MUNI MARKET UPDATE
DECEMBER 2009

One Year Later – What Is Different Today?

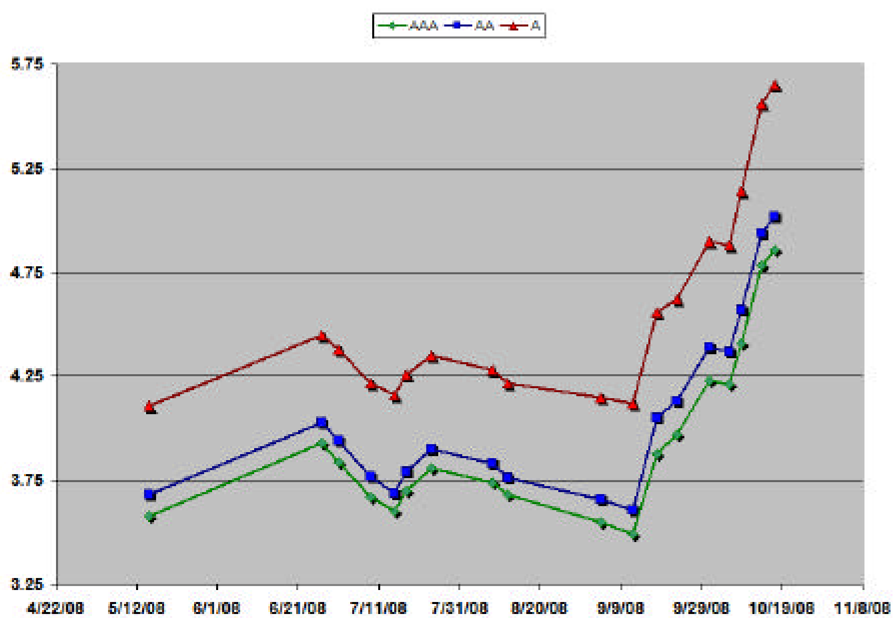
> "Cities, states and other local governments have been effectively shut out of the bond market for the last few weeks raising the cost of day-to-day operations, threatening longer term projects…at a time when other parts of the economy are weakening."
>
> -New York Times, 9/30/2008

Municipal bond prices plummeted and yields soared last fall as the onset of the 2008 financial crisis greatly affected the municipal bond market and municipalities across the nation. As bond yields soared, municipalities that came to market with new issues paid a much higher interest rate than they had become accustomed to paying. For a brief period, some issuers were unable to borrow in the public marketplace altogether.

Last fall, we witnessed a staggering set of events befall the municipal bond market. One, two, perhaps, even three together would have been manageable circumstances for the historically resilient municipal bond market. Taken in sum, however our market, like others, faltered under the pressure.

The first major event foreboding the coming market turmoil was the downgrading of several mono line insurance companies from "AAA" to lesser ratings. The rating downgrades flooded the marketplace with municipal bonds as investors sold credits that were no longer "AAA" and, in many cases, not well researched and therefore, often misunderstood. Over the past year, billions of dollars worth of once triple AAA rated municipal bonds (by virtue of bond insurance) became non-rated as the insurers struggled to stay in business while losing their investment grade ratings.

At about the same time, the auction rate market collapsed leaving thousands of investors holding illiquid investments once thought to be a money market alternative. This event further panicked already nervous investors. As many issuers opted to repay their auction rate issues with newly issued fixed rate, fixed maturity bonds, supply increased as demand was waning adding to the downward pressure on bond prices, pushing yields even higher.



"AAA", "AA", "A" 10 Year Muni Bond Yield (May-October 2008)

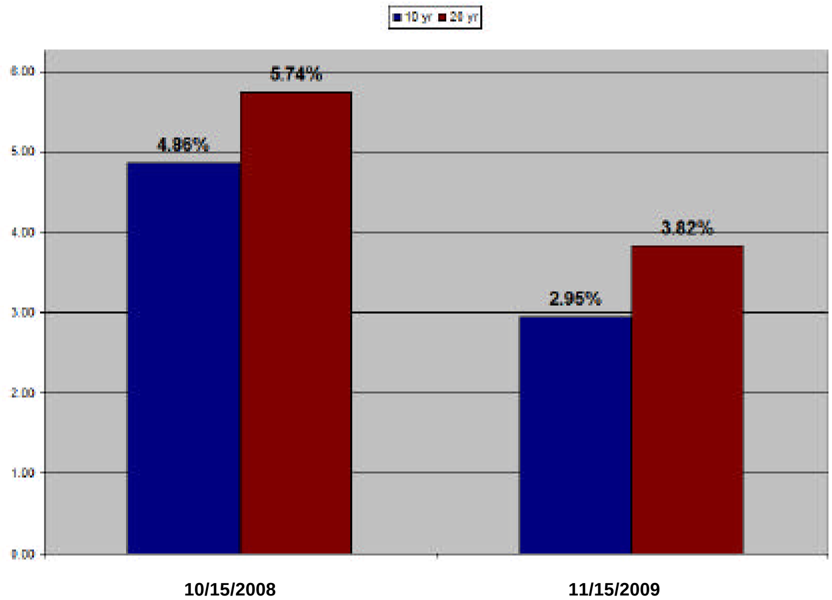
Contemporaneous with the above two events, many wire houses and dealers were in a state of disarray and therefore unable and unwilling to commit capital to the municipal bond market. Several major firms exited the market completely due to bankruptcy or buyouts by competitors. Most of the largest firms significantly reduced their inventory purchases of municipal bonds in order to deal with their bigger balance sheet problems. These actions put further downward pressure on bond prices.

Add to the above mix, massive hedge fund sales to meet bank capital calls and bond fund sales in order to meet fund redemptions and the result was one, awful, wretched mess and **one tremendous opportunity.**

* * *

Today, one year later, the above dynamics have changed markedly. Clearly, in retrospect, the municipal bond market was significantly undervalued last fall. Below are three charts showing the dramatic change in bond yields over the last 12 months.

Chart A (right) compares the 10 and 20 year yields for "AAA" rated issues on 10/15/2008 and 11/15/2009. The numbers speak for themselves and demonstrate the significant improvement in the market from the issuer's perspective.



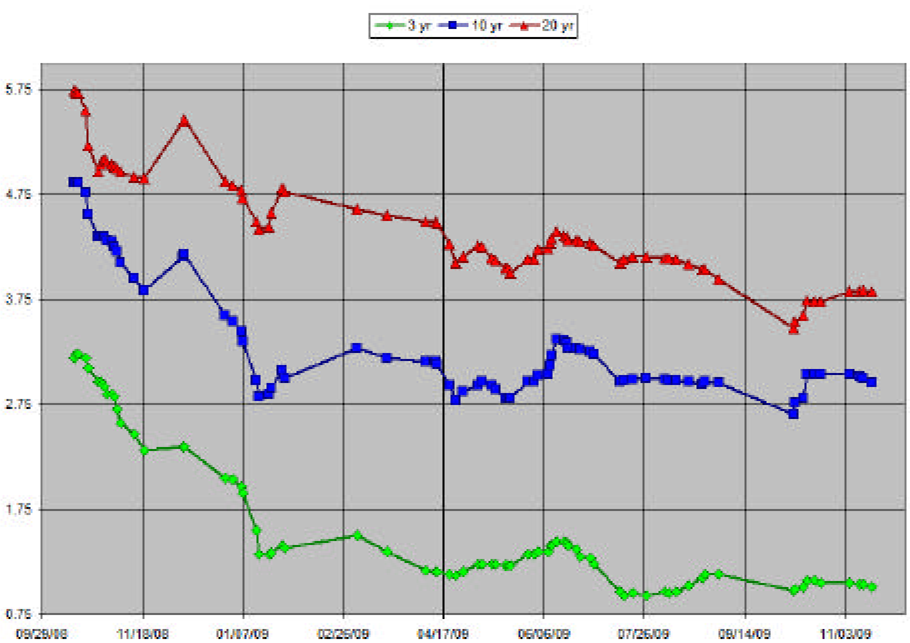
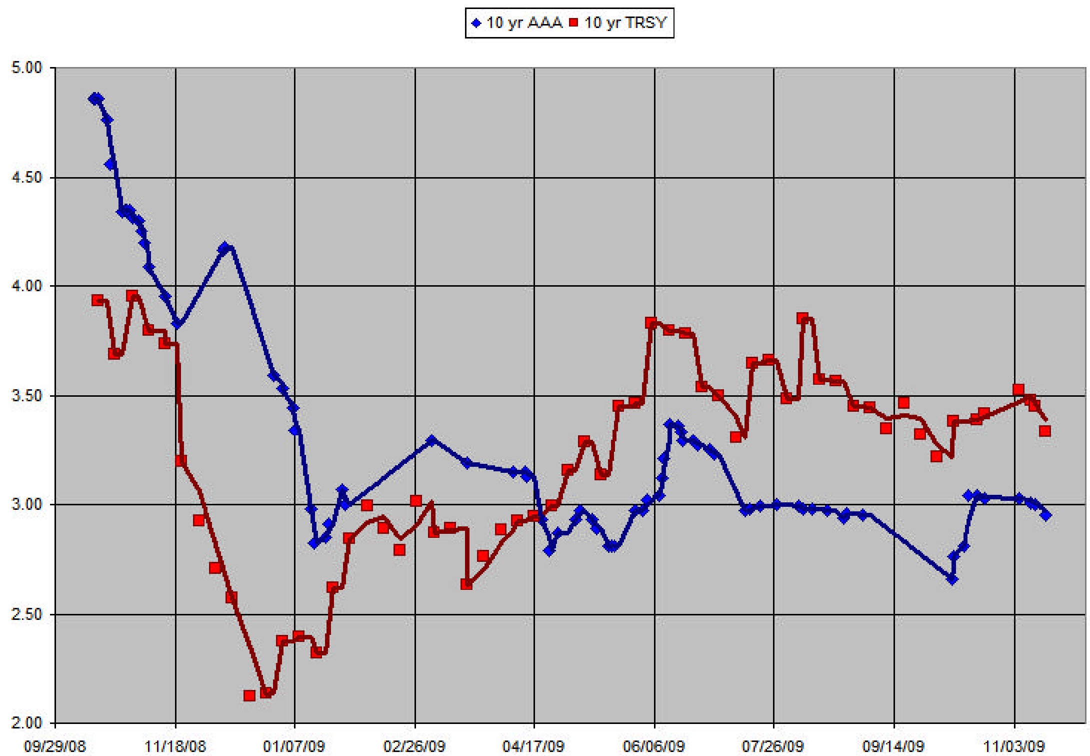


Chart B (left) shows the "AAA" rated bond yield levels from 10/15/2008 through 11/16/2009 for 3, 10 and 20-year maturities. The table shows the decline in the absolute yields over the past year.

Chart C (below) compares the yields of the 10-year "AAA" rated, non-taxable municipal bonds to comparable maturity Treasury bonds. Historically, the ratio approximates 80%- 82%. Clearly, last fall and into the early part of this year, this ratio was extraordinarily favorable for municipal bond investors. Today, the ratio more closely resembles its historic norm.



What events have occurred to spark this significant turnaround?

Investor confidence in the credit market has been greatly restored resulting in appreciating municipal bond prices as capital has flooded the marketplace.

Retail investors have been dominant investors this year moving significant sums of money out of money market investments and into the municipal bond market. Supply continues to be moderate as new issuance is down from last year and the massive selling programs initiated last fall by hedge funds, bond funds and other panicked investors have mostly ended. The short-term success of the taxable, Build America municipal bond program has also played a significant role in reducing tax-exempt municipal bond yields. The government program has shifted approximately 25% of recent new issuance supply from the tax-exempt to the taxable sector.

The double effects of a reduced tax-exempt supply and the introduction of a large, new investor class interested in buying taxable, municipal bonds has helped push tax-exempt bond yields lower. Additionally, many of the large broker dealers and banks that fled the marketplace last year have returned to support it in a significant manner. Lastly, high income tax bracket investors are warily eyeing 2011 when most expect the top marginal income tax rate to increase making tax-exempt municipal bonds even more appealing.

All of these factors have helped push tax-exempt municipal bond yields to very low levels by recent historical measures. There is no arguing that tax-exempt bond yields are low today compared to this time last year begging the question, what do we do now?

Those who know us well already have answered the question: Stick to your game plan and adhere to the discipline of a separate account, bond portfolio management process. Fixed rate, fixed maturity**,** quality bonds weathered the financial crisis of 2008 very well producing positive returns during the most calamitous time I have ever experienced. Now is not the time to stray from this time-tested strategy regardless of low interest rates. If 2008 taught us anything it is that seemingly different asset classes can move in the same downward direction simultaneously and that complex derivative hedge investments do not always serve as the hedge they are professed to be.

Admittedly, quality, fixed rate, fixed maturity, municipal bonds are boring investments. What better way to protect your overall investment portfolio from a cursed repeat of 2008 than by making sure a portion of the portfolio is invested in ordinary and boring municipal bonds?

Thank you for your continued confidence.

Sincerely,

Ronald P. Bernardi
President and CEO
Bernardi Securities, Inc.
December 2009

Graph Source Data: Bloomberg and Thomson Financial
