Fixed Income Market Commentary

April 2011

That Time of Year

"I am proud to be paying taxes in the United States. The only thing is I could be just as proud for half the money." Arthur Godfrey.

Key Points:

- Is there a threat to the tax-exempt status of municipal bonds?
- Emerging Market debt shrugs off recent global events.
- There is still a lot of value in the muni market.

It's tax time and there is something I notice every year when I prepare my return. It is line 8b on the IRS 1040 Form and it instructs you to list how much tax-exempt interest income you've received. They aren't really going to do anything with that information, are they? I know some who believe that sooner or later the IRS (meaning the government) will somehow try to get their hands on that pile of money. Not to take it, of course, just to tax it. Now if that ever occurs then that would totally ruin my day….and probably yours too. Well, the fact of the matter is this conversation is not new. There have been several occasions throughout my career when the subject came up and it has come up again very recently. In December the President's "National Commission on Fiscal Responsibility and Reform" released its report entitled "The Moment of Truth." Contained within the report there is an illustrative proposal that references treating municipal bond interest as taxable, but only on newly issued municipal bonds (State and Municipal Bonds, page 31). I read that this and other proposals on the matter were key topics of discussion this past week at the National Municipal Bond Summit.

There would certainly be a great political fight if the tax-exempt status of the muni market was seriously challenged and I don't think that is about to happen in the immediate future. It's worth knowing that it would not just be wealthy individuals fighting for tax relief either. The borrowing costs for every city, state, town and countless other issuers would rise by a fair amount if they had to compete on a taxable basis and those issuers are sure to join the fight to keep the status quo. "The tax exemption has been the foundation of state and local finance since the inception of the first Internal Revenue Code," observes one market participant. However, I find it not too surprising that the Government tracks the figure.

I don't want to get too far ahead of myself here discussing what Congress may or may not do down the road, but I will say at the very least that I'm glad there is a group having formal discussions on ways to preserve the tax exemption. Also, thank goodness for the idea of grandfathering in existing issues of muni debt. We'll comment in greater detail about Congress tinkering with tax law changes when I see a collective movement with enough of a head of steam to become an issue. Until then, think about that number you put down on line 8b. It's all yours. Let's keep it that way.

March overall was a weak month for the bond markets with many of the major sectors we follow in our data box below struggling to stay in positive territory. The asset class that performed best was Emerging

Markets, up 1.37%. This was somewhat surprising given all of the events going on around the globe. Continued political uncertainty stemming from protests (civil war?) calling for leadership change in parts of the Middle East and North Africa typically would have raised the risk level and resulted in greater demand for high quality fixed income assets, but clearly that was not the case. Granted, the EM asset class is much bigger than parts of the Middle East and North Africa, but bond investors are known to spook easily at times.

In the Treasury market it came down to the final days of the month to determine if this asset class would finish in positive territory or not. It didn't and the index closed down a modest 0.06%. The index now has a string of six consecutive losing months in a row, but even that is not a total rout. The cumulative effect of that streak is just -2.79%. The better performer within the Treasury market has been inflation-linked bonds. The TIPS market soundly outperformed the nominal Treasury market, returning 1.01% in March. Year-to-date TIPS are up 2.08% while nominal Treasuries are down 0.16%. TIPS were part of the Fed's asset purchase program in the final week when they bought more than $1.5B in the open market. Our thought here remains unchanged. If you want an allocation to the highest quality you can get then invest in Treasuries and if you are going in that direction, then why not invest in Treasury debt that has a built in inflation hedge?

In the taxable / corporate bond market the story was the large new issue volume. Corporations from just about every sector and credit quality seemed to have a need to borrow. Volume exceeded $50B for the month as issuers were eager to borrow before rates begin to rise. The CFOs may not have a crystal ball telling them where rates are going, but it is clear they have at least a hunch and they acted on it. Meanwhile, over in the municipal bond market volume struggled to get to $47B for the quarter. One factor influencing the volume here was the rush to get bond deals done as 2010 drew to a close. The popular Build America Bond program was phasing out and issuers flooded the market to get deals done ahead of time. Essentially, 4Q 2010 sales came at the expense of 1Q 2011.

An item that sticks out when reviewing the muni market returns is that the overall muni index was negative in March, down 0.33% while the muni 5-year index component was positive, up 0.31%. They are both of similar credit quality, but the big difference is that the main index has an average maturity of greater that thirteen years while, surprise, the muni five year index has an average maturity of just 4.9 years. Investors showed a clear preference for the shorter part of the curve.

For various reasons, demand seems to have dropped in the muni market. Some of it may still be the fear factor about the safety of the asset class. I believe that the continued absence of bad news will bring individual buyers back before long. Others, meaning institutions, may be on the sidelines in expectation that a pick up in the new issue calendar will put more pressure on long-end prices. They are waiting it out to see what happens. Whatever the case, munis continue to trade at an attractive level relative to their historic relationship with Treasuries. It remains easy to find high quality munis trading at levels equal to Treasuries. Treasuries typically trade with higher yields to compensate investors because the income they produce is taxable.

On an administrative note, we have just completed our first couple of weeks in our new location and as part of Adviser Investments / Kobren Insight Management. As expected, all has gone well. During the process I learned that the time, effort and energy that go into moving an entire office full of people and property are enormous. One needs to have a lot of patience, too. I have to say that the move went incredibly well and I honestly can't come up with one single item that fell through the cracks. That is a tip-of-the-hat to those who made it all happen. I say "Thank you" to the many of you who have called in and asked how the transition went.

Barclays Fixed Income Index Returns Through 3/31/11	Duration	Mar	YTD '11	Return '10	Return '09	Return '08
US T-Bill Index	0.32	0.02%	0.05%	0.22%	0.37%	2.44%
US Treasury Index	5.29	-0.06	-0.16	5.87	-3.57	13.74
US TIPS Index	5.27	1.01	2.08	6.31	11.41	-2.35
US Aggregate Bond Index	5.12	0.06	0.42	6.54	5.93	5.24
US Govt / Credit Index	5.47	-0.03	0.28	6.59	4.52	5.70
US Credit Index {A2}	6.38	-0.04	0.89	8.47	16.04	-3.08
US High Yield Index {B1}	4.28	0.32	3.88	15.12	58.21	-26.16
Caa component	3.53	0.40	4.90	16.43	90.65	-44.24
Emerging Market ($$) {BA1}	6.39	1.37	1.57	12.84	34.23	-14.75
Municipal Index	8.46	-0.33	0.51	2.38	12.91	-2.47
Municipal Index - 5 Year	3.94	0.31	0.61	3.40	7.40	5.78

Source: Barclays Capital

Christopher Keith
Senior Vice President
Fixed Income Manager