MARKET COMMENTARY

December 2012

If there is one person who has not heard of the "fiscal cliff" and its looming impact on the U.S. Economy and taxpayer, we would be (in an understatement) surprised. The back and forth between the White House and Republican leaders in Congress has been unceasing – and infuriatingly unproductive. With Congress' approval ratings (disapproval, perhaps?) in the single digits and the Obama Administration "basking" in its re-election victory it should not be surprising that we have come to the edge of this so-called "cliff."

But with apologies and a nod toward the guys on APA's compliance team, shouldn't we be able to expect more from Washington? Does anyone remember when President Reagan and House Speaker Tip O'Neil managed to come together in the early 80s to craft a solution to the economic catastrophe that had the bank prime rate at 20%, or was it 21%?

As we point out in this Commentary, the job losses and tax increases now "looming" could impact nearly every corner of the still struggling U.S. economy. And yet the cacophony in Washington continues. Rearranging the "deck chairs" or "fiddling while Rome burns," – whatever the fitting description, it would be comical if not exasperating. And by the way, who elected Grover Norquist to anything?

We at APA wish you, your families and friends a Happy, Healthy and Hopeful Holiday season.

- As the December Commentary was being written, Congress and the President had yet to reach an agreement to avoid going over the so-called "fiscal cliff", the $600 billion of tax increases and more than $1 trillion in automatic across-the-board Federal Government spending reductions scheduled to take effect on January 1, 2013 should leaders fail to act.

- Many of the "fiscal cliff" reductions and tax increases have the potential to impact States and local municipalities' finances, both in terms of forced job losses and Federal government direct payments and reimbursements.

- As Congress and the White House continue to search for new revenue sources in an attempt to reduce the Federal deficit, some form of municipal tax exemption "cap" appears to be back on the negotiating table.

- With Congress focusing its attention on the elimination of certain deductions, including tax-exemption for municipals, market participants are being proactive in their lobbying efforts and in demonstrating the negative effects any change to the Municipal tax exemption could have on local governments' cost of borrowing and the impact on taxpayers and local jobs.

“Fiscal Cliff” Looms

As of APA’s release of this commentary, Congressional leaders and the President had yet to reach an agreement to avoid the “fiscal cliff”, the $600 billion of tax increases and over $1 trillion in automatic across-the-board Federal Government spending reductions scheduled to take effect on January 1, 2013. The impact the fiscal cliff would have on a wide ranging set of factors in the national economy was debated as leaders attempted to reduce the Federal deficit by $6.8 trillion over a ten year period. If the cliff was not avoided, the country was projected by many economists to be headed for another recession. The following key provisions were those contained in what technically is called “sequestration” or the forced cuts required of government departments should an agreement be missed by year end.

- The Bush Era tax cuts extended in 2010 by President Obama would expire. The Tax Policy Center estimates that an average middle-income family would see an increase of around $2,000 a year to their 2013 tax bill. In addition, many itemized deductions would be phased out, along with the earned income tax credit, child tax credit and other specific preferences.
- Reversion of the Alternative Minimum Tax (AMT) threshold to the 2000 tax year level.
- Across-the-board spending reductions, known as “sequestration”, in many discretionary government programs as directed by the Budget Control Act of 2011. On January 1, 2013, $1.2 trillion in automatic spending cuts will occur. The result will be a 9.4% reduction in defense spending and an 8.2% reduction in non-defense spending. Federal agencies such as the Food and Drug Administration, the Center for Disease Control and Prevention, and the Department of Homeland Security (among many) would all see reductions in funding.
- Implementation of new health care taxes as imposed by the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010.
- Expiration of the 2% Social Security payroll tax cut.
- Reductions of 2% to Medicare re-imbursement. The American Hospital Association estimates that the $11.3 billion in spending cuts could result in over 495,000 job losses in the health care sector.
- Reduction in the number of weeks individuals could claim unemployment benefits.

States facing the Greatest Impact from Fiscal Cliff

Many of the proposed fiscal cliff reductions have the potential to impact States, both in job losses and in terms of federal payments to local governments. APA examined those States with the highest number of military personnel, as defense spending would see a 9.2% reduction in spending along with Health Care cuts, which are part of an 8.2% reduction in non-defense spending. California, for example, had the highest number of military personnel with an estimated 212,800 total jobs. This includes Active, Reserve and National Guard personnel. Table 1 shows the top 5 States including Texas (194,965), Virginia (123,686), Florida (109,390) and Georgia (105,914). With regards to Health care reductions, the American Hospital Association has estimated that Medicare reductions in 2013 resulting from the fiscal cliff could total $11.6 billion and reduce the workforce by 496,431. And in terms of states, California once again tops the list with potential job losses of 50,785.Table 2 indicates the number of job losses among the top 5 states: Florida (35,827), Texas (32,172), New York (31,801), and Pennsylvania (24,201). APA currently has three of these states (California, Florida, and Pennsylvania) on an internal “Watchlist,” meaning we are highly selective when investing in the states on this list. The “Watchlist” is updated quarterly.

Table 1: Top 5 states for Military Personnel Employment

State	***Number of Military Personnel***
California	212,800
Texas	194,965
Virginia	123,686
Florida	109,390
Georgia	105,914

Source: American Forces News Service

Table 2: Top 5 States for Potential Health Care Job Losses

State	***Number of Potential Losses***
California	50,785
Florida	35,827
Texas	32,172
New York	31,801
Pennsylvania	24,201

Source: American Hospital Association

Impact of Fiscal Cliff on Municipals

As the White House and Congressional leaders continue to search for new revenue sources in an attempt to reduce the growing Federal deficit, some form of municipal tax exemption "cap" appears to be back on the negotiators' table. Chris Meir at Loop Capital indicates four potential proposals for change in the municipal bond market:

1. Limit the Municipal tax-exemption to 28% of a taxpayer's income.
2. Completely eliminate the tax-exemption on municipal bonds.
3. Conversion to a tax credit system for interest on the bonds.
4. Reducing the types of municipal deals eligible for tax-exemption to "pure" government purposes.

We believe (as does Mr. Meir and Citibank) that the proposal with the highest probability of enactment is the limitation on tax-exemption to 28%. The original idea for this limitation came from President Obama in the American Jobs Act of 2011 and appears to be gaining traction. Under such a proposal, a taxpayer would pay a tax on the interest earned on municipal bonds at a rate equal to the difference between their individual tax rate and the 28% tax cap. For example, an investor in the 35% tax bracket would pay a 7% tax (or "haircut") on the interest earned from tax-exempt bonds. The cap would only apply to individual taxpayers with adjusted gross income (AGI) exceeding $200,000 or families with AGI greater than $250,000. There is also no grandfathering for outstanding or currently owned municipals in this proposal. APA believes, however, that current bond holdings would be grandfathered given the legality of changing a contract after the fact. While it would be relatively easy to implement a cap by the Internal Revenue Service, it would substantially raise the cost of capital for issuers. Some estimates show issuer borrowing costs increasing by 60-75 basis points to as much as 200 basis points. Such an increase in borrowing costs would come at a time when state and local governments are emerging from one of the worst economic downturns in U.S. history, further challenging their financial stabilization efforts.

Municipal Bond Market Participants Going Proactive

With Congress focusing its attention on the potential elimination of tax-exemption for municipals, market participants are being proactive in attempts to demonstrate the significant negative effects any

change to the tax exemption would have on issuers. Formed in September of 2012, the group spearheading the campaign calls itself *Municipal Bonds for America*. This group is trying to protect the tax exemption of interest from federal taxes and is comprised of government officials and bond issuers as well as key municipal market participants such as banks and investment advisors. They argue that by limiting or replacing tax-exempt bonds with another form of investment product municipalities would face substantially higher issuing costs and corresponding higher costs for local taxpayers. The State Treasurers Association has made similar claims, with both groups stating they will continue to demonstrate the effectiveness of the tax exempt market in lowering government borrowing costs, ensuring continued job creation at the local level and preserving lower local taxpayer burdens.

APA's 2012 Strategic Direction

APA's Investment Committee believes the best strategy in today's market environment is a modified barbell strategy. A sample portfolio consists of high quality bonds, half with a 1 to 5 year maturity and half with an 8 to 12 year maturity. APA's overall duration target is 4 to 4.5 years. To help enhance clients' portfolio yield, APA invests up to 20% of the total portfolio within the A-rated category. More specifically:

1. For investors with a lower risk tolerance, APA recommends a **Short-Term Strategy**. We feel that lower duration and high credit quality bonds offer clients a defensive position against rising interest rates. We recommend this strategy to investors seeking principal protection in a rising rate environment while looking for higher returns compared to traditional money market funds. APA tailors this portfolio for each client based on their individual liquidity and future cash flow needs.

2. For investors seeking slightly higher yields at lower risk than longer duration bonds, APA recommends an **Intermediate Strategy**. With a slightly longer duration than APA's Short-Term Strategy, bonds are selected utilizing a modified barbell investment approach targeting bonds with 1 to 12 year maturities. We also increase our A rated bond holdings from 10% to 20%.

   As we do not see any significant near-term threat from inflation, the Investment Committee believes that subtle improvements in the current economy could benefit investors buying along this curve. As stated, our overall duration target is now in the 4 to 4.5 year range. The

top five municipal bond sectors in our Intermediate Strategy include local general obligation bonds (GOs), higher education, “other revenue”, state GOs, and utility bonds.

3. For investors with a higher risk tolerance seeking stronger yields and attractive after tax returns, APA recommends our **High Income Strategy** which provides a higher return with exemption from federal income taxes. The bonds purchased in these portfolios have a longer duration, lower credit ratings and longer maturities. The top sectors in this strategy typically include the following: hospitals and health care, higher education, local GOs, and continuing care retirement communities.
4. For all of the strategies detailed above, APA recommends investors allocate a portion of their portfolios to out-of-state bonds, even in high-tax states, in order to increase geographical diversification and help mitigate concentration risk. Currently, investors may take advantage of a municipal yield curve that has flattened slightly but remains steep overall to lessen the tax effect on out-of-state bonds by extending maturities a year or two out.
5. Additionally, we believe that APA is well positioned to capture higher yields by investing in market sectors where credit spreads remain wider than historical averages. For example, we emphasize purchases of single A-rated issues, water & sewer bonds, highly rated hospital bonds, public power authorities and public school district debt in states offering an “intercept” program which can strategically bolster diversification and price stability.

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