March 1, 2011

Locust Capital Management
1629 Locust Street
Philadelphia, PA 19103
Office: 215-735-9530
www.locustcap.com

RE: The Municipal Bond Market

Dear Friends:

With all the news circling regarding the Municipal Bond (Muni) Market, we wanted to share our thoughts on Muni's and why we continue to believe in the asset class for our clients.

Our economy is recovering; the S&P remains robust, and is less volatile. Treasury rates, while rising, have also begun to stabilize. These favorable trends have not filtered into the municipal bond market. Late in 2010 negative reports on the Muni market caused significant outflows, particularly in various municipal bond mutual funds. Meredith Whitney, one of Wall Street's well known analysts, warned about a financial meltdown in local and state governments citing budgetary constraints, high debt levels, and under-funded pension liabilities, claiming Muni bond defaults and state bankruptcies. Exacerbating the situation were fears related to the rebounding housing market. Lagging home sales often lead to a strain on states and municipal budgets.

As a result of the above factors and Wall Street's unwillingness to add Muni's to their balance sheets before the end of 2010 (thereby stabilizing the market), Muni outflows reached an estimated $34 billion. This situation caused yields on Muni's to exceed yields on US Treasuries with similar duration. This is extremely abnormal given the tax preferred status of Muni's.

While the Muni volatility is cause for concern, there are factors that mitigate the risks of holding Muni's and the reason we still use the asset class for our clients.

The information in this article is not intended as tax or legal advice, and it may not be relied on for the purpose of avoiding any federal tax penalties. You are encouraged to seek tax or legal advice from an independent professional advisor. The content is derived from sources believed to be accurate. Neither the information presented nor any opinion expressed constitutes a solicitation for the purchase or sale of any security.

The mitigating factors include:

- Tax free interest income
- Historical default rates are incredibly low. According to Fitch Rating Agency, the cumulative default rate over the past ten years for all rated municipal bonds – including non-investment grade – ranges from 0.04% to 0.29%, based on estimates from all three major rating agencies.
- Moody‘s Rating Agency found significantly higher default rates on corporate bonds over a similar time frame (2.5% of investment grade and 0.5% of AAA-rated corporate bonds default over a similar time frame.[i])
- State governments are obligated to balance their budgets and meet their municipal debt obligations. States are also not legally allowed to file for bankruptcy. If they were, it would be highly unlikely given their reliance on federal funding.
- Economists are predicting a 3% boost in GDP for 2011. In an improving economy, state governments can expect a rise in tax revenues thereby easing budgetary issues. This boost should help significantly given the fact that most states have already taken steps to close budget deficits.

In summary there are many positive indicators that cause Locust Capital to believe there are opportunities in maintaining exposure to municipal markets

<u>Thank You</u>

We are honored to be your fiduciary partner with respect to your wealth management and stand ready to assist you in all matters related to your wealth creation, preservation, and other related needs. We hope you are looking forward to Spring and we look forward to speaking to you in the coming weeks.

Sincerely,

Locust Capital Management, LLC

---

[i] Richard Raphael, Laura Porter, et al. ―U.S. State and Local Government Bond Credit Quality: More Sparks than Fire.‖ Fitch Ratings, 16 November 2010.

The information in this article is not intended as tax or legal advice, and it may not be relied on for the purpose of avoiding any federal tax penalties. You are encouraged to seek tax or legal advice from an independent professional advisor. The content is derived from sources believed to be accurate. Neither the information presented nor any opinion expressed constitutes a solicitation for the purchase or sale of any security.