

Municipal Markets Investment Commentary

Highlights

- ▶ January was another negative month for the tax-exempt municipal market, which continued to be pressured by negative headlines related to state and local fiscal woes.
- ▶ Monthly issuance of just \$12.2 billion represented the lowest January supply figure since 2001, but this positive technical point did little to rescue the market.
- ▶ Notwithstanding the headlines, state tax receipts are showing signs of recovery, with revenues projected to be up for the fourth consecutive quarter.

Municipal Market Overview

Tax-exempt performance disappointed again in January as yields continued to climb higher across the curve. Yields rose 10 basis points (bps) in the 2-year sector, 15 bps in the 5-year sector and 10 bps in the 30-year sector. While the spread between 2- and 30-year maturities was unchanged for the month, it remained quite steep at 406 bps.

January is generally a positive performance month for munis, with large reinvestments from bond calls and January 1 maturities coming into the marketplace. Additionally, with the anticipated end of the Build America Bond (BAB) program on December 31, the supply of new issues was very heavy during the fourth quarter, reducing the supply that would have been issued in January. In fact, monthly issuance of just \$12.2 billion represented the lowest January supply figure since 2001. Under normal circumstances, this would have set the stage for a positive technical rally in the market (a common scenario when low supply meets with strong demand). However, negative headlines around budget woes, pension obligations and the discussion of bankruptcy options for states continued to dominate the markets.

Amid the negative press, municipal bond mutual funds continued to see outflows, resulting in forced selling of bonds. At one point, however, tax-exempt bonds were trading at the same level as their BAB counterparts. This sparked the interest of non-traditional investors, who began to purchase high-grade private universities and corporate-backed bonds that were trading cheaper than their taxable counterparts. This brought some measure of stability to the market.

Making Headlines

A front-page article in *The New York Times* stated that Newt Gingrich and other policymakers were working on a plan that would allow states to declare bankruptcy to relieve themselves of overwhelming debt and pension obligations. Most market participants viewed this as a political rather than a practical effort and deemed implementation as unlikely.

Moody's Investors Service indicated that it would begin recalculating states' debt burdens by factoring unfunded pension obligations into their ratings calculations. As such, pension liabilities would no longer be treated as soft obligations. We could envision some negative rating action for states that are not addressing their pension problems.



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Current Municipal Investment Strategy

Duration	• Neutral
Yield Curve	• Favor short and intermediate maturities
Overweight Sectors	<ul style="list-style-type: none"> • State tax-backed bonds • Essential service bonds, particularly the Southwest (TX), Plains and Southeast (VA) regions • Dedicated-tax bonds • Housing issues
Underweight Sectors	<ul style="list-style-type: none"> • Land-secured bonds • Senior living bonds • Tobacco bonds • Bond insurers • Student loans • Pre-refunded bonds • Local tax-backed issues

State tax receipts are starting to show signs of recovery. According to the Nelson A. Rockefeller Institute of Government, state tax collections rose 4.5% in third quarter 2010 compared to the same period one year ago. Preliminary figures for the fourth quarter show continued improvement, with revenues up 6.9%, which would mark the fourth consecutive quarter of growth. These numbers are promising; however, collections are still below pre-recession levels, unemployment remains elevated and spending continues to trend upward.

By the Numbers

The S&P/Investortools Municipal Index was down for the fifth consecutive month, returning -0.93%. Returns were negative for maturities of 5 years and longer, with the longest (20+ years) performing the worst. Heightened credit concerns led to a widening of spreads. Consequently, lower-rated credits (the high yield index) underperformed the general market while the high-quality pre-refunded index outpaced the main index and posted a modestly positive overall return. As for the sector indices, the housing index was the top performer, which is typical when rates back up, providing 66 bps of excess return.

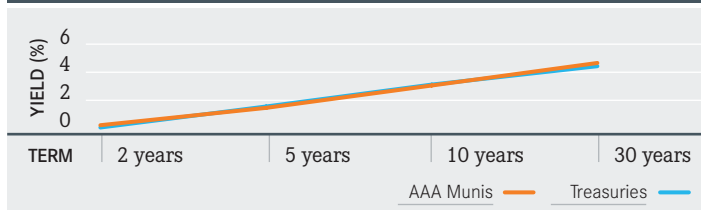
Strategy and Outlook

January is traditionally a period of seasonal strength for the municipal markets. However, negative headlines and mutual fund outflows continued to move municipal rates higher (and prices lower). Fundamental challenges will continue to be met with negative press, prompting us to adopt a neutral view for the market. That said, we would remind investors that setbacks can be healthy in that they allow the markets to reprice and can present an attractive value for long-term investors willing and able to participate and weather interim volatility.

Monthly Change in Municipal and Treasury Yields

Term	AAA Muni Yield (%)		Treasury Yield (%)	
	12/31/10	1/31/11	12/31/10	1/31/11
2 years	0.62	0.72	0.60	0.57
5 years	1.63	1.85	2.01	1.94
10 years	3.16	3.31	3.30	3.37
30 years	4.68	4.78	4.34	4.57

Municipal and Treasury Yield Curves as of 1/31/11



Sources: Thomson Municipal Market Data; Bloomberg.

Municipal Markets Monthly Performance Analysis

	Jan. 2011	Dec. 2010
S&P/Investortools Municipal Index	-0.93	-1.90
Long maturities (20+ yrs.)	-1.86	-3.14
Intermediate maturities (3-14 yrs.)	-0.50	-1.38
Short maturities (6 mos.-3 yrs.)	0.15	-0.19
High yield	-1.56	-1.75
Pre-refunded bonds	0.13	-0.50
GO bonds	-0.64	-1.79
Regions		
California	-1.14	-2.17
Florida	-0.98	-1.98
New Jersey	-0.77	-2.06
New York	-0.87	-1.63
Pennsylvania	-0.81	-1.79
Puerto Rico	-1.89	-2.40

Source: Standard & Poor's/Investortools.

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