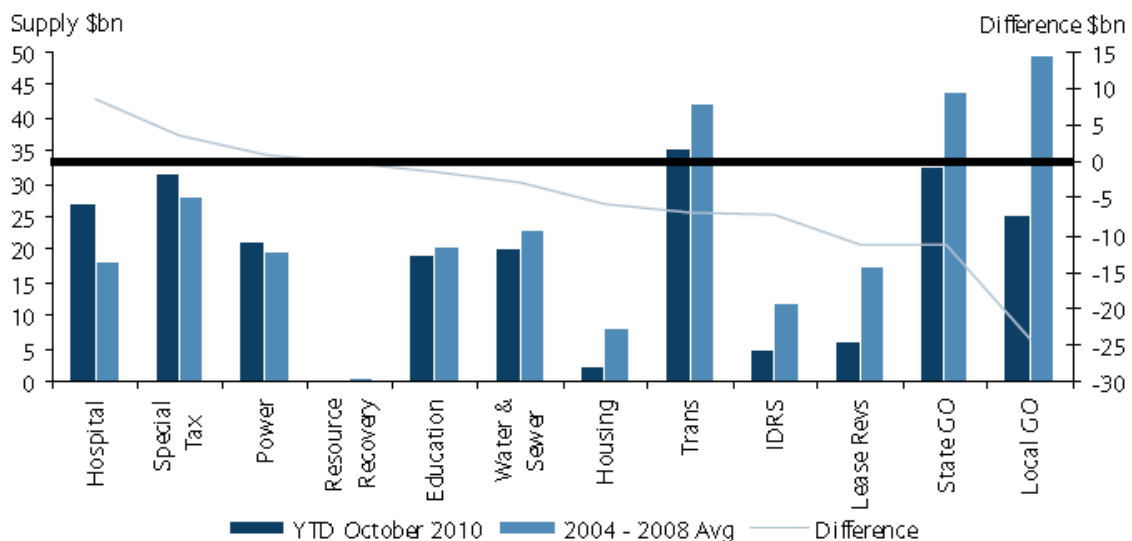


Stronger than expected economic data, coupled with lower than expected Federal Reserve Treasury bond purchases, have resulted in a steeper Treasury curve. Economists expect the combination of accommodative monetary policy, a weaker dollar and strong corporate balance sheets to result in additional hiring and capital expenditures in the second half of 2010...

Overview

- Yields on the tax-exempt municipal curve continued to move higher during October, due to negative headlines, higher supply and slower mutual fund flows.
- Taxable municipal supply has spiked amid the rush to tap the federal government subsidy before it expires at the close of this year. Further extension of the BAB program may occur before year-end.
- Given the amount of taxable issuance, most sectors of the tax-exempt market have issued fewer bonds than typical for a January-October period. As conditions have become more favorable in the tax-exempt market, sectors not authorized to issue BAB paper have chose to issue higher levels of tax-exempt bonds. As the following graph shows health care volume has been 48% higher this year versus average issuance from 2004 to 2008:

Figure 3: Year-to-date Tax-Exempt Issuance by Sector vs. 5y Average 2004-08



Source: Barclays Capital

The Municipal Market

Municipal bond performance was weaker in October mainly due to higher supply. The 30-day visible supply climbed to an uncommonly high of \$17 billion. Total issuance in October reached \$42.7 billion, of which \$11.2 billion were taxable Build Americas Bonds (BABs). Since the end of September, yields on high grade municipals with 5-year maturity are slightly lower by 3 bps, while at the 10-year and 30-year segments, yields increased by 8 bps and 20 bps respectively. Credit concerns remained a focus as the last of the “AAA” bond insurers, Assured Guaranty lost its AAA rating on October 25th.

A noticeable shift to a more conservative slate of governors in state houses across the country occurred as a result of the 2010 mid-term elections. Most political observants expect a great deal of legislative scrutiny regarding state expenditures and public pension liabilities. The new occupants in governors’ mansions may be more willing than their predecessors to forcefully address these issues and more reluctant to rely on taxation as a solution to structural imbalances, which could be beneficial to the creditworthiness of the tax-exempt market.

Build America Bond (BAB) Pending Legislation

Market participants expect to know about the BAB extension by the end of the month as maintaining the Bush-era tax cuts are expected to be of the highest priorities in the lame duck session.

Republican gains in the House and Senate speak well for the probability of extension through the highest income levels but also indicate further compromise with the Democrats on deficit reduction. While it is extremely difficult to project the outcome of lame duck sessions, particularly after periods of high turnover, market analysts expect the modest pace of recovery will underscore the need to renew the program for another year and insure low cost of capital for municipalities. Under this scenario, the BAB program will likely continue to account for significant issuance during the final months of 2010, possibly eclipsing 40% of total issuance at the expense of tax-exempts. This could present a window of opportunity to purchase the federally taxable municipal product at compelling spread levels versus similarly rated corporate bonds. Based on current market data, Build America Bonds are changing hands at spreads that can be as much as 30 to over 100 bps wider than comparably rated corporate bonds, depending upon maturity.

Three are the possible scenarios regarding the potential expiration of the Build America Bonds program:

1. An extension of the program during the post election Congressional session for one year at a reduced federal subsidy level versus the current 35%.
2. No action taken during the post-election session and the program expires at the end of 2010.
3. A year-end expiration with a subsequent revival by the new congress in early 2011.

Given these potential outcomes, investors may need to be alert through year-end to capitalize on potential market dislocations. BABs issuance is likely to grow relative to tax exempts in all three scenarios and spreads may further widen under the weight of greater supply, as issuers seek to utilize the program ahead of potential expiration. An extension of the program during the “lame duck” session would be most constructive for BAB spread performance, as the market would likely be more comfortable buying such paper knowing that dealer resources will likely continue to be committed to the product. Continued program uncertainty, culminating in a year-end expiration, could drive BAB spreads significantly wider on forward liquidity concerns. The third scenario of year-end expiration with subsequent revival in early 2011 could similarly drive BAB spreads materially wider until program extension is assured, which could set the stage for a BAB spread rally in 2011.

Taxable Municipals Are Trading at Historically Wide Spreads vs. Corporate Bonds

Spreads in the highest quality (AAA) municipal taxable sector are surprisingly large. AAA-rated taxable municipal are currently trading at spreads over 100 bps versus similar quality corporate bonds. Similarly, the spreads of AA-rated taxable municipals are 86 bps wider than AA-rated corporate issues and even 39 bps wider than A-rated bonds. The spreads on A-rated taxable municipals are 137 bps wider than A-rated corporate issues and 93 bps wider than BAA-rated corporate bonds. The market is bracing for additional supply as issuers take advantage of the current BAB subsidy. The recent increase in Treasury yields has resulted in greater cost savings for issuers in the BAB market compared with issuing bonds in the traditional tax-exempt market. Market participants expect taxable issuance to be more than 50% higher than last year's November (\$8.8 billion) and December (\$10.5 billion) taxable municipal volume. Clearly, investors could take advantage of the opportunity to pick up yield and/or increase credit quality by adding municipal credit to taxable fixed income portfolios.

The Municipal Yield Curve

The municipal high grade spread (2-30 year) widened 17 bps in October, to 340 bps, as intermediate and long yields rose. Yields were up about 16 bps in the 11-12 year and 22+ year area of the curve while the 13-20 year area was higher by 19-21 bps. The 10-year high grade yield climbed 13 bps while shorter maturities experienced small yield increase. The 10-30 year high grade spread ended the month at 135 bps or 3 bps higher, while the 5-10 year spread widened 10 bps, to 131 bps, its highest since early April. So far this year, according to the high grade scale, the largest decline in yield along the curve has been in the 7-8 year spot, which experienced a drop of 56 bps. The Treasury curve steepened to record levels; the 2-30 year Treasury spread rose 39 bps, to 365 bps as 2-year yields dropped 9 bps and the 30 year yield rose 30 bps. The 5-year bellwether rate was 9 bps lower as well, while the 10-year climbed 9 bps.

APA's Strategy

We continue to favor the short/intermediate part of the municipal bond yield curve (5-13 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, given the lower yield environment and the steep municipal yield curve, we have adjusted our strategy regarding yield curve positioning as follows:

10% of total holdings allocated to 0-2 years in maturity.

70% of total holdings allocated to 5-13 years in maturity.

20% of total holdings allocated to municipal bonds that present an investment opportunity including longer duration callable issues, specific credits that appear to be undervalued etc.

In addition, we do not see an imminent threat from significantly higher inflation. Our overall duration target remains within the 4.50-5.00 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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