ASSET PRESERVATION ADVISORS

APA

MARKET COMMENTARY

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Although the re-election of President Obama was a decisive victory for his supporters, the celebration may prove short-lived as both camps in Washington faced the complex challenges of dealing with tax reform, deficit reduction and revenue enhancements. All wrapped up in time for the holidays, the "fiscal cliff" and its impact on taxpayers and the economy appeared to only increase anxiety across all income levels.

In a unique approach to quantifying this anxiety, two professors and a Ph.D. candidate from Stanford University and the Booth School of Business at the University of Chicago, launched a website at "policyuncertainity.com." Their research and methodology is explained in detail on the website and we encourage our readers to visit the site as a useful component in trying to decipher exactly what is behind all the noise surrounding the "fiscal cliff" and what the debate can mean for all. To quote the opening paragraph under the "results" section of the website: "As measured by our index, we find that current levels of economic policy uncertainty are at extremely elevated levels compared to recent history… Since 2008, economic policy uncertainty has averaged about twice the level of the previous 23 years." So, while the election proved decisive in one sense, we respectfully submit that the victory might resemble the adage of the dog chasing a car. What does the dog do when he catches it? The President and his Administration now own the economy.

At the conclusion of this Commentary, Congressional leaders were making the trek to the White House to begin the negotiations. So much for the honeymoon. More like a hangover for America just in time for the holidays.

- The 2012 U.S. Presidential Election concluded with President Obama winning re-election in a close race, the Republicans retaining a majority in the House by approximately 236 to 196, and Democrats increasing their majority in the Senate by 53 to 45 with 2 independents.

- Muni market observers are focused on a proposed 28% cap on the value of tax-exempt interest for the wealthy. Issuers and other municipal market participants argue the Obama proposal would increase borrowing costs for state and local governments at a time when many are facing challenging financial hurdles.

- Immediately following the election, however, the most pressing issue for Congress and the White House was the "fiscal cliff", the $600 billion of proposed tax increases and over $1 trillion in automatic across-the-board Federal Government spending reductions scheduled to take effect on January 1st, 2013.

- With voters nationwide approving more than 380 state, local government and school bond measures worth more than $30 billion, APA believes this indicates voters' willingness to pay for higher government expenditures despite certain Tea Party protests.

- Superstorm Sandy, which hit the northeast on October 29th,was tagged as the 2nd most damaging and costly storm to hit the Continental U.S. in many years. Estimates of economic damage approached $50 billion.

- Issues in the euro zone remained in the headlines as the latest compromise had Germany opting to provide funds to Greece so as to not risk a complete default that might lead to Greece's exit from the euro zone.

Presidential Election Results and Tax Impact; The Looming "Fiscal Cliff"

The 2012 U.S. Presidential Election concluded with President Obama winning re-election in a close race, Republicans retaining a reduced majority in the House by 236 to 196, and Democrats increasing their majority in the Senate by 53 to 45 with 2 seats declared "independent." As a result, APA believes there will be fiscal and tax reform legislation that could have an uncertain impact on the $3.7 trillion municipal bond market. As APA reported in our October 2012 Commentary, President Obama's tax plans proposed extending all of the 2001 and 2003 Bush tax cuts only for individuals making less than $200,000 yearly and for families making less than $250,000. The Obama plan would return the top tax rate to 39.6% as a way to boost government revenues and reduce the Federal deficit. The President is also advocating for the so-called "Buffett Rule", which would impose a minimum 30% overall tax rate on those taxpayers with adjusted gross income exceeding $1 million, including capital gains and dividends. Republicans in the House remain unwilling to raise tax rates on any taxpayer, preferring eliminations of deductions and loopholes. Market participants believe that with the 2012 election results, there is renewed risk that Congress could take action to curtail or eliminate certain tax exemptions within the framework of fiscal or tax reform. The President has already proposed a 28% cap on the value of tax-exempt interest for the wealthy, which issuers and other municipal market participants argue would increase borrowing costs for state and local governments at a time when many are facing challenged financial operations. Another impact such a change in the tax exemptions could bring to the market includes reducing confidence by the retail investor, who accounts for approximately 72% of all municipal bonds outstanding. Additionally, market access for smaller municipal issuers could be hurt, with investors looking for a greater discount to compensate for the reduced liquidity of smaller, less frequent issuers. *The Bond Buyer* reports that the Senate Republicans on tax writing committees have privately stated that the 28% cap "has legs." In order to prevent the 28% cap

from becoming law according to Senate aides, market participants must demonstrate that the expired Build America Bonds are not an alternative to tax-exempt issuance and further would have to convince Democrats of the need to maintain a full tax-exemption for state and local issuers. Any change is likely to grandfather outstanding bonds.

However, the more pressing issue for Congress is the “fiscal cliff”, the $600 billion of tax increases and over $1 trillion in automatic across-the-board Federal Government spending reductions that are scheduled to take effect on January 1st, 2013. Congress will also face an increase in the debt ceiling, which led to a Congressional impasse and the agreement creating the fiscal cliff in 2011. Key revenue items that may be affected include higher payroll taxes, higher overall taxes as the Bush Tax cuts expire, unemployment benefits, and depreciation incentives for businesses. On the expense side, automatic spending reductions would take place including significant cuts to the Defense budget and reductions in social programs such as Medicare and Social Security. The President and Congressional leaders are expected to meet on their return from the election recess and begin negotiations in an attempt to avert the fiscal cliff as there is a widespread fear among many economists that failure to reach an agreement could trigger another recession.

State and Local Referendums Show Voters Willingness to Pay for Education and Services

With voters approving more than 380 state, local government and school bond measures worth more than $30 billion nationwide, APA believes these results show voters’ willingness to pay for various government programs and are a rebuff to the Tea Party’s “no new tax” pledges. As of November 9th, 384 ballot measures were approved amounting to more than $33 billion in new programs. According to *The Bond Buyer*, this was the fourth largest referendum movement approved in U.S. history but was lower than the 2008 presidential election when $67 billion in referendums appeared on various ballots. The most notable voter approved items were:

- California’s Proposition 30, which was forecast to raise $6 billion annually for education and State budget deficits by increasing the sales tax by a quarter-cent for four years and raising income taxes on the wealthy by some 3% for seven years.
- California residents also passed Proposition 39, eliminating a loophole that allowed multistate businesses to pay fewer state taxes. The new law is expected to bring in an additional $1 billion a year in revenue for the state.

- Michigan voters rejected a proposal to uphold the state's emergency management law, the impact of which is expected to hurt financially struggling municipalities in that state.
- Four out of five states passed various ballot measures against the Obama healthcare insurance mandate. Those States include Wyoming (77% approved), Alabama (59%), Montana (66%), and Florida (51%). Missouri voters did not approve the healthcare insurance exchange provision of the Affordable Care Act.
- Puerto Rico's voters approved statehood, although it was a purely nonbinding referendum according to Wells Fargo, as the proposal was also voted on in 1967, 1991, 1993, and 1998.
- At the local level, voters in Portland, Oregon approved a small tax to preserve arts and cultural programs in schools along with a tax hike for school bonds. City voters also approved limitations on police and firefighters retirement funds.

Impact of Superstorm Sandy on Municipal Markets

Superstorm Sandy, which hit the northeast on October 29, was one of the most damaging storms to hit the Continental U.S. in many years. The property destruction caused by high winds and flood waters, power outages, gas shortages and rationing, and transportation shutdowns caused by Sandy were massive, with many of these issues still not completely resolved weeks after landfall. The State of New York and New York City particularly and New Jersey, especially along its shore, saw the brunt of the damage. The States of Connecticut, Massachusetts, Rhode Island, Delaware, Pennsylvania, Maryland and Virginia were also affected. Standard and Poor's (S&P) reports that early estimates of insurance losses could reach $20-25 billion and total economic damages could be as high as $50 billion. Moody's Analytics reports similar cost estimates. The higher end cost estimates ($50 billion) would make Sandy the third costliest storm in U.S. history after hurricanes Katrina in 2005 and Andrew in 1992. Despite these losses, S&P reports that because of advance planning by Federal, State and local officials, which reduced the impact of the storm, Sandy "will likely have no impact on our ratings on investment-grade infrastructure, transportation, communication and local government issuers, and only a limited impact on re-insurers." They also believe the national economy will see minor but still significant effects from the storm with most local economic impact recovered through rebuilding efforts. We expect this trend to continue as federal and state funds are sure to flow into storm damaged areas over the new few months as issuers rebuild infrastructure. Market impact has been minor and as an example, a New York

Metropolitan Transit Authority deal priced a week following Sandy saw little impact on pricing and actually saw spread tightening of +13bps from a comparable issue three months ago.

European Union Issues Ongoing as Predicted

Issues in the euro zone remain in the headlines. The latest compromise had Germany agreeing to the Northern Euro economies providing funding to Greece rather than risk a Greek default leading to that nation's exit from the common currency. German Finance Minister Wolfgang Schaeuble stated that Greece had made "far-reaching decisions that go in the right direction." Bloomberg reports Schaeuble also said the Greece aid program could be re-engineered to reduce a financing gap by nearly 32.6 billion euros with little impact on investors. The International Monetary Fund (IMF) objected to the Euro ministers' decision to postpone a requirement for a Greek debt reduction to a "sustainable" level of 120 percent of GDP by two years to 2022. (The IMF has been responsible for about a third of the 148.6 billion euros in loans provided to Greece since 2010.) The IMF did say it will continue to loan Greece funds after Euro-area ministers agreed to allow Greece higher GDP to debt levels for the longer period however and ruled out any write-off of IMF debt. The market's reaction to the announcement was mixed, with Bloomberg reporting that Euro and Greek bond prices initially fell, yet rebounded after Germany's decision to increase loan subsidies as requested despite popular protests in Germany.

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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