



## THE MUNICIPAL BOND MARKET – QII 2010

### VALUE IN THE MUNICIPAL MARKET

The Municipal Market has been the beneficiary of the flight to quality trade that took place in the QII10. As the national economy continues to struggle and find its stride, the underpinnings for sustainable performance in the Municipal bond market remains. While the asset class fundamentals are struggling, the technicals resulting from supply and demand imbalances have created a positive backdrop for Municipals. The weakness of the economic recovery, the negative headlines related to pension funding, and the challenges facing state and local issuers in budget season are being offset by several market based positives:

- Interest rates are, and we believe will remain, low for some time.
- New money continues to migrate out of money market funds and into municipal bond funds. Municipal Funds had been averaging inflows of \$379 million over the last 4 weeks. The last time the 4-week moving average was negative was January 2009. (source: Bond Buyer)
- The prospect for higher State and Federal income taxes in 2011 and beyond becomes more imminent as these deficits build and the Bush Tax Cuts sunset at the end of 2010.
- Build America Bond issuance continues to limit the traditional tax exempt offerings that the markets look for, particularly in the June/July reinvestment period, creating an ongoing demand for quality issuance.

A diligent Municipal credit process continues to be critical as we take advantage of these market imbalances and create value for our clients. While the headline risk we have seen deserves some attention, in many cases long term progress is being made in the areas of expense cutting and the renegotiation of union contracts and employee benefits. The possibility of another fiscal stimulus package from the federal level is also under consideration.

### RATE OUTLOOK

Early in QII10, as the domestic US Economy showed hints of recovery, the problems in the Eurozone and talk of a weaker outlook in Asia resulted in a *flight to quality* trade which greatly benefited Treasuries. The Treasury market reached its near term high in yields on April 5<sup>th</sup> when the 10Yr Treasury closed at 3.99% only to grind lower and end the quarter at 2.93%. This dramatic Treasury move caused a temporary dislocation in the relationship between Treasuries and Municipals, increasing Municipal ratios as the quarter progressed. The 10Yr AAA Municipal began the quarter trading at 78% of the 10-yr Treasury, but ended the quarter at 2.79%, more than 95% of 10-yr Treasuries. This relationship will normalize in a rising rate environment.

We believe that the Fed will remain on hold for at least the next 12 months, and possibly into 2012, keeping the Fed Funds rate at 0.00 - 0.25 basis points. Inflationary expectations are low and in fact there is increasing market concern that deflationary pressures are consistent with the downward pressure on wages and benefits and a lack of pricing power at the consumer level. With slow employment growth, excess capacity in the residential and commercial real estate markets, and the decline of government stimulus, we remain cautious on the timing for future economic growth that would dictate higher short term rates. Unlike Treasuries, which flattened in the quarter as a result of the flight to quality bid, the Municipal curve in 2-yrs to 10-yrs was largely unchanged at 229 basis points. Again, this was a reflection of the reactionary move in Treasuries.

### MUNICIPAL MARKET CREDIT TRENDS

Credit spreads, which had been tightening all year, showed some signs of resistance in mid-quarter as the flight to quality trade transferred over from the Treasury market and general risk aversion reappeared. Despite the late quarter demand for high quality credits, the AA and A rated credits in the Municipal Bond Index out-performed the AAA rated bonds by 10 to 15 basis points, and BBB portion of the index outperformed all investment grade at 2.85%. Credit spreads for all investment grade levels remained wide versus historical averages in the quarter, enabling us to find value in certain lower investment grade sectors. Based on our proprietary research, Appleton has identified several new credits in both the Healthcare and Airport sectors and we continue to feel that there is opportunity to find value in the lower rated AA and higher rated A bonds at attractive spreads.

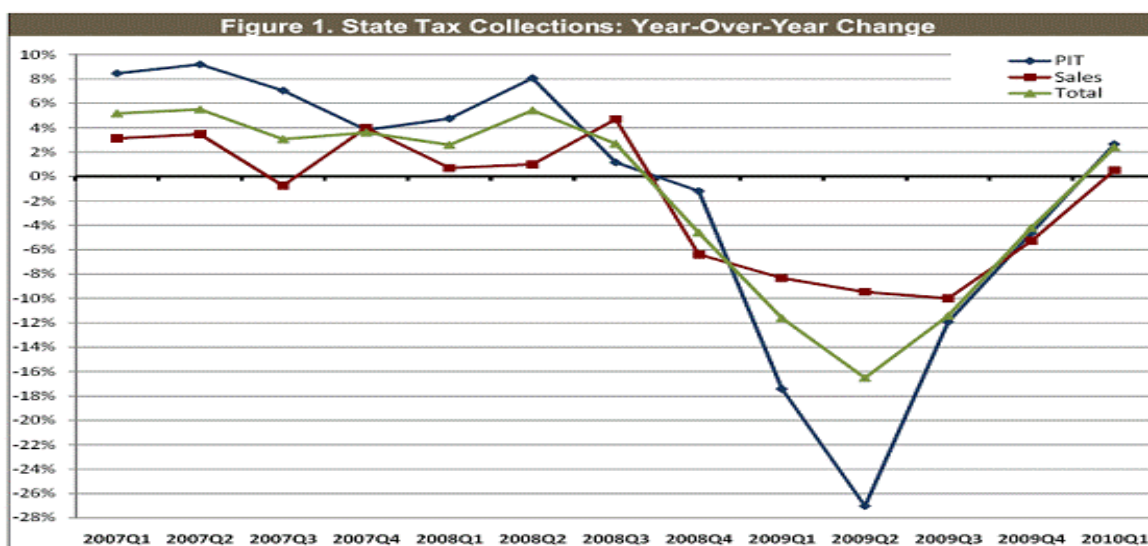
Second Quarter issuance was down 13.5% over the same period in 2009. After a strong 1<sup>st</sup> quarter of issuance, year-to-date issuance is flat, up 1.8% from the first half of 2009. The increased taxable issuance, especially BABs, is growing at the expense of traditional tax exempt issuance. Tax exempt issuance is down 21% year-to-date over the same period in 2009 and taxable issuance is up 152% from 2009. BABs are 25% of the market with \$50.9 billion in issuance in 2010. With the increased scrutiny being paid to the BAB market and debate on how the program will be extended and at what subsidy rate we expect BABs to continue to take up 25+% of the new issuance market through year end. We also do anticipate the program will be extended, albeit with a lower reimbursement rate.



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MUNICIPAL MARKET FUNDAMENTALS

Recent reports have indicated that year-over-year revenue collections have turned for the better and in fact due to some large increases in 1st quarter 2010 revenues in California and New York, posted increases as reported by the Census Bureau and Rockefeller Institute. As shown in the graph below, the uptick in revenues was the first positive quarter since 3rd quarter 2008. We remain cautiously optimistic that the bulk of the downturn in revenue is behind us, and although we do not expect revenues to significantly exceed expectations, we take comfort knowing that the worst of the revenue downturn may be behind us. State tax revenues are still significantly below pre-recession levels. In fact, personal income tax receipts, although up 2.7% in the QI10 over QI09, are still 14% below the QI08. Sales tax receipts were up 0.5% year-over-year in QI10 and off 7.5% from QI08. Part of the turn around in revenues is attributed to increases to the actual state income tax rates. State income tax rates remain a potential target for those states that have not yet balanced their budget shortfalls for 2010.



Source: Rockefeller Institute

The main news story of the 2nd quarter was, and remains, the Gulf Oil Spill. The Spill will certainly have a long-term impact on the fishing and tourism industries as well as the overall environment in the impact areas of the Gulf region. It is too early yet in the disaster to fully evaluate the long-term credit effect on the states most at risk of contamination; Louisiana, Mississippi, Florida and Alabama. For more on the Spill's impact on the municipal market, please see our latest credit piece on the Gulf Spill which is posted on our website: [www.appletonpartners.com](http://www.appletonpartners.com) under the News and Insight section.

MUNICIPAL BOND PERFORMANCE

Performance in QII10 was largely driven by where one was invested on the yield curve and credit selection. The recent success of long maturities and low grade credits did not necessarily lead to outperformance in the quarter. Within the Barclay's Municipal Bond Index, the 10-yr Index was the best performing maturity Index, and the best performing investment grade sectors were Hospitals, Housing and State GOs. Where the overall Municipal Bond Index was up 2.03% for the quarter, the 10-yr Index was up 2.68% while the 7-yr Index (Appleton's benchmark Intermediate) was up 2.27% and the 3-yr Index (Appleton's benchmark Short Term) was up only 1.21%. The Long Bond Index (22 years and longer) was up 2.43%.

As we head into the 3rd Quarter of 2010, we will maintain our diligence from a credit perspective, while looking for further signs of an economic turnaround. We anticipate further Treasury market volatility and thus will maintain our duration target at or slightly short of the benchmark, continue to favor non-callable securities over callable bonds, and continue to favor higher coupon bonds for their defensive attributes.

As always, we welcome your comments and questions. Please contact us if there are any changes to your financial situation or investment objectives. This commentary reflects the opinion of Appleton Partners based on information from sources which we believe to be reliable. It is intended for informational purposes only and not to suggest any specific performance or results.