



MARKET COMMENTARY

February 2010

MARKET REVIEW

Fixed Income Returns Continue Positive Trend

Most fixed income sectors posted another month of positive returns in February, again reflecting a flight to quality and search for higher yields. Treasury yields were volatile, responding to opposing views of higher growth and eventual Fed tightening, and renewed fears of a debt default by Greece and possibly other European countries. Macro-economic data revealed continued weakness in the all-important housing and employment sectors; however, future data revisions may reveal temporary weather-related weakness. Inflation remained low and once again, Japan-like deflationary fears gripped investors. By month end, yields on intermediate Treasuries were modestly lower as investors fled riskier assets. The Treasury yield curve steepened slightly as yields on longer maturities rose under supply-related pressure.

TAX-EXEMPT MARKET REVIEW

Limited Supply Benefits Municipals

Municipal bond yields declined in February primarily reflecting limited supply and steady inflows into tax-exempt bond funds. Low yields and limited supply has investors reaching for yield and credit spreads have narrowed. The demand for higher yielding bonds pushed investors further out the yield curve. In response, yields in the 5 to 10-year maturity range declined significantly. Once again, a substantial portion of new issue supply came in the form of taxable Build America Bonds. Build America Bond issuance has grown markedly over the last ten months. As a percentage of total municipal bond issuance, they are replacing tax-exempt issuance as shown below.

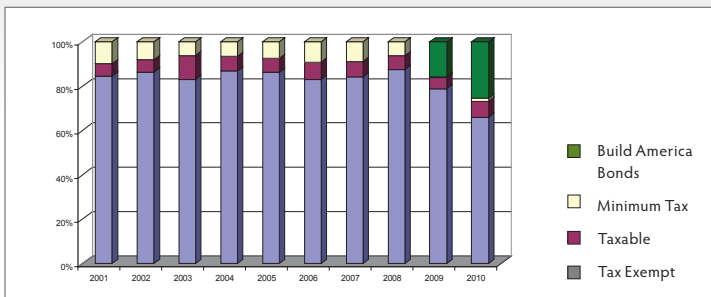
TAXABLE MARKET REVIEW

Safety and Yield Are Primary Drivers

The ongoing struggle between opposing economic forces of growth/inflation and weakness/deflation is causing Treasury yields to remain range-bound.

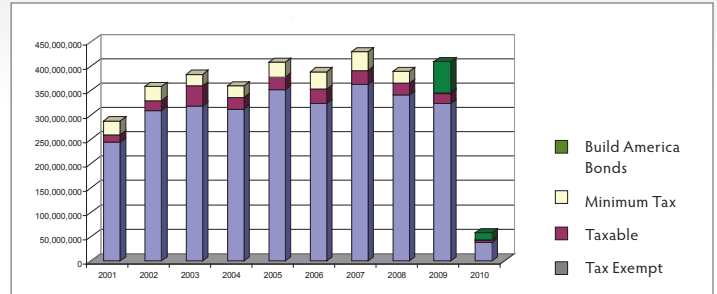
MUNICIPAL BOND ISSUANCE (%) CHART

Source: Bond Buyer



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Consequently, the search for yield continues, and yield spreads in general continue to tighten. In February, agency and taxable municipal bond spreads narrowed as higher quality assets outperformed lower quality assets. As a sector, corporate bond spreads widened as risk aversion returned. However, corporate bond yield spreads, particularly high quality bonds, remain at historically narrow levels.

The Build America Bond program continues to generate investor acceptance and involvement as evidenced by the narrow yield spreads on some of the larger, higher quality new issues. For example, highly rated (Aaa/AAA) State of Maryland bonds were issued at yield spreads that were narrower than agencies of comparable maturity. The 10-year maturity was issued at 40 basis points over the 10-year Treasury. In contrast, Florida Inland Protection (rated Aa3/AA) issued a 10-year BAB at 116 basis points over the 10-year treasury. Many smaller, lesser-known BAB issues present excellent investment opportunities.

POLITICAL POLICY AFFECTING MUNICIPALS

Sunsetting Tax Rates/New Proposals

The dynamics of the municipal bond market have changed significantly over the past year with the development of the Build America Bond program. More changes are expected as existing tax-cuts sunset and new proposals evolve. As Congress tries to deal with the expanding budget deficit, more revenue-raising proposals will be put forth. Several bills have been proposed that could impact the municipal bond market. The Senate jobs bill proposes making the BAB program permanent, but with a lower subsidy to issuers. We believe this change has a very good chance of being enacted. If enacted, it could lead to a surge in BAB issuance to lock in the current higher subsidy.

In late February, the Wyden-Gregg tax reform bill was unveiled. This proposal would significantly impact the municipal market by eliminating tax-exempt bonds beginning in 2011, changing the tax exemption for state and local bonds to a tax credit, and prohibiting advance refunding of bonds. We do not expect the Wyden-Gregg bill to pass. Historically, tax credits have not been effective in raising revenue, or helping municipalities issue debt. However, this bill is indicative of the uncertainty that surrounds the municipal bond market in the current political climate.