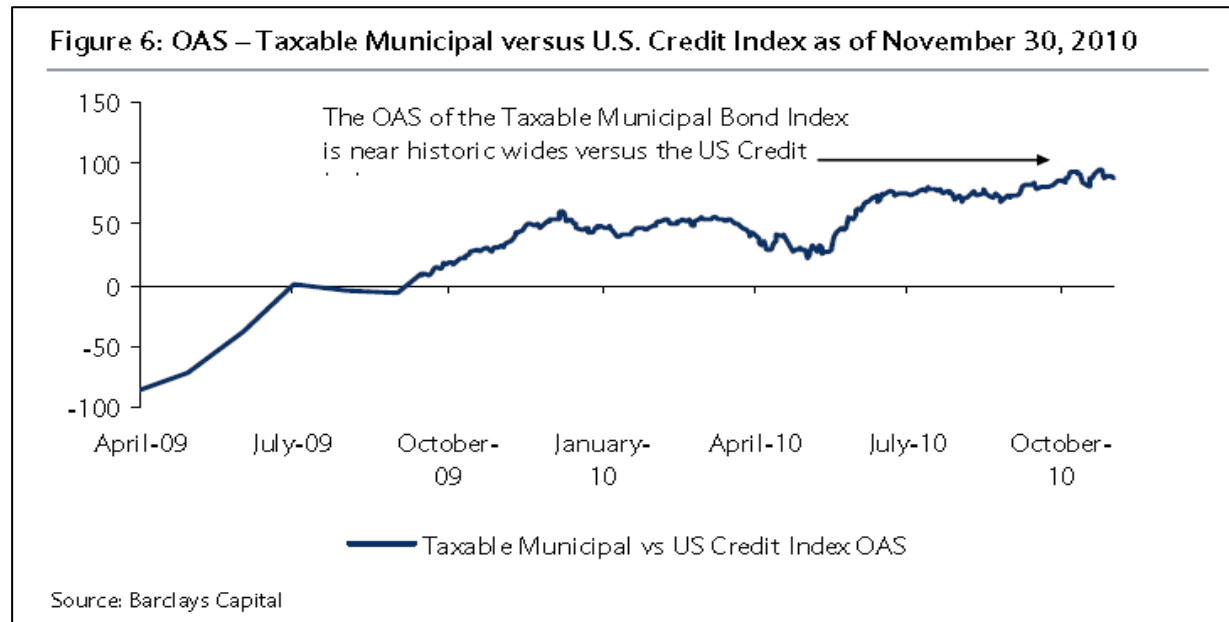


OPPORTUNITY IN TAXABLE MUNICIPAL BONDS

Attractive Time to Invest in Taxable Municipal Bonds

On Wednesday, December 15, the Senate passed legislation that will extend the Bush tax cuts for a period of two years. It is important to note that the new bill did not include any language to extend the Build America Bond Program beyond the end of this year.

APA feels that a unique opportunity now exists for investors looking for additional yield and higher credit quality than Corporate bonds in the fixed income market. The spread between Taxable Municipals and Corporate bonds is near record historical levels as the following graph shows:



The recent surge in supply has created an attractive entry point for the asset class. The spread of the Taxable Municipal Index widened 8 bps, to 247 bps, during November. The Corporate Index widened 6 bps, to 159 bps. The difference between the spread of the Taxable Municipal Index and the Corporate Index is now 88 bps, near its record wide levels of 95 bps set on November 22. The mean spread between the two indexes since the inception of the BAB program has been 53 bps. We expect the spread between the Taxable Municipal Index and the Corporate Index to tighten considerably during the first half of 2011.

We expect some portion of the spread widening of taxable municipal bonds will be reversed with the resolution of the BAB extension question, regardless of outcome and a moderation of the glut of recent supply. Longer-term spreads will likely tighten steadily as supply dwindles and bonds continue to be sought after by pension funds and life insurers. Therefore, we recommend overweighting taxable municipal bonds. To ensure liquidity, we recommend buying higher-quality issues. Investors with buy-and-hold mandates can find record wider spreads in A-rated taxable municipal paper.

An Opportunity to Improve Credit Quality in a Fixed-Income Portfolio

As the following table shows, spreads in the highest quality (Aaa) sector of the markets are surprisingly large, with the spread of Aaa-rated taxable municipals 106 bps wider than Aaa-rated corporate issues. Similarly, the spread of AA-rated municipals is 93 bps wider than AA-rated corporate issues and is even 48 bps wider than A-rated corporate paper. The spread of A-rated taxable municipals is wider than A-rated corporate bonds and 104 bps wider than BAA-rated corporate issues.

APA expects these opportunities to disappear as markets normalize and spread relationships return to their historical risk/reward profile.

Figure 7: OAS by Rating (bp), November 30, 2010

	U.S. Taxable Munis	U.S. Credit	Difference
Aaa	145	39	106
Aa	214	120	93
A	308	166	142
Baa	293	204	88
Total	247	159	88

Source: Barclays Capital

Disclosure:

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