

The municipal market drastically underperformed the taxable market during the second quarter. Although municipal new issue supply has remained very manageable and demand has steadily increased during the latter part of the quarter, building investor apprehension to add new municipal holdings at very low absolute yield levels provided significant enough headwinds to keep municipals from mustering the necessary follow-through to match the dramatic move in Treasury yields, which fell by 90 basis points in 10 years.

Grossed-up municipal yield spreads versus Treasuries for the quarter widened by 44 to 46 basis points from 5 to 10 years and by 69 to 73 basis points from 15 to 20 years. However, the municipal market has seen a significant turnaround over the last two weeks. Since the end of June, both the resulting relative attractiveness of municipals and solid seasonal technicals, have provided a significant boost to municipal demand. This demand should persist for the remainder of the third quarter.

Favorable technicals have been tied to both a significant drop-off in new issuance supply that's currently running below 2009 by 21% YTD and from strong reinvestment flows of coupons/calls/maturities that should equate to a total of \$140 billion for the three month period of June to August. We are almost two-thirds of the way through that reinvestment cycle, but new issuance is expected to remain below trend through the remainder of the summer and into the early fall. That should provide municipals with the additional impetus to continue to outperform over the course of the next few months, especially if Treasuries rates move higher and begin to trade outside of their recent trading band of 2.95% to 3.20%.

As of July 12th, the slope of the municipal yield curve from 10 to 20 years has steepened by 17 basis points since June 1st, which resulted both from a sharp rally in the 10 year area of the curve and from increased concerns over the future of the Build America Bond program, which prompted some liquidity concerns for longer-term bonds. The extension of the program, which was once thought to be almost a certainty, is now in jeopardy after the American Jobs and Closing Tax Loopholes Act, which included the Build America Bond extension, was tabled after being repeatedly blocked in the U.S. Senate. If the program is not extended, we would expect to see even more compelling arguments for issuers to rush to the market with new taxable issuance before the program expires in December, 2010. The resulting lack of issuance in the tax-exempt market should provide support for longer-term tax-exempt municipals to perform well into year end. However, after that point, longer-term municipals could see a weakening bias as issuers return to issuing long-term tax-exempt debt. At this point, finding passable companion

legislation in which to include the Build America Bond extension by year-end is a 50/50 proposition, at best.

Overall, municipals at their current tax-adjusted yield levels continue to look attractive 10 years and longer. The favorable supply/demand backdrop should continue to improve relative valuations to taxables. If the Build America extension legislation is not passed this year, we will look to opportunistically pare back our longer-term maturity exposure ahead of what could be a challenging liquidity environment during 2011, when issuers return to issuing long-term debt in the tax-exempt space.

Gregory A. Bell, CFA, CPA
Director of Municipal Products

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