Market Commentary

Period Summary

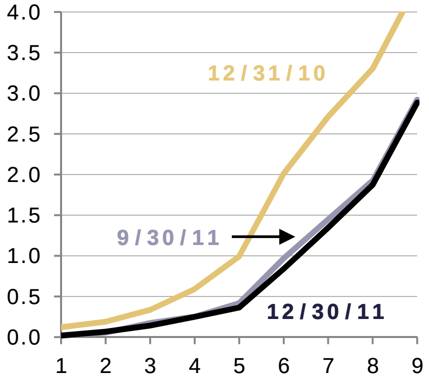
The municipal market entered 2011 with significant headwinds as many skeptics anticipated, and in some cases publicly predicted, widespread defaults throughout the sector. The municipal bond market responded to these exaggerated concerns by turning in a stellar year. Limited supply, increased demand, and an absence of widespread defaults helped drive the market.

Volatility increased during the fourth quarter due to mixed economic news and changing information from Europe. Strong supply, positive market sentiment, and hopes for a quick resolution to the European debt crisis put pressure on municipals in October, but as these factors unwound, municipal prices ticked steadily upward. Ultimately, the combination of Treasury strength, a shrinking new issue calendar, and inflows into mutual funds drove yields lower and brought about a strong quarter for municipals.

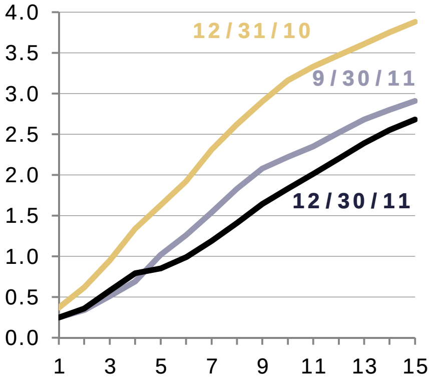
Early in 2011, it appeared that the U.S. economy was gradually moving in the right direction and consumer sentiment appeared on the upswing, as reflected in the 5.9% return in the S&P 500. However, a confluence of events - disasters in Japan, unrest in the Middle East, the worsening European debt crisis and a visible downturn in U.S. economic performance – created an environment in which high quality fixed income instruments again became safe haven investments. For example, U.S. Treasury rates in February had been as high as 2.4% and 3.7% for five and ten-year maturities. By the beginning of the second quarter, Treasury yields began to decline and ultimately ended the year at 0.8% and 1.9%, respectively. The strength of the Treasury market, which remained close to these historically low levels over the past nine months, has confounded many. A number of external factors, including the European debt crisis and concerns about global economic weakness in general, have kept rates substantially lower than had been anticipated at the start of 2011. In addition, the Fed's plan to keep the overnight funds rate close to zero through the middle of 2013 and "Operation Twist", which allows the Fed to invest in long-term bonds (such as 10-year and 30-year Treasuries), will continue to support a low-rate environment.

Except for Treasuries, the municipal bond market outperformed every other fixed income-sector in 2011. Much of this outperformance can be attributed to the 10-year low in municipal bond issuance, which fell 32%, to $295 billion from 2010's $433 billion. There were two key drivers of the reduced supply: 1) many issuers accelerated issuance in the second half of 2010 to take advantage of the expiring Build America Bond program,

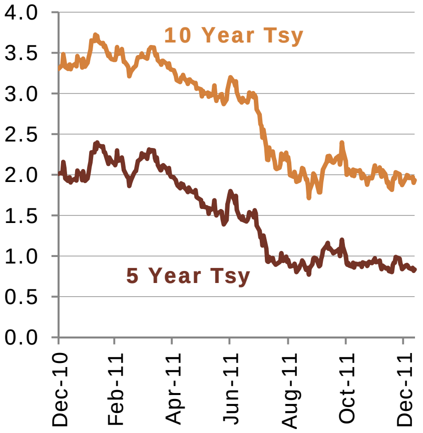
Treasury Yield Curves



Municipal Yield Curves



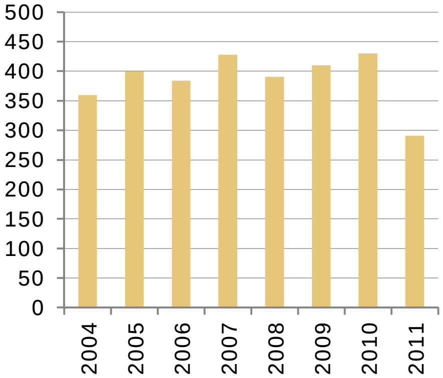
Historical Treasury Yields



Sources: JP Morgan DataQuery, Thomson

which reduced their borrowing needs for 2011 and 2) state and local governments employed strict fiscal austerity measures to balance their budgets and, as a result, reduced the funding of new projects in general. While we anticipate a potential uptick in new issuance in 2012, we do believe that supply will remain at relatively low levels as state and local borrowers continue to face budgetary challenges throughout the year.

Municipal Issuance ($Billions)



Source: Bond Buyer

Demand for investment grade tax exempt municipals held up throughout the year as the predicted widespread defaults never materialized and investors preferred sectors offering capital preservation over riskier sectors typically associated with high returns. The market did sustain a couple of high profile bankruptcy filings; Harrisburg, Pennsylvania and Jefferson County, Alabama (the largest for a municipal government in U.S. history). These failures were essentially a culmination of years of fiscal stress or corruption and were anticipated by most in the marketplace. The majority of other defaults were concentrated in bonds of community development districts, nursing homes and other small and more speculative parts of the market that Samson does not purchase.

In an environment where many state and local governments face persistent long-term fiscal challenges, credit surveillance is an absolute necessity in the municipal market. We closely monitor those geographic areas most impacted by the lingering effects of the recession, such as those that have experienced high foreclosures, a struggling labor market and declining property values. Our vigilance in maintaining a strict credit review process that entails the analysis of cash and debt levels, pension liabilities, revenue growth and security pledge to the bondholders remains the essential component in building credit-worthy portfolios.

We expect the municipal bond market will continue to be influenced by political and economic factors that transcend state and local financial performance in 2012. Sovereign debt volatility in Europe, U.S. and global economic growth prospects, and the U.S. Presidential Election have the potential to significantly impact interest rates and relative sector performance. We will closely monitor these and other factors as they develop. Although we gained confidence in 2011 that state and local governments in aggregate are taking the necessary steps to maintain their fiscal health, we remain cautious on a credit-by-credit basis. The potential for rates to decline further is limited and has led us to position portfolio durations between neutral and modestly defensive when compared against benchmark indices.

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