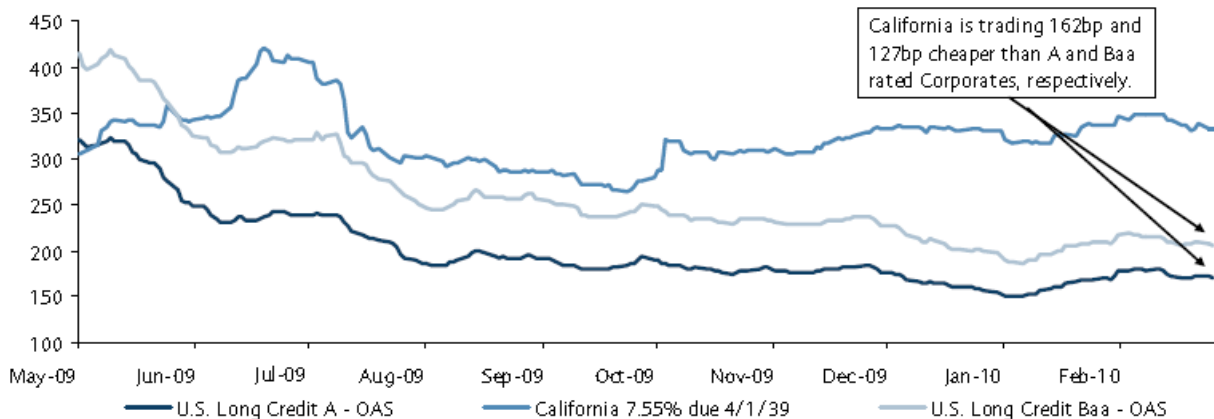
Recently released economic indicators showed mixed signals regarding the overall direction of the economy. 4Q 2009 GDP of 5.9% came in stronger than originally reported; however, employment related statistics and consumer spending data have been weak or revised lower while housing related data has been disappointing...

Overview

- The municipal bond market has remained relatively stable over the last few weeks despite continuing volatility in Treasuries.
- Limited new issue supply resulted in extremely low municipal high-grade yields, making it difficult to produce attractive income in tax-exempt portfolios.
- The increased demand from mutual funds and ongoing low default characteristics will likely support municipal issues over the remainder of the year.
- Taxable municipal bonds have traded better in 2010 due to the prospect of permanent BAB authorization, growing acceptance among traditional taxable investors and continued low default probabilities.
- As the graph below indicates, California Build America Bonds (BABs) currently yield 162 bps above long A-rated corporate issues while they continue to trade at much wider levels than the rest of the taxable municipal universe.

Barclays Capital | Municipal Market Commentary

Figure 17: California BABs Trade at Higher Spreads than Long A Rated Corporates



Source: Barclays Capital



The Municipal Market

Tax-free municipal bond yields continue to trend lower, despite the challenging fiscal environment for state and local governments. The tax-exempt municipal market continues to exhibit effects of supply/demand imbalance with considerably more capital pursuing a relatively limited amount of tax-exempt debt. Strong inflows to municipal mutual funds continue; February averaged about \$1.14 billion in weekly flows. On the other hand, February's municipal paper supply of \$18.2 billion was down 20.6% from the same period in 2009. Ultimately, municipal bonds remain "expensive" by historical standards and it's unlikely that they will become "cheap" as long as two forces are in play:

- Mutual municipal bond funds absorb a substantial amount of tax-exempt paper.
- Build America Bonds (BABs) replace a large proportion of tax-exempt supply as roughly 30% of new issue supply in the municipal market has come in taxable rather tax-exempt form since the beginning of 2010.

Lower municipal yields have also driven a considerable amount of capital to the sidelines in anticipation of higher Treasury yields later in the year. However, thin money market rates make it extremely costly to invest capital in the short-term market, particularly given the extended time that the market has produced anemic yields.

The Municipal Yield Curve

The municipal high grade spread (2-30 year) tightened 3 bps to 359 bps during February, as long-term yields dropped slightly more than the short-end of the curve. Yields in the intermediate portion of the curve saw double-digit declines. The 10-30 year high grade spread steepened 8 bps, to end the month at 132 bps. In contrast, the Treasury curve steepened in February. The 2-30 year Treasury spread widened by 7 bps to 373 bps, as 2-year yields were unchanged and the 30-year rose 7 bps. The current steep shape of the municipal curve (2-30 yr spread of 359 bps) is unusual. Indeed, there have been only two sustained periods of over 300 bps spread: October 1981-November 1985 and June 2002-August 2004. The average daily spread of the current run from November 2008 through February 2010 is 358 bps. Market participants expect the curve to flatten modestly over the course of the year. The 10-year average of the 2-30 year spread is 221 bps.

**Bipartisan Tax Fairness and Simplification Act of 2010.**

In February, senators from Oregon and New Hampshire proposed legislation that would replace traditional tax-exempt municipal issuance with tax-credit bonds bearing taxable coupon interest. The bill was introduced as a successor to the Tax Reform Act of 1986 and includes provisions that would make bonds issued by state and local governments beginning in 2011 federally taxable, while giving holders a tax credit of 25% of the bonds' interest cost. The spirit of this legislation is cause for concern among tax-exempt investors; however, market participants expect little support for this type of lending structure, given the ineffectiveness of prior tax-credit programs. Indeed, past issuance of traditional tax-credit bonds such as Qualified Zone Academy Bonds (QZABs) has been very small while the demand for this type of instrument was modest, resulting in an overall cost to the issuer and the federal government that far exceeded the cost of either BABs or tax-exempt bonds. Consequently, replacement of tax-exempt bonds by a tax-credit structure would result in a massive increase for state and local governments' borrowing costs at a time when their budgets are already strained. Furthermore, in the unlikely event that a bill which reduces or eliminates the future issuance of tax-exempt bonds is approved, investors should not be concerned about their holdings since existing tax-exempt issues may become more valuable due to the diminished supply.

Standard and Poor's & Moody's Update Their Default Studies.

Both Moody's and S&P recently updated their studies of defaults of state and local credits. According to the Moody's study during the period 1970-2009 only 54 rated issues, including below investment grade credits, actually defaulted and only three of these were in the general obligation sector. In addition, only 12 of these occurred in sectors other than local housing or healthcare. According to the S&P study, only 39 defaults occurred from 1986 to 2009. Of these, 37 were rated below-investment grade at the time the default occurred. Although historical results are not necessarily a guide of future performance, most market analysts believe that the nature of state and local credits is simply different than corporate credits and that state and local credits tend to be stronger, rating for rating, than their corporate counterparts. Furthermore, it is also expected that both Moody's and Fitch will move toward a "global credit ratings scale" as they have committed to do so, and that under such a scale, a large number of municipal ratings will be adjusted upward. S&P changed their ratings criteria in a number of sectors last year and despite the weak economic and budgetary climate, it upgraded 2,265 municipal issues while downgrading only 637 bonds.



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 4.50-5.50 year 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.

Costas Kalaitzidis, CFA

Analyst / Portfolio Manager

costas@assetpreservationadvisors.com



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