ASSET PRESERVATION ADVISORS

MARKET COMMENTARY MARCH 2014

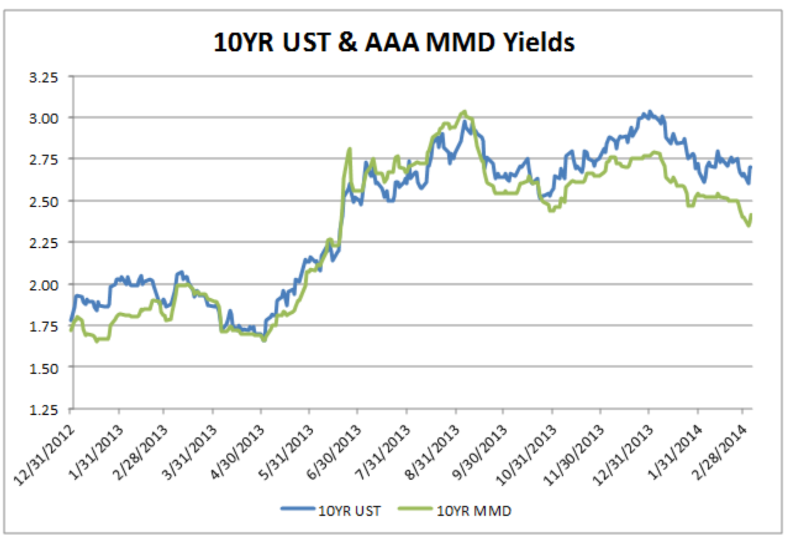
Trading Markets

Munis Continue to Rally in 2014

The municipal rally that started in January 2014, continued in February and munis again outperformed treasuries. The 10-year US Treasury began the month yielding 2.65% and ended the month flat at 2.65%; while the 10-year AAA Municipal bond rate started the month yielding 2.54% and ended slightly down at 2.40%. The biggest factor driving the municipal market performance is the lack of new issue deal supply in the first two months of 2014. New issue supply was $14.4 billion in February; making it the second lightest supply month in the past decade. Supply was down approximately 40% from February 2013 and down 30% from January's $18.8 billion. Overall, year-to-date issuance is down 35% from the same time last year. The supply factor continues to mean many muni buyers are paying up for municipals in the secondary market and subsequently munis continue to outperform treasuries.

Additionally, states with high tax rates have performed very well as the 3.8% Affordable Care Act tax takes effect. Specifically, in California, municipals have seen a significant rise in demand while supply has dwindled. This made California one of the best performing states in February. APA believes that the lack of supply will continue through 2014 and that high tax rate states, like California, will likely perform very well.

Welcome to our new newsletter format. We appreciate any feedback and hope you enjoy the new layout!



Source: MMD, US Treasury

In This Issue

Highest Tax Brackets by State

April 15th is quickly approaching and our thoughts have turned to paying taxes. The first year implementation of the additional 3.8% Affordable Care Tax levied on the highest earners in states has made tax-exempt municipal bonds even more attractive. The adjacent chart depicts highest tax rates by states and the taxable equivalent yield (TEY) of a 3, 4 or 5% municipal bond. The calculation of the highest tax rate is the sum of the federal tax rate, the state tax rate and the 3.8% additional ACA tax.

The State with the highest taxes? California where a high earner pays 50.83% on income. In CA, a 5% municipal bond has a very attractive TEY of 10.17% for the highest earners.

Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming tie for the lowest tax rate at 43.4% on high earners. In those states, residents who hold a 5% bond issued by an in-state municipality have a TEY 8.83%.

State	Highest Earner Tax Rate	3.00% TEY	4.00% TEY	5.00% TEY	State	Highest Earner Tax Rate	3.00% TEY	4.00% TEY	5.00% TEY
AL	46.42	5.60%	7.47%	9.33%	MT	47.57	5.72%	7.63%	9.54%
AK	43.4	5.30%	7.07%	8.83%	NE	47.53	5.72%	7.62%	9.53%
AZ	46.14	5.57%	7.43%	9.28%	NV	43.4	5.30%	7.07%	8.83%
AR	47.63	5.73%	7.64%	9.55%	NH	46.42	5.60%	7.47%	9.33%
CA	50.83	6.10%	8.14%	10.17%	NJ	48.82	5.86%	7.82%	9.77%
CO	46.2	5.58%	7.43%	9.29%	NM	46.36	5.59%	7.46%	9.32%
CT	47.45	5.71%	7.61%	9.51%	NY	48.73	5.85%	7.80%	9.75%
DE	47.48	5.71%	7.62%	9.52%	NC	48.08	5.78%	7.70%	9.63%
FL	43.4	5.30%	7.07%	8.83%	ND	45.81	5.54%	7.38%	9.23%
GA	47.02	5.66%	7.55%	9.44%	OH	46.98	5.66%	7.54%	9.43%
HI	50.04	6.00%	8.01%	10.01%	OK	46.57	5.61%	7.49%	9.36%
ID	47.87	5.75%	7.67%	9.59%	OR	49.38	5.93%	7.90%	9.88%
IL	46.42	5.60%	7.47%	9.33%	PA	45.25	5.48%	7.31%	9.13%
IN	45.45	5.50%	7.33%	9.17%	RI	47.02	5.66%	7.55%	9.44%
IA	48.82	5.86%	7.82%	9.77%	SC	47.63	5.73%	7.64%	9.55%
KS	46.36	5.59%	7.46%	9.32%	SD	43.4	5.30%	7.07%	8.83%
KY	47.02	5.66%	7.55%	9.44%	TN	47.02	5.66%	7.55%	9.44%
LA	47.02	5.66%	7.55%	9.44%	TX	43.4	5.30%	7.07%	8.83%
ME	48.23	5.79%	7.73%	9.66%	UT	46.42	5.60%	7.47%	9.33%
MD	46.87	5.65%	7.53%	9.41%	VT	48.81	5.86%	7.81%	9.77%
MA	46.57	5.61%	7.49%	9.36%	VA	46.87	5.65%	7.53%	9.41%
MI	45.97	5.55%	7.40%	9.25%	WA	43.4	5.30%	7.07%	8.83%
MN	48.14	5.78%	7.71%	9.64%	WV	47.38	5.70%	7.60%	9.50%
MS	46.42	5.60%	7.47%	9.33%	WI	48.08	5.78%	7.70%	9.63%
MO	47.02	5.66%	7.55%	9.44%	WY	43.4	5.30%	7.07%	8.83%

Source: Bloomberg

Credit Markets

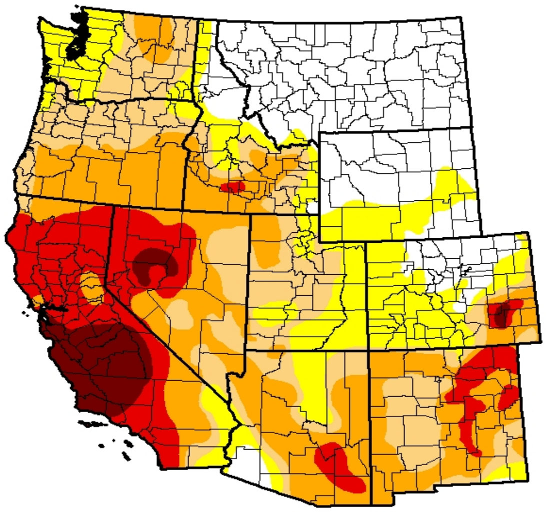
Puerto Rico Brings GO Deal

After much speculation, the Puerto Rican legislature approved a $2 - 3.5 billion General Obligation (G.O.) debt offering expected to come to market in mid-March. This is the first G.O. debt Puerto Rico is issuing since 2012. Originally, the offering had been proposed as a COFINA deal backed by a third-lien on the sales tax. The COFINA bonds continue to be the highest rated debt issued by the Commonwealth, due to the strong legal pledge of segregated sales tax revenues that are not subject to a constitutional claw-back, according to the Attorney General of Puerto Rico. However, this has yet to be challenged and thus remains unconfirmed by the Supreme Court. In the event of a restructuring of the Commonwealth's debt, it is possible the COFINA revenue stream could be challenged. Depending on the outcome, it would either bolster the General Obligation or the COFINA bondholders of Puerto Rican munis.

The market will be watching this deal closely as successful completion of the offering would provide Puerto Rico with much needed liquidity relief in the near term. If the Commonwealth is unable to complete the deal at the proposed size, they would need to attempt to access the capital markets again in 2014 in order to balance the budget. We expect Puerto Rico will maintain its junk rating and negative outlooks at all three rating agencies until they are able to achieve a structurally balanced budget and return to normal market access.

U.S. Drought Monitor

West



February 25, 2014

(Released Thursday, Feb. 27, 2014)

Valid 7 a.m. EST

Drought Conditions (Percent Area)

	None	D0-D4	D1-D4	D2-D4	D3-D4	D4
Current	22.41	77.59	59.61	40.34	15.67	4.12
Last Week 2/18/2014	21.76	78.24	59.88	40.17	14.89	2.58
3 Months Ago 11/26/2013	29.00	71.00	49.99	30.86	7.56	0.63
Start of Calendar Year 12/31/2013	22.20	77.80	51.44	31.11	7.75	0.63
Start of Water Year 10/1/2013	25.25	74.75	58.96	34.18	5.57	0.63
One Year Ago 2/26/2013	21.53	78.47	64.32	42.23	15.92	3.47

Intensity:

D0 Abnormally Dry
D1 Moderate Drought
D2 Severe Drought
D3 Extreme Drought
D4 Exceptional Drought

The Drought Monitor focuses on broad-scale conditions. Local conditions may vary. See accompanying text summary for forecast statements.

Author:
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U.S. Department of Agriculture

http://droughtmonitor.unl.edu/

Western States Seek Drought Relief

As the drought in the Western United States rages on, Moody's published a note stating that of the seven states that withdraw water from the Colorado River basin Arizona would face the greatest hardship if allocation from river was reduced. The report speculates that "should drought conditions persist into 2016 or become more severe, reduced water allocation from the Colorado River to Arizona and Nevada are probable."

Meanwhile, California's historic drought reached a new milestone when the U.S. Drought Monitor announced that the drought now covers 9% of the state. To provide some relief, Gov. Jerry Brown signed a bill which accelerates funding of local and regional projects to aid in increasing water supplies across the state.

If the drought were to continue long term, this could mean additional strain on local water/sewer system ratios which may lead to credit re-evaluations and possible downgrades in the sector.

Detroit's Cramdown Plan

Motor City filed its proposed debt Plan of Adjustment with the federal bankruptcy court on February 21st, granting creditors 30 days to file objections. The Plan offers general obligation (GO) bondholders a meager 20 cents on the dollar. The Emergency Manager, Kevyn Orr, maintains that general obligation bondholders are unsecured creditors, therefore subject to steep haircuts. However, under the current proposal, general pensioners will receive about 66% of their monthly pensions while police and fire departments will receive close to 90% in their promised payouts.

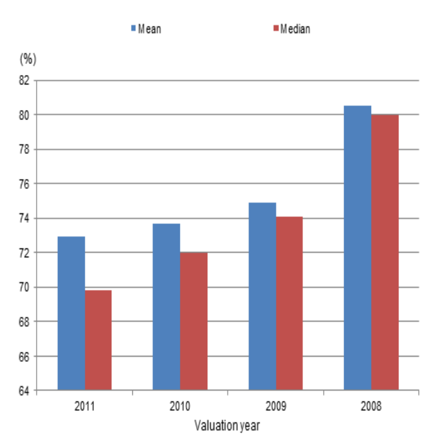
The proposed plan has many analysts speculating upon the meaning of the "full faith and credit" pledge of a general obligation offering. If the city cannot or will not raise taxes to fulfill this promise, is the GO pledge as sacrosanct as it once was? As the Detroit bankruptcy moves closer to settlement (a trial is set for June 16th, 2014) analysts are questioning if future municipalities faced with a Chapter 9 filing would pursue the same approach. We expect this story to continue dominating muni credit headlines as a final ruling that holds pensioners in higher legal standing than bondholders could set a game changing precedent in the municipal credit space.

Pensions Pressures

Warren Buffet's March 3rd "pension tapeworm" comments sparked another round of troubled pension plan stories from various media outlets. While some pension funds are underfunded and in great need of reform, we would caution investors that pension funds are like snowflakes; no two are exactly alike. There are also many pension funds in the US that are well funded and should not be a source of angst for municipal bonds investors.

For example, while the state of Illinois has a notoriously underfunded pension system with a 43.4% funding ratio, the state is also home to the Illinois Municipal Retirement Fund (IMRF) which is 90% funded. The difference lies in management and the ability of the IMRF to enforce participating municipalities to fully fund their annual contributions. The chart to the right shows the mean and median funding ratios of state systems throughout the recession. While funding levels have declined, more than half are still greater than 70% funded, which is considered adequate by industry standards.

Aggregate Mean And Median Funded Ratios



© Standard & Poor's 2013.

Final Thoughts

The total amount of outstanding municipal securities in the market fell almost 1.2% to $3.67 trillion last year from 2012, according to the Federal Reserve's latest Flow of Funds report released Thursday. Following this trend, over the last two months the municipal bond market has experienced a strong tailwind from reduced new issue supply and has continued to outperformed most other fixed income markets. According to the Bond Buyer, total year-to-date (YTD) supply is down 35% versus the YTD February 2013 data. Refunding volume is also down 65% year-over-year. This has not only has been due to a precipitous drop in advanced refundings, but many municipal leaders are unable to issue more debt given the slowly recovering economy and the ongoing battle with taxpayers to raise taxes. Over the last six weeks, municipal bond funds have had almost an additional $1 billion in new money inflows needing to be placed in the market. Moreover, issuers like Detroit and Puerto Rico have become isolated from general investment grade muni buyers, further reducing the existing supply of quality bonds. We believe tax exempt bond markets will continue to perform as long as the current supply/demand imbalance persists.

Recently, the House Ways and Means Committee Chairman, David Camp, has proposed a broad-based tax reform bill. Part of the proposal is a 10% surtax on modified adjusted gross income above $450,000. In essence, as written the surtax would be a backdoor tax on municipal tax exempt interest. While most of the proposed legislation would be a revenue positive, another part of bill, the elimination of the AMT tax, would reduce revenue to the government by $1.4 trillion. In our opinion, we cannot see Congress giving up the AMT tax of $1.4 trillion, therefore the chances of sweeping broad-tax reform in the near-term should be limited. Thus, we do not expect any major change until after the 2016 election and we expect that politics will play a significant role in when or if any changes in tax policy take place.

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