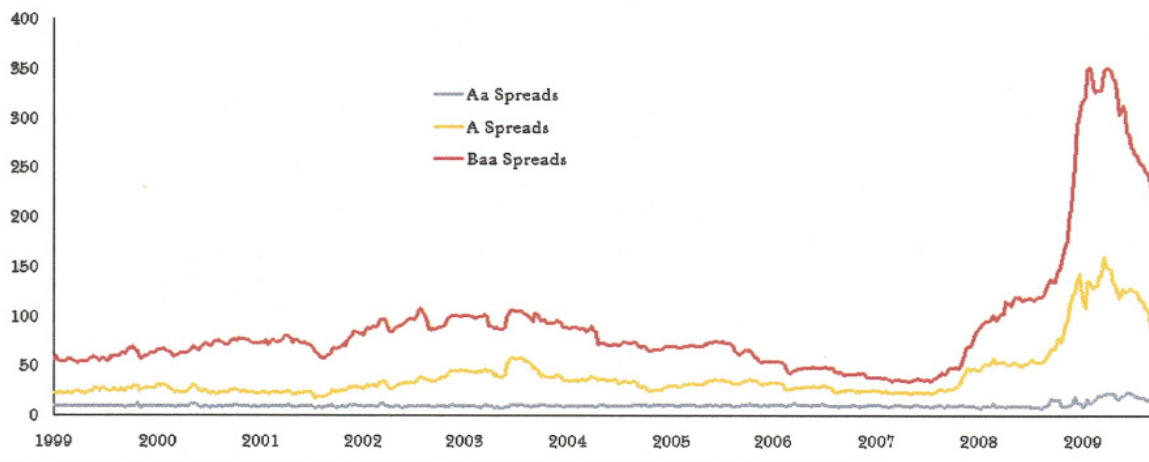




## Municipal Credit Spreads

Municipal credit spreads, which measure the difference in yield between AAA-rated municipal issues and lower rated credits, are important variables to consider when assessing relative value within the municipal universe. Credit spreads reflect investor's perception of risk within a particular sector or rating category. Credit spreads typically widen in a contracting economic environment as was the case from the end of 2007 until the summer of 2009 and typically tighten during periods of improving economic activity. This relationship is primarily a function of broad-based risk aversion, and weakening macro economic factors will increase the risk of municipal defaults. Credit spreads at each rating level in the municipal market experienced a structural tightening trend from 2004 until 2007, a trend which we attribute largely to yield chasing from the leveraged institutional buyers, as well as generally favorable credit conditions. When news of mortgage loan write-downs started in early 2007, credit spreads began to widen and continued to do so until September 2008 when investors' panic fueled an extreme flight to quality and the spread of a triple A municipal to a triple B municipal increased to as high as 350 bps (see graph below). Recently, as investor risk aversion is easing, equity prices are higher and economic conditions are improving, credit spreads in the municipal market have tightened significantly. More capital is flowing into municipal investments as investors are starting to take on more risk. Municipal credits at all levels have contracted closer in line with historical averages.

### Muni Credit Spread History to AAA-rated Curve



Source: Janney FI Strategy; Thompson



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## An Expected Correction

After rallying or moving sideways every week between mid-June and the end of September, the market seems to be coming under heavy pressure over the last couple weeks, particularly in the intermediate part of the yield curve. As the following table indicates the sell-off on the front end of the yield curve was not significantly worse than that on the 30-year Treasury where yields increased 30 bps from October 5 to October 10. However, the intermediate part of the curve performed far worse than Treasuries. Indeed, the 10-year Treasury yield increased by 25 bps that period, while high grade municipal yields increased by 47 bps. The 5-year Treasury increased 20 bps while the high-grade increased 33 bps during the same period. Another way to analyze the value of municipal bonds is to compare the percentage of yield to comparable Treasury Bonds. The greatest shift in high-grade yields as a percentage of Treasury yields has occurred in the 10-year range, where the ratio has increased from 76.4% on October 5 to 87.6% on October 15. The AAA/Treasury ratio in five years is 79.3%, a single percentage point below the average ratio since January 1996. The 10-year ratio is roughly 4 percentage points above its long-run average. The 30-year yield is very close to its long run average, at 94.9% versus a long-run average of 93.5%.

### AAA GENERAL OBLIGATION YIELDS

	1-yr	3-yr	5-yr	7-yr	10-yr	12-yr	15-yr	20-yr	25-yr	30-yr	Slope
<b>10/05/2009</b>	0.37	0.98	1.57	2.05	2.57	2.79	3.04	3.43	3.74	3.81	344
<b>10/08/2009</b>	0.37	0.99	1.67	2.22	2.76	2.98	3.19	3.54	3.86	3.93	356
<b>10/15/2009</b>	0.37	1.07	1.90	2.55	3.04	3.25	3.45	3.74	4.02	4.09	372
<b>Change: 10/5-10/15</b>	0	9	33	50	47	46	41	31	28	28	

Source: Thomson Reuters MMD

Equally important was the credit spread widening that occurred during that period. In the intermediate maturity range, in particular, the spread widening was dramatic, resulting in yields in the 7-10 year range that were as much as 60-80 bps above the recent lows.



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We think the reasons for the expected rebound are the following:

- Concerns about credit quality in an environment with tighter credit spreads and continuing headlines about state and local budgetary pressures.
- A sharp drop in municipal bond fund flows for the week ended October 14<sup>th</sup>.
- Declining dealer willingness to buy blocks in the secondary market on the bid side or hold new issue balances.
- Many individual investors tried to lock in profits on municipal positions that had run up sharply since May 2009.

Adding to investor's market worries was a report published by the Rockefeller Institute on October 15 in regard to state revenues. According to the report overall state tax collections declined by 16.6% in the second quarter from the same period in the previous year, the largest decline since the Institute began collecting data in 1962. For the past 12 months, the year-over-year change in tax collections, adjusted for inflation, was 9.2%. Interestingly, despite the subprime housing crisis and the overall drop in property values, the decline at the local level for the second quarter was only 2.8% year-over-year and property collections were actually up 3.10% as a result of hikes in ad valorem tax rates. However, both income and sales collections declined sharply, with income taxes pulled down by a sharp decline in capital gains taxes.

### **How the Municipal Market Could Be Affected by State Budgetary Pressures**

The municipal market could be affected by shortfalls in state revenues in the following ways:

- Budgetary pressures at the state level can translate into pressures at the local level, as the capacity of states to support their localities comes under pressure.
- Severe revenue shortfalls are likely to result in downgrades by the rating agencies. Examples include the states of California, Michigan, and Illinois. In addition, states could be placed on negative watch or outlook as Moody's did with Ohio.
- Headlines regarding severe fiscal pressure have the potential to cause credit concerns among investors.



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- Severe fiscal imbalances and deficits require quick and effective responses/policies from local governments. The practical implementation of these policies is likely to have consequences on ratings over time as local governments are put to the test of successfully stimulating economic activity and cutting expenses the same time.

## The U.S. Economy Improves

Economists expect a modest recovery in the economy with 3.5% GDP growth in 4Q 2009. GDP is expected to accelerate, reaching 5.0% in 1Q 2010 before settling in at 3.0-3.5% over the remainder of 2010. Furthermore, housing prices may be close to bottoming, and as a consequence, state and local revenues should begin to rebound. There will likely be an expected lag for state and local revenues to recover relative to the rest of the economy. Meanwhile, we have seen some reports suggesting a truly disastrous outcome from revenue and expenditure trend for state and local governments which, we believe, are vastly exaggerated. The federal government has paid out all but \$1 billion of the anticipated \$49 billion in stimulus money for states and localities for fiscal 2009. More than three quarters of the federal stimulus dollars for states went for Medicaid and state stabilization funds. Officials are now turning their attention to help states fund vital services such as education and health care when the federal aid runs out. The federal government has not stated whether there would be another fiscal aid package for the states, but officials have stated that the fiscal relationship between the states and the federal government could change after the worst economic downturn in years. The stimulus package is scheduled to end in December 2010; however, given the importance of well-functioning state and local governments to the overall U.S. economy, many market participants expect some sort of renewal of the federal support beyond 2010.

## What's Ahead for the Municipal Market

It appears that we may be approaching a near-term bottom at the municipal market after a fairly impressive correction. The direction and size of cash flows into municipal funds will likely affect the next move of the market. Also, the outlook for economy and thus for Treasury yields will likely play an important role in the direction of the municipal market in the intermediate term. The fact is that projections of the U.S. economy going into 2010 vary widely among economists. Some observers believe that unemployment may peak as early as the first quarter of 2010. If that happens the Federal Reserve Bank could start the first round of tightening earlier than currently anticipated at the end of 2010. Such development will likely put some upward pressure on Treasury yields which could



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ultimately affect municipal yields as well. On the other hand, if the economy remains soft during 2010 Treasury and municipal yields may remain around current levels for quite some time.

Municipal supply is expected to increase as issuers tap the lowest tax-exempt borrowing costs in 40 years and take advantage of the Build America Bond (BAB) program. Higher levels of municipal issuance have historically coincided with periods of low interest rates. Recent issuance records have been achieved in years when yields had been falling and the tax-exempt 30-year to 10-year taxable spread was tight. Market participants expect the municipal market could set a new record for issuance in 2010 if yields remain at these low levels. They expect total municipal issuance (\$430-\$440bn) to increase, given continued low Treasury yields. This elevated issuance is largely a by-product of low tax-exempt borrowing costs, a flattening curve and continued access to the taxable market through a BAB structure (\$85 billion). An increase in Treasury yields would likely curb both tax-exempt and BAB issuance substantially.

## **Municipal Bonds May Have Best After-Tax Returns over 10-year Horizon**

The taxable equivalent returns of the Municipal Index and Municipal High Yield Index over the past 10 years ending September 2009 were 9.11% and 9.18%, respectively. The Municipal Index year-to-date return of 14% is the highest return since 1995. The Municipal High Yield Index year-to-date return of 32.76% is the highest performance on record for any municipal bond index since 1980s. The following graph shows the taxable-equivalent returns for the municipal investment grade and municipal high yield indices, as well as the total return of the major taxable fixed income and equity asset classes. The chart also illustrates the volatility of the various asset classes, expressed in terms of the annualized standard deviation of the monthly return series. On a taxable equivalent basis over this period, municipals have outperformed all major asset categories and equities while maintaining lower volatility than many of their taxable counterparts.

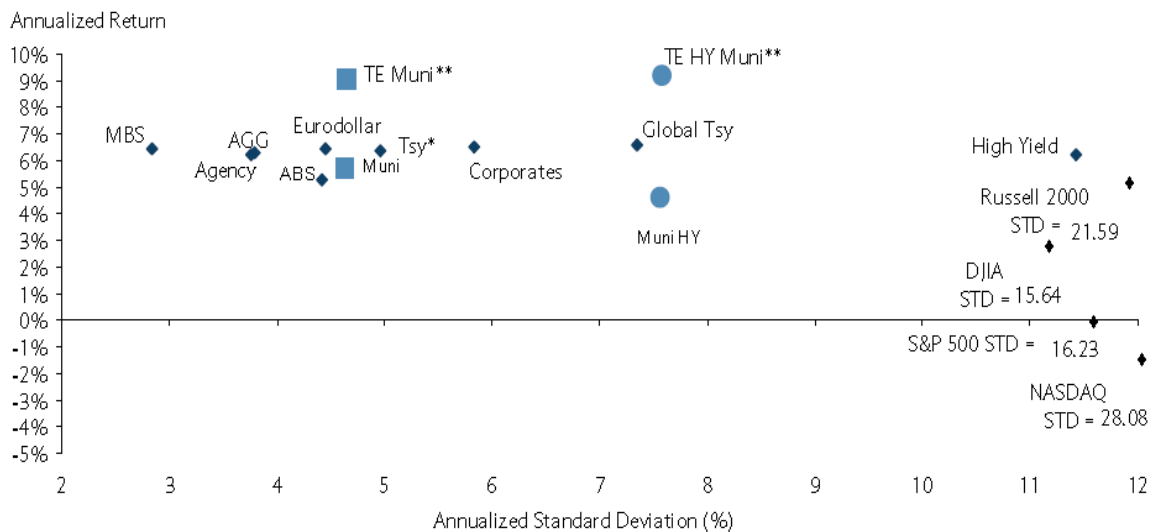
Going forward the demand for tax-exempt municipals is likely to remain strong. The current highest federal tax bracket is 35%, but that will change, as the Bush tax cuts are set to expire after 2010 and revert to 39.6%. Many states have already begun to raise taxes and Congress is looking for ways to pay for healthcare and social security. Some analysts believe current effective tax rates could increase for the highest bracket and could reach 50% in the next few years. Therefore, investor's appetite for tax-exempt municipal bonds may grow while supply continues to be below traditional levels.



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Figure 29. Comparison of Taxable Equivalent Returns and Volatility of Municipals and Other Asset Classes (10 Years Ending September 30, 2009)



Note: \* U.S. Treasury income returns are exempt from state income taxes and adjusted (3.25% in 2002-09, 3.23% in 2001, and 3.18% prior) using a national state average (top bracket), net of federal income tax.  
 \*\* Based on an equally weighted national average federal and state (top bracket) income tax rate (38.48% in 2009, 38.45% for 2003-08, 41.85% for 2002, 42.33% for 2001, and 42.78% prior—local taxes have not been considered in the analysis). Source: Barclays Capital

## APA Strategy

It is important to note that the basic tenets of our strategy remain unchanged and we remain constructive long-term on the municipal bond market in general:

- In the near term (12 to 18 months) we continue to expect negative pressure throughout much of the spectrum.
- We still expect solid A-rated and some stronger BBB-rated general obligation bonds and essential service revenue bonds to provide a source of stable value, with spreads continuing to grind tighter in the long run.
- We expect states to successfully close recurring budget gaps. Such gaps should diminish in intensity as the economy recovers.



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- Even if the default rate trends higher we do not expect a domino effect. Instead we expect the default rate itself to remain manageable, especially for investment grade issues that we invest in.
- We are maintaining a relative short overall duration of 4.00-4.50 years in our portfolios that will protect in case of a major downfall in municipals.
- Our experienced credit research team thoroughly researches an issue before we add it to our portfolios.

**Costas Kalaitzidis, CFA**  
*Analyst / Portfolio Manager*

### **Disclosure:**

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