THE MUNICIPAL BOND MARKET – QIV 2012

Where does the Municipal Market go from here? As we entered 2012, expectations for municipal returns were minimal after experiencing such strong returns in 2011. Rates were low (so we thought), the economy was stagnant, and the Fed remained on hold. Rates, however, found more room to fall as weekly inflows supplied portfolio managers with historic levels of new cash to put into the market and credit spreads tightened. The market drifted in the fourth quarter as market discussions were dominated by the Fiscal Cliff and constant news of negotiations for a "grand bargain." Although there are glimmers of hope, the economy is still weak and expectations are for continued weakness in 2013.

Even though a deal was eventually struck with the passage of the American Taxpayer Relief Act on New Year's Day, this first step in budget reform can hardly be considered a grand bargain. The clock is now counting down again to March 1st, and the prospects for major tax reform and massive entitlement and spending reform remain challenging. Based on the initial reaction by global equity markets, the deal was considered major progress. The bond markets have a less sanguine view. We continue to see progress on the domestic economic front, but that progress is not even close to achieving the Federal Reserve's stated goals for employment growth in the context of price stability. We anticipate interest rates will stay low, and any expense cutting will act as a drag on the economy, further pushing the pendulum to the side of economic weakness in 2013.

At this point, municipal bonds and municipal bond issuers have benefited tremendously by the increase in tax rates at the upper levels. Major tax reform could impact the level of tax exemption, but right now that does not appear to be an imminent threat. Additionally, let us not forget that as part of the Affordable Care Act passed in 2010, there is a mandatory 3.8% surtax on net investment income for filers with adjusted gross income of more than $200,000 for individuals and more than $250,000 for families. This will take capital gains and dividend rates to 23.8% for the highest earners and will affect most other forms of income. Municipal bonds are exempt from this surtax.

Issuance was among the many stories of 2012. After lower issuance in 2011, expectations coming into 2012 were for an increase, largely driven by increased refundings and new money issuance. The new money issuance did not materialize, but refundings more than made up for this, driving total issuance to $373 billion, a 30% increase over 2011. New money issuance was off 2% in 2012, as municipalities continued to adhere to austerity measures. Meanwhile, low rates opened the door for an onslaught of refundings, which were up over 70% for the year. We believe that deferred maintenance and declining concerns for fiscal austerity could lead to increased new money issuance in 2013. In fact, expectations are for issuance to be slightly ahead of 2012 levels, largely driven by an increase in new money issuance, while refundings are expected to be in line with current levels. An unexpected change to tax policy could impact our expectations.

Another positive technical that played out in 2012 and will continue to factor into the municipal market in 2013 is the notion of *net negative issuance*. In 2012, the onslaught of advance refundings and more bond maturities coupled with a decline in new money issuance put us in a position of *net negative issuance*. JP Morgan estimates that total net issuance in 2012 was negative $8.8 billion and net issuance in 2013 should be slightly positive at $13.9 billion, despite an expected 15% increase in bonds maturing in 2013. We expect this to be a positive for the municipal market.

The other major technical positive for the market has been the strong fund flows which began in 2011 and lasted throughout the entire year of 2012, with only 3 or 4 weeks of outflows. According to JP Morgan data, total net investment into municipal bond funds was $50.2 billion.

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We are 5-6 years into this downturn and credit remains a focus. It seems we have turned a corner on the national credit picture as we experienced the 11th straight quarter of increasing state revenues in the third quarter of 2012, according to the Rockefeller Institute. But, in reality, things have only gotten relatively better as states struggle with growing mandated budget expenditures and attempt to tackle ballooning pension liabilities. While it is positive to see revenues rise, we remain hesitant to say we are out of the woods. This phenomenon also impacts how we feel about local cities and towns, as austerity measures at the state level continue to squeeze the flow of revenues down to local governments from the states. We continue to feel it is important to remain focused on local credits and are aware that Moody's and Fitch have warned of increased credit downgrades in the Local GO space. This continues to play into our credit selection approach and the thoroughness of our credit review process.

The credit story has supported performance in the broader marketplace. As previously discussed, credit spread tightening was largely a result of improving market technicals and NOT improving credit profiles. While in the fourth quarter we saw minimal tightening in the relationship between "AA" and "A" rated credits versus the "AAA" scale, over the whole year we saw a strong tightening in credit spreads, as well as in specific names. In our credit universe, spread tightening contributed to our total return for the quarter and the year. On a sector by sector basis this was most evident in our exposures to Healthcare and Airports, and California and New York exposures performed well from a state perspective. Our California exposure contributed broadly to the portfolios' performance since spreads tightened over the quarter and the year. 10-year CA GO spreads tightened 10 basis points in the quarter and over 30 basis points for the year. High grade sectors like Water and Sewer and Prerefunded/Escrowed bonds did not benefit from the spread tightening as these sectors were already trading at tight spreads.

The phenomenon that really was the big surprise of the year was the importance in maintaining our duration targets despite concerns a year ago of low rates and potential for an improving economy. While the fourth quarter saw significant trading volatility based upon a relief rally, once the election and some Fiscal Cliff anxieties were over, rates ended the quarter relatively unchanged in the 10-year range, while they were slightly higher in the 3 to 7-year range. Over the quarter, the 5-year Barclay's Index was the worst performing segment of the market returning -0.21%, while the long-end returned 1.15% and the 7-year returned 0.39%. In contrast, earlier in the year, longer duration contributed to out-performance. The long end of the municipal market was the best returning segment. The Long Bond Barclay's Index, which holds bonds 22 years and longer, returned 11.26% over the year; the 7 year Barclay's Index returned 4.20%.

We anticipate that 2013 will be filled with volatile trading based upon economic head fakes and budget news out of Washington, while in the end, the Fed has been very clear that it remains on hold through late 2014, possibly 2015. With this in mind, we expect the front end of the yield curve will be anchored. After such a significant flattening trade in 2012, it is possible we could see some pressure on longer term bonds which will result in the curve steepening a bit, and we will be focused on Washington throughout budget discussions. Where passage of the American Taxpayer Relief Act was positive for Municipals, we are aware that future discussions on tax reform could re-surface. Managing our curve exposure in 2013 will once again be a large component of success in the year.

As always, we welcome your comments and questions. Please contact us if there are any changes to your financial situation or investment objectives.

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