Municipal Market | *ADVISORS*

MUNI OUTLOOK FOR SEPTEMBER

ABOUT US

Municipal Market Advisors is the leading independent strategy, research and consulting firm in the municipal bond industry. MMA's subscription services provide clarity and insight into the complex world of municipal bond investing. Our independence facilitates objective analysis and distinctive views of the issues confronting investors so informed investment decisions can be made.

WHAT WE OFFER

- Timely independent unbiased market coverage delivered intraday, daily and weekly via internet, email, Bloomberg and PDA.
- Cost effective solution to monitoring and understanding "The Market".
- Interaction with regulators, Congressional leaders and Central Banks provides distinctive insight.

CONTACT US

For additional information on how our advisory or subscription services can add value to your portfolio, please contact Steve McLaughlin at 973-701-1111 or log on to www.mma-research.com and sign on for a welcome trial

MARKET SUMMARY

September was the most volatile month of the year amid the acceleration of financial calamity attributed to the ongoing consequences of the subprime adversity. The magnitude of the associated problems became acute as the US Government took over Fannie Mae, Freddie Mac and AIG, and Lehman entered bankruptcy (later to be bought by Barclays), JP Morgan acquired WaMu's assets, Bank of America bought Merrill and Citigroup purchased the banking operations of Wachovia. Goldman Sachs received a $5B investment from Buffet's Berkshire, while Goldman and Morgan Stanley filed with the Federal Reserve to become bank holding companies. However, it was the events of September 15, led by Lehman's bankruptcy, which exerted the greatest degree of force on the municipal market. The loss, albeit temporary, of the firm as a market-making entity and counterparty decreased secondary market liquidity for investors, inhibited issuers access to the capital markets and increased the risk perception regarding the credit-worthiness of remaining securities firms. The immediate impact emanated from decisions of money market funds to exercise the put options on VRDN programs that were so massive that remarketing agents were unable to hold the securities because of capital constraints. The consequence was that the "synthetic" VRDN's, which attained historically high rates, **Figure 1**, triggered the collapse of leveraged positions, which resulted in reconstituted bonds being sold into the compromised secondary market where liquidity was absent. The fragile market conditions resulted in transactions that were of limited size and challenged evaluation and pricing processes for the latter half of the month. The direct result was that isolated adverse transactions exerted an undue amount of influence to investors' detriment, as they were over-weighted in pricing matrices and NAV's.

While performance investors suffered, income seeking

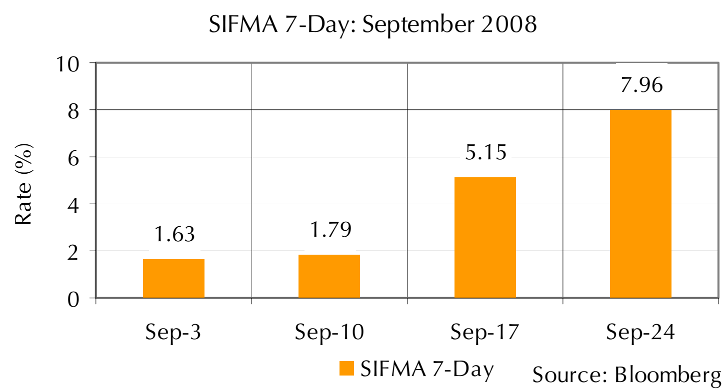
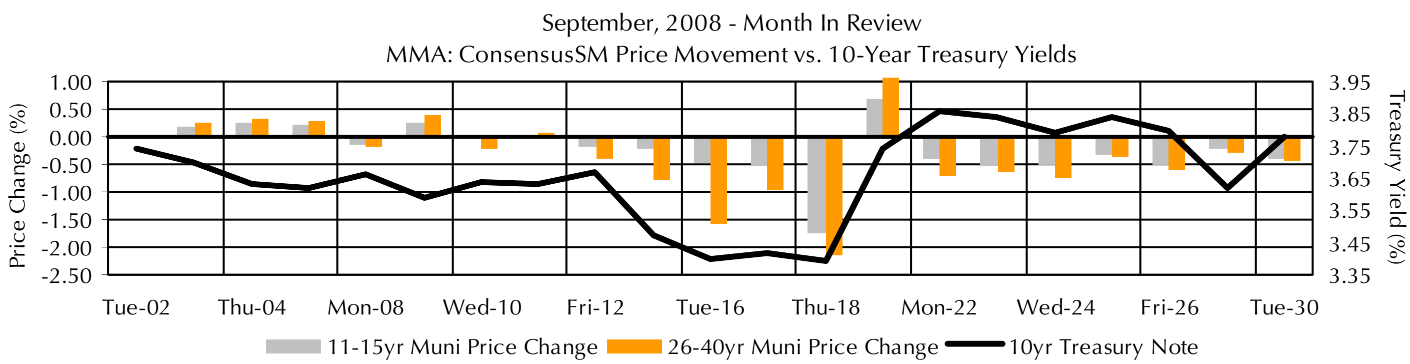


Figure 1: Fears after Lehman's bankruptcy resulted in massive VRDN positions being "put-back" to dealers i.e. re-marketing agents producing record rates.

investors received the benefit of high yields and attractive income opportunities. The taxable equivalent yields for AAA GO bonds surpassed 6% and 8% in 10 and 30-years respectively. Tax-exempt yields far exceeded the low Treasury levels that plummeted as a result of the immense flight-to-quality surges, which returned the Treasury 30-year yield to its lowest level in history. The cross-market ratios for the 2, 5, 10 and 30-year maturities were, at month-end, 131.6%, 111.4%, 108.9% and 124.6% respectively. The value and relative secure credit quality of tax-exempts became even more pronounced as equity investors experienced negative returns (as measured by the S&P 500) of -9.2%, -9.0% and -20.7% for September, 3Q and 2008 respectively.

Redemptions were also part of the money market funds problems and tax-exempt funds lost 6% of their assets. Many fund families feared even great redemptions when during the negotiations of the $700B US Treasury's financial rescue plan, the $50B to support the beleaguered money funds was initially believed to have excluded the tax-exempt sector. However, the municipal funds were included and a potential "run-on-bank" was avoided. The efforts in Washington DC to confer approval on a

MUNI OUTLOOK FOR SEPTEMBER



rescue plan remained elusive at month-end and the ebbs and flows of negotiations and the failed initial vote by the House, contributed to excess equity and bond volatility. September's municipal price volatility surpassed that of February, when the first wave of municipal hedge funds collapsed.

MUNICIPAL ISSUANCE WAS HALTED

Municipal issuance was $19.9B for September, the lowest total for the month since the 9/11 impacted year of 2001. The month was 38% lower than the month's average of the last 5 years. More dramatically, however, was that of the $19.9B, 91% (or $18.1B) was issued prior to September 19. During the year fixed-income weekly issuance, as estimated by Bloomberg, has averaged more than $6B, well above the cumulative $1.8B that represented the last two weeks of the month.

CREDIT NOW A CONCERN AND SPREADS WIDENED

As US economic data reflected weakness, the financial health of municipal issuers became a growing concern. 29 states were reported to have a cumulative estimated $48B in 2009 budget deficits (that coincided with the US governments forecasted 2009 budget deficit of $438B). As a result, the additional yield required to place lower rated credits increased, especially as bond insurance has been thoroughly discounted and liquidity remained inconsistent at best. Reflective of the credit problems were the potential default of the $3.2B Jefferson Co AL Water and Sewer debt in October, and the 38% decline of a leading high-yield municipal bond fund since August 2007.

The *Municipal Advisor* is prepared monthly by
Thomas G. Doe & MMA Team
978.287.0014
tdoe@mma-research.com