OBSERVATIONS ON THE **MUNI BITES** MUNICIPAL BOND MARKET

APRIL 2014

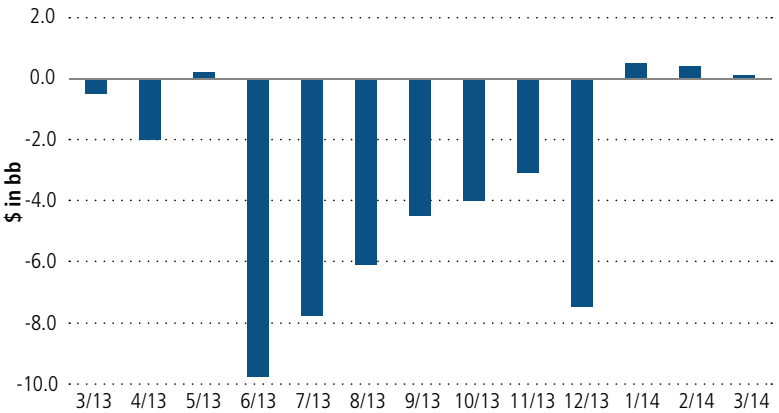
MARKET COLOR

- One notable event over the course of the first quarter has been the dramatic flattening of the municipal yield curve. In fact, the AAA benchmark municipal yield in the five year maturity spot ended the quarter almost flat while the ten year maturity spot dropped almost 30 basis points and the 30 year maturity spot dropped over 55 basis points. Of course, the flattening of the U.S. Treasury yield curve played a role. Several factors in the municipal market also contributed including low new issue volume, attractive relationships to U.S. Treasury bonds in longer maturities and modest inflows into mutual funds compared to massive outflows last year.
- The City of Detroit recently submitted new proposals to exit bankruptcy which reflect the current capital available to the City. In short, the two most significant changes were an increase in the haircut for pensioners and a reduction in the recovery rate for general obligation bond holders. The recovery rate for general obligation bonds is now expected to be reduced to 15 cents on the dollar, or almost 5% lower than original. All-in-all, the municipal market reaction has been muted to the Detroit bankruptcy headlines.
- Standard & Poor's rating service recently upgraded two bond insurers, Assured and National Public Finance (MBIA) to AA and AA-, respectively. The ratings upgrade suggests that a larger share of the municipal market could be insured moving forward.

FACTS & FIGURES

- Supply continues to run roughly 20% lighter year-on-year. According to Bond Buyer data, March issuance was nearly double that of February at $31bln, with most of the additional size coming from large California and Puerto Rico deals.
- A March uptick is not suggestive of an overall improvement in forecast, and the market is still anticipating net negative supply trends in 2014 driven by a roughly 40% reduction in refundings
- Demand held in the positive territory, with fund inflows totaling $220mm in March. Given recent history of heavy outflows in past quarters, we are cautiously optimistic about sustaining positive demand trends in an increasing rate environment

MONTHLY MUNICIPAL FUND FLOWS ($BB)



Source: iMoneyNet.com

STRATEGY THEMES

- We are currently focusing on essential purpose revenue bonds that rely on identifiable and sustainable revenue sources that are generally immune to economic swings. Examples are water, electric and toll revenue bonds.
- Our sector allocations are based on fundamental research combined with relative value assessments. At the present time, we have identified bonds in the hospital and transportation sectors that are especially attractive and have the potential for higher than average spread tightening.
- Our yield curve management process involves positioning investments optimally in the most attractive spot on the maturity curve. Currently, the yield curve is quite steep and we favor bonds in the longer maturity range of a client's benchmark where we can pick up additional yield.
- Our overall duration is modestly defensive, so we are balancing some of the longer duration bonds with additional front end maturities and floating rate structures.
- We favor the "A" to "AA" rating category as these bonds are trading at favorable spreads not seen since before the credit crisis and the fall of bond insurers.

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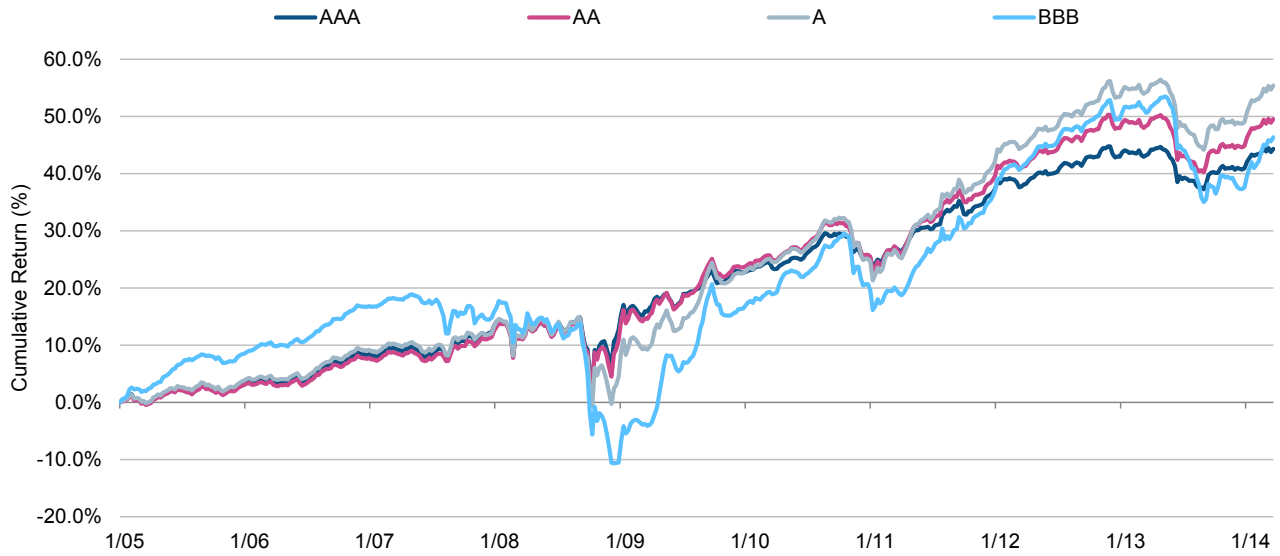
CHART OF THE MONTH

MUNICIPAL PERFORMANCE – 10-YEAR CUMULATIVE RETURNS – WHAT IT MEANS TODAY

THE SINGLE "A" RATED SEGMENT IS THE "SWEET SPOT"



Source: BAML indices

REASONS TODAY TO FOCUS ON "A" RATED BONDS

- The single-A segment appears to be the "sweet spot" of long-term performance. This provides the additional yield that one would expect from moving out of AAA securities into lower-rated credits, but does not suffer the same degree of price volatilitiy as the BBB segment.
- "A" rated bonds outperform over the longer term.