CUTWATER ASSET MANAGEMENT

Municipal Bond Commentary, 4th Quarter 2011

United States economic releases had a positive tone during the fourth quarter and many surpassed market expectations. Weekly initial jobless claims trended below the closely watched 400,000 level and the unemployment rate impressively decreased to 8.5 percent in December. Durable goods orders exhibited consistent growth and early indications show a promising outlook for retail sales during the holiday season. Despite these positive forward looking indicators we did see a notable revision to the third quarter's gross domestic product growth down to an annualized 1.8 percent. Through much of the quarter investors' focus was on the European sovereign debt crisis and one cannot ignore the media coverage of the Occupy Wall Street protests. The market was quick to react to any news out of Europe, good or bad, which increased market volatility—resulting in flight to quality rallies and generally benefitting US Treasury securities and the US dollar.

Continuing budget deficits at the federal, state, and local levels may be a cause for concern in the coming year. Legislative proposals that target tax reform, diminish or eliminate the tax exemption of municipal securities, or reduce revenues to states and local governments will win the attention of municipal market participants. Tax receipts are generally improving, but states and local governments are still dealing with the effects of the recession and operating in an environment of austerity as they attempt to get their fiscal houses back into order. Predictions of widespread municipal defaults did not materialize during the year and were limited to a few large issuers with well known long-term financial issues. Defaults actually decreased from the previous year, an indication of the ability and the willingness of municipalities to make debt service payments. Although states' seemed to have turned the corner as personal income and sales tax revenues rise, depressed property values continue to plague some local governments, since property taxes comprise the largest portion of their revenues.

Municipal market behavior over the last year was somewhat bifurcated. The first half of the year had a negative bias and centered on concerns relating to municipal defaults, potential amendments allowing states to file for bankruptcy, credit downgrades, potential changes to the tax code, and mutual fund redemptions. The second half of the year was spent adjusting to the low interest rate environment created by the Federal Open Market Committee. Absolute low yields coupled with tepid primary market supply drove investors into the municipal bond market and sent annual returns into double digit territory. Primary market issuance for 2011 amounted to a meager $295 billion, a decrease of over 30 percent from the previous year. As many issuers remain in "belt tightening" mode, there is reluctance to issue new debt unless necessary.

Despite increased market volatility, one should not ignore the 10.7 percent return of the Barclays Municipal Bond Index in 2011. The Fed's announcement of "Operation Twist" advanced the long-end (22+ years) of the interest rate curve to the top performing area of the index during 2011 with a return of 14.8 percent. Single-A rated securities outperformed the index by 183 basis points for the year as investors reached for yield by investing in slightly lower quality securities. Supply may increase in 2012 as issuers look to refund previous years' debt issuances, but supply estimates remain well short of their 2010 peak. Tax exempt to taxable ratios will likely remain elevated if this low yield environment persists, and credit spreads may remain stubbornly wide as budget deficits persist and underfunded pension balances receive media attention.

Persistently low United States Treasury yields and high tax-exempt to taxable yield ratios attracted cash

CUTWATER ASSET MANAGEMENT

Municipal Bond Commentary, 4th Quarter 2011

into the municipal market during the fourth quarter with a bias towards intermediate maturity paper—perhaps an indication of investor unease that an increase in interest rates could erode the market value of their securities. The Barclays Municipal Bond Index returned 2.12 percent in the fourth quarter. The slope of the municipal yield curve (from 1-30 years) was unchanged quarter over quarter at 330 basis points. The yield on 30-year AAA general obligations ("GOs") was unchanged at 3.55 percent while 10-year yields decreased by 39 basis points. Tax-exempt bonds slightly underperformed Treasury bonds, which pushed the ratio of 30-year tax-exempt yields to 30-year Treasury yields from 122.4 percent at the start of the fourth quarter up to 122.8 percent at quarter-end.

Investors maintained their appetite for risk during the fourth quarter as credit spreads tightened with healthcare and corporate-backed paper exhibiting top returns. Return data shows that investors favored securities with intermediate (10-20 year) maturities as the relatively flat interest rate curve caused some investors to shy away from long maturity bonds. According to Barclays Capital, single-A rated bonds outperformed the general index by 27 basis points and BBB rated bonds outperformed the index by 61 basis points. High-yield, tax-exempt spreads widened during the quarter as the Barclay's municipal non-investment grade index underperformed the investment grade index by 133 basis points. Much of high yield sector's underperformance can be attributed to the tobacco sector, which came under pressure due to weakening credit concerns.

Cutwater Asset Management
113 King Street
Armonk, NY 10504
866-766-3030
www.cutwater.com