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2010 — In Retrospect

A subdued sense of optimism gradually built momentum through the first few months of 2010 as a handful of economic signals hinted at a stabilizing and potentially recovering U.S. financial system. Fourth Quarter 2009 economic data, published in late January of 2010, exceeded most forecasters' expectations, and by the beginning of February housing statistics began showing the first signs of modest improvement since the start of the Great Recession. Following an 18-month streak of worsening data dating back to April 2008, the unemployment rate moved below 10% that same February week. Consumer and busi-

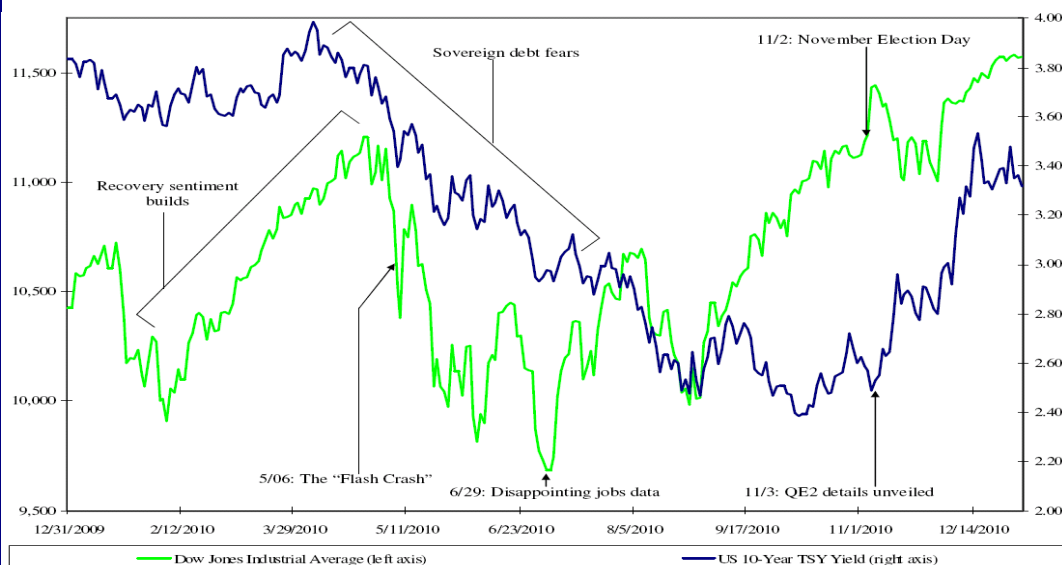


Figure 1. The Dow Jones Ind. Avg. and 10-Year TSY Yields in 2010

Source: Bloomberg

ness confidence were growing, and better manufacturing activity and stronger corporate earnings supported the opinion that a sustainable recovery seemed to be underway. Meanwhile, the Federal Reserve was in the final stages of winding down its basket of Quantitative Easing tools. These constructive signals helped ignite a seven-week, 1,300 point rally in the Dow Jones Industrial Index, a rally that would hit its apex on April 26th. However, the path to recovery proved to be bumpier than optimists had hoped, as the European debt crisis loomed on the horizon.

Investors' focus decidedly shifted from an improving domestic macroeconomic landscape to global fears over sovereign debt on May 4, 2010. Years of heavy borrowing, massive entitlements, and a populace unwilling to accept reform brought Greece to the brink of financial collapse. Confidence in Greece's ability to meet its debt obligations entered a freefall considering its \$400 billion in obligations exceeded its entire economy. And anxiety escalated over other European countries thought to share Greece's fiscal problems – namely Spain, Portugal, Ireland and Italy. The potential for a true sovereign debt crisis seemed increasingly valid, with some questioning the continued existence of the Eurozone

Highlights:

- 2010 CHARACTERIZED BY THE SLUGGISH, ONGOING RECOVERY AND AGGRESSIVE FED ACTION
- STATE BUDGET STRUGGLES AND BUILD AMERICA BOND PROGRAM HELPED CREATE A VOLATILE MUNI MARKET IN 2010
- CAREFUL SECURITY SELECTION AND CREDIT SURVEILLANCE TO REMAIN AT FOREFRONT OF CAPRIN'S ACTIVITIES IN 2011

“2010 likely will be remembered for its market volatility, the aggressive measures implemented by policymakers, international uncertainty reinforcing the interconnectedness of global markets, and an agonizingly slow recovery from the Great Recession.”

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and its currency. Global investor confidence was further rattled on May 6th by the 900 point late-day drop in the DOW that included a 600-point plummet within a five-minute span. The “Flash Crash,” as this event came to be called, remains largely unexplained.

In response to a possible global debt crisis and the economic ramifications, U.S. equity markets by early June tumbled to an eight-month low, erasing all of 2010’s year-to-date gains and more. Against the backdrop of lost momentum and confidence, the string of improved U.S. economic data ended with mixed to negative labor and housing market statistics, both still considered key drivers to any sustainable recovery. Over the next several months, global investors sought the relative safety of U.S. Treasury debt in a classic “flight to quality,” and bond yields in all sectors went lower.

This weakened domestic economic outlook also suggested that a more normalized Federal Reserve interest policy would likely be many months away, possibly as far as late 2011. In fact, and in an effort to encourage activities such as business lending and home refinancing, the Fed implemented a second round of quantitative easing, aptly named “QE 2.” By early October, U.S. Treasuries had rallied to their highest prices (and lowest yields) since the most stressful days of the Great Recession.

However, as all investors can appreciate, trend reversal occurs when the ground rules of the decision making process are altered from their previous state. Two market-changing events occurred in early November and would change how investors set expectations for future investment returns. First, the Fed announced the details regarding QE2, allowing fixed income traders to incorporate the timing, duration, and extent of Treasury purchases into their strategies. In the end, the program’s reasonable scope suggested that profit opportunities might not be as great as had been bid in the market. Second, and more importantly, the national elections reflected a broad based message from the American public regarding their expectations for governing policies and mandates. Elected leaders wasted no time in conveying the scope of legislative activities for the new Congress, and that continues even as we finalize this review.

Renewed confidence and optimism grabbed the markets over the final two months of 2010, sending interest rates, equities and commodities prices higher. By December 21st, the S&P 500 Index had returned to a level not seen since before the September 2008 collapse of Lehman Brothers. Fixed income yields in all sectors rebounded from their lows, signaling the expectation of a more favorable economic environment in the coming months. With that said, investment markets always price assets based on forward looking expectations, and the challenge rests with assessing whether those expectations will be realized or whether, as noted above, the rules are about to change in response to new conditions.

2010 likely will be remembered for its market volatility, the aggressive measures implemented by policymakers, international uncertainty reinforcing the interconnectedness of global markets, and an agonizingly slow recovery from the Great Recession. Still unclear, though, are the long-term effects of a Fed balance sheet in excess of \$2 trillion and the unwinding process that will be employed to remove this unprecedented stimulus.

As we start the New Year, rhetoric and optimism remain the driving forces of current market activity. A solid foundation for recovery has not become widely apparent, so we continue to expect a slow global recovery peppered with mixed economic data and ongoing volatility. Though the likelihood of a double-dip recession seems increasingly low, our domestic economy requires stronger housing and employment markets along with confidence that excess personal and government indebtedness can be successfully managed.

2010 — Our Municipal Bond Perspective

The dynamic Municipal bond market was dominated in 2010 by pervasive headlines prognosticating widespread state and local financial struggles and the Build America Bond program that enabled municipalities to issue debt with a federal subsidy to reduce interest expenses.

A More Challenging Credit Landscape

Municipal investor concerns were thrust to the forefront in mid-December following a *60 Minutes* exposé in which a high profile analyst with limited municipal market experience called for “hundreds of billions of dollars” of defaults in 2011. While the report highlighted many of the fiscal challenges that we have been discussing throughout 2010, it seemed to focus primarily on eye-popping, headline-grabbing numbers rather than well-founded conclusions.

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The *60 Minutes* exposé also gave short shrift to officials' efforts to address the budget issues they face. States and localities have been aggressively cutting spending since the onset of the financial crisis, and their efforts continue. These same municipalities have seen tax collections rise in recent months and continue to forecast improvements for total 2011 tax revenue. Lower spending and improving revenues are healthy and encouraging trends as governments continue to recover from the recession, and the primary reasons we do not subscribe to the exposé's exaggerated conclusions.

Another important distinction the *60 Minutes* piece failed to make is not all municipal bonds are created equal, and this exacerbated the report's misleading perspective. The U.S. municipal market is among the largest and most diverse financial markets in the world, comprised of roughly \$2.7 *trillion* in outstanding debt. In all of 2010, there were approximately 70 defaults totaling \$2.5 billion, and while \$2.5 billion seems large, it's less than one tenth of one percent (0.1%) of total outstanding municipal debt and only about one-third (1/3) the value of defaults seen in 2009. Notably, the vast majority of these defaults were debt issued by special entities for small, "one-off" projects, such as individual housing projects, healthcare facilities, and golf courses planned and funded at the peak of market expectations.

The Rise and Fall of the Build America Bond Program

The American Recovery and Reinvestment Act introduced a new funding vehicle to the municipal market in April 2009 – the Build America Bond

(BAB). BAB's allowed municipal borrowers to issue debt in the taxable market with the federal government covering 35% of qualified issuers' total interest cost. BAB's became an attractive option for hundreds of issuers totaling roughly 30% of all 2010 municipal issuance, mostly in long maturity debt that maximized issuers' savings. This "BAB substitution" reduced the amount of available, traditional, tax-exempt bonds, and sent tax-exempt yields lower and prices higher.

However, the November elections created uncertainty about the program's future. Would a

Republican-controlled Congress, one that was elected largely due to voter resistance over Washington's spending habits and quick bailouts, extend the Obama Administration BAB program set to expire December 31, 2010? The answer did not come quickly, leaving mixed messages and speculation to generate additional market volatility. Uncertainty about the BAB program's future sent tax-exempt yields higher, especially for longer maturities as investors considered the additional billions of issuance potentially returning to the tax-exempt market in 2011 and beyond. Rumblings of a BAB resurrection were heard as 2010 closed, but as of this writing, revival seems unlikely.

2011 — Finding the New Normal

The spending and revenue patterns (and habits) of municipalities were built over a period of years, and it is unrealistic to believe excesses, where they exist, will be rehabilitated over one or two budget cycles. We remain encouraged by improving revenues and heightened spending awareness. Municipalities now have confidence of a halted downward trend, allowing officials to assess the ground rules for "the new normal." The aspects of a new normal we believe municipalities must embrace include tax revenues and revenue trends at lower levels than expected in the economic and real estate

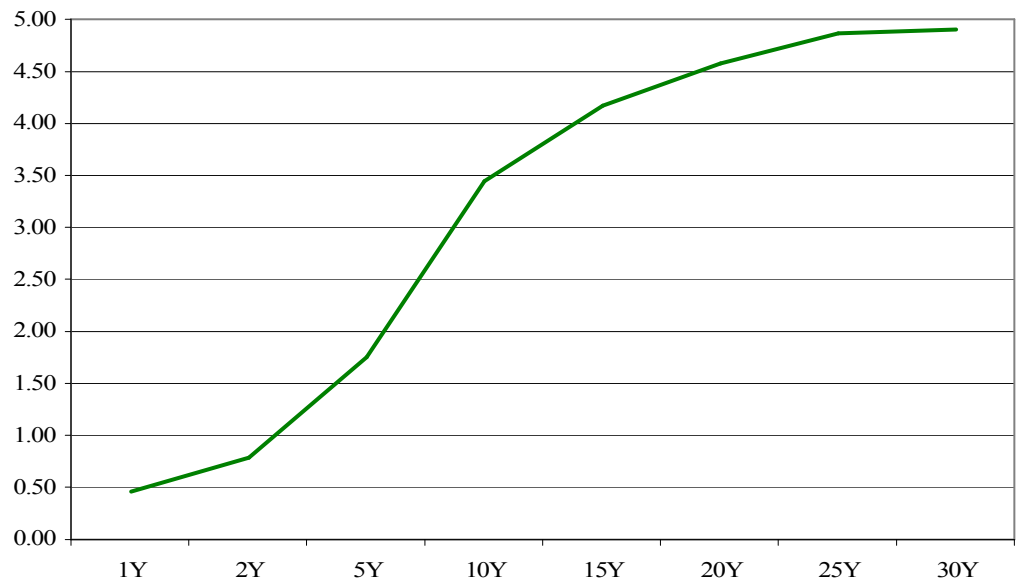


Figure 2. U.S. Muni G.O. AAA Yields as of 12/31/10

Source: Bloomberg

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boom, the inability to provide endless benefits and services to every constituency, and the political will to make decisions for fiscal management in times of prosperity and scarcity. Certainly, the political mood in Washington suggests Capitol Hill may be less bailout-friendly, demanding that state and local governments make these tough management decisions.

As stated above, there is diversity and opportunity in the municipal bond market, and we continue to invest client assets in issuers that our assessment suggests are better positioned to meet the challenges of managing through both prosperity and scarcity. The importance of security selection in the construction of municipal bond portfolios will remain at the forefront of our activities as we strive to deliver client portfolios with attractive *risk-adjusted* yields and return opportunities.

We expect the U.S. economic recovery to slowly but steadily continue, battling the ongoing headwinds of housing and unemployment in 2011. Interest rates for all of fixed income, including municipals, are most likely to trend higher as long as expectations are confirmed by actual conditions. As discussed in past newsletters, Caprin has been repositioning portfolios to reduce potential volatility and sensitivity to rising rates, a decision that benefitted returns as municipal yields spiked in November and December.

The sporadic recovery process and the alignment of expectations versus reality will perpetuate volatility in all financial markets. Volatility, though, also creates opportunity. Selectively entering the market to sell bonds at appreciated levels and deploying proceeds to undervalued issuers or maturities allows Caprin to manage portfolios toward our fundamental objectives of lower volatility and attractive risk-adjusted returns. We are also mindful of the prospect of higher interest rates, managing those risks within our portfolio mandate and offering strategies with lower risk profiles.

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