

Market Overview

Flight to Quality Dominates Treasury Market

Treasury yields declined in November as investors reached for yield beyond money market funds and later in the month looked for the safety of U.S. Treasuries. Investors continued to move funds out of money market funds and into short and intermediate maturity bond funds in their search for higher yields. Then, late in November, the possible debt default from Dubai World triggered fears of a global banking crisis. As a result, intermediate maturity treasury yields declined more than short and long maturities.

Recurring bouts of investor fear, combined with the quest for higher yields provides support for lower treasury yields despite macroeconomic and technical forces that would typically lead to higher treasury yields. We do not expect these trends to end for quite some time as the Fed remains committed to keeping rates low for an extended period, and the economy navigates its way through a fragile recovery.

Tax Exempt Strategy

Heavy Issuance Weighs on Market

During the month of November the municipal bond market was impacted by extremely heavy issuance as well as renewed investor concern over municipal credit quality. A large amount of new issue supply both in tax-exempt and taxable (BAB) municipals had to be absorbed in a market which had once again become risk averse. In general, credit spreads widened and lower quality bonds underperformed higher quality bonds. Returns were positive due to the decline in overall yields. Yields in shorter maturity bonds (1-5 years) declined significantly as investors reached for yield out of money market funds; resulting in an unusually flat tax-exempt yield curve from 1-5 years, then steep curve from 5-10 years. Accordingly, we are taking advantage of this yield pick up in intermediate maturities and are focusing new purchases in the five to ten year part of the yield curve.

Taxable Strategy

Focus on Taxable Municipal Bonds

In the flight to quality and amidst fears of another banking crisis, lower quality corporate bonds and bank-related bonds sharply underperformed other sectors in November. Spreads also widened in the taxable municipal sector reflecting additional supply and credit concerns. We continue to overweight taxable municipals given their relative yield spread advantage over comparably rated corporate bonds.

Qualified School Construction Bonds (QSCB)

What are QSCBs?

Tax-credit bond program part of the federal stimulus act

Created as part of the American Recovery and Reinvestment Act of 2009, the QSCB program enables states and local school districts to issue bonds that provide a federal tax credit to investors in lieu of some or all interest payments. Principal is due at maturity. The bonds must be used to finance the construction or rehabilitation of a public school facility or the acquisition of land on which a public school is to be constructed.

The U.S. Treasury sets the structure for each QSCB, including maturity and tax-credit coupon rate, on the date of sale. Maturities have typically ranged from 14 to 16 years. Above 7

percent through July, tax-credit coupon rates have recently ranged between 5.8 and 6.3 percent. Some QSCB issuers have been forced to offer supplemental coupon payments of up to 2 percent to achieve par pricing. Congress authorized stripping of the tax credits from QSCBs, enabling investors to buy or sell the tax credits separately from the underlying debt obligation. However, the U.S. Treasury has not issued guidance on how stripping would work or advised when guidance might be released.

QSCB Issuance on the Rise

Issuance of QSCBs has increased dramatically—from \$128 million in August to \$233 million in September, \$634 million in October and \$721 million in November. The trend is likely to continue in December as school districts worry they may lose any unused 2009 state allocation at year-end. While QSCB market activity has increased, many open issues remain.

Only small percentage of 2009 allocation has been issued

The U.S. Treasury authorized \$11 billion of QSCBs for 2009 and another \$11 billion for 2010 through volume cap allocations to states and local school districts. Through the end of November, \$1.9 billion of QSCBs had been issued in more than 125 transactions.

While anyone may purchase a QSCB, insurance companies with a buy-and-hold strategy are the largest buyers of QSCBs to-date. In many cases, sales were transacted through private placements rather than through competitive bidding. Market activity has been limited by the program's newness, complexity and unresolved issues.

Open Issues Remain, Stripping guidelines needed

Uncertainty around the ability to strip tax credits has limited market demand for QSCBs to buy-and-hold investors. There are many open issues related to stripping. For example, Treasury guidance is needed to define what would happen to a stripped tax credit in the event a QSCB issuer defaults on the principal payment.

Additionally, tax credits are subject to denial and possible claw back if a QSCB issuer fails to meet the standards specified to maintain qualified tax status. Standards include using all QSCB proceeds for construction less issuance costs of no more than 2 percent, spending all proceeds within three years of issuance date and complying with the Davis Bacon Act requirement that workers be paid prevailing wages.

The QSCB structure, which calls for a one-time repayment of principal at the maturity date, also necessitates further credit evaluations of QSCB issuers. QSCB bond ratings are likely to depend partly on the issuer's specific plan for financing the one-time principal repayment, which may include invested sinking funds.

Monitoring QSCB's Going Forward

BCA continues to monitor developments in the taxable municipal market, which includes Build America Bonds as well as QSCBs. While we see many opportunities in the BAB program, we believe limited liquidity and open issues surrounding the QSCB program currently limit its appeal. Therefore, we do not expect to purchase these securities in client portfolios in the foreseeable future.