



AQUILA
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The State of the Municipal Bond Market

March, 2011

What caused municipal bond market volatility in late 2010 and early 2011?

Prior to November, 2010, the municipal bond market had seen several months of improving bond prices brought about by light new issuance, a flight to quality, and demand for tax-exempt investments. November's elections brought a political shift, and with it, expectations that the flow of federal funds to state and local governments would decline, and that the Bush era tax cuts might be extended beyond year-end. While the first scenario would potentially impair state and local finances, the second would potentially reduce demand for tax-exempt bonds. An S&P downgrade of 'tobacco bonds' to 'junk' status on Veteran's Day appears to have sparked a sell-off of those issues which then spread throughout the municipal bond market. A rush by issuers to bring new tax-exempt and taxable issues to market before year-end 2010, due to the uncertainty around the future of the Build America Bond program, significantly increased year-end supply and may be partly to blame for the increase in yields. Rising rates on treasury securities also contributed to the increase in municipal bond yields. Mid-way through Q4 2010, and continuing into mid-January, 2011, municipal bond yields spiked significantly before the asset class experienced some stabilization in February.

The very controversial and highly publicized comments of an independent analyst, made in December, appear to have motivated indiscriminant selling on the part of individual investors in municipal bonds, and municipal bond funds. Net asset values of municipal bond mutual funds dropped sharply as portfolio managers sold fund holdings to generate the cash needed to meet unprecedented redemptions.

Has the municipal bond market stabilized?

Outflows from municipal bond funds began to taper off during the week of January 17, 2011 and have continued to decline since then. Fear in the market seems to be subsiding as investors realize that the yield spike in the latter part of 2010 was a not the result of widespread credit risk. Mutual fund net asset values appear to be stabilizing. Many traditional and non-traditional municipal bond investors have been taking advantage of what we consider to be buying opportunities made available by the shake-up in the asset class.

To what extent are municipal bond defaults likely?

We do not believe widespread municipal bond defaults are likely. Although there are real fiscal issues facing state and local governments, it simply will not benefit issuers to default on their outstanding debt. Principal and interest payments on debt represent less than 10% of the budgets in most states, and states rarely roll-over debt into new bond issues. Defaulting on debt would not provide a meaningful benefit in terms of budgetary relief, but would have a significant negative impact by reducing access to the bond market at reasonable rates. Measures such as reducing government funded programs, layoffs, and furloughs for local and state employees have already been put in place and will continue to be implemented in an attempt to resolve budget issues.

Why are state and local governments feeling budget pressure?

State and local governments are feeling budget pressure due to a decrease in income, sales, and property tax revenue along with the growth of unfunded future healthcare and pension obligations. These two issues represent different types of fiscal stress, one cyclical and shorter-term, and the other structural and ongoing. The decrease in revenues for state and local governments is cyclical and brought on by the ongoing economic downturn that has resulted in higher unemployment, reduced spending and lower property values. The structural issues that states are facing with pension and healthcare obligations are the result of contracts that were put in place years ago coupled with insufficient funding and overly optimistic growth assumptions.

An additional stress for both local and state governments is the loss of Federal stimulus spending in FY2011, which will begin in June of this year for most states. In 2009, President Obama enacted the American Recovery and Reinvestment Act that provided states with Federal assistance to stimulate recovery during the Great Recession. This spending will expire this year, leaving state and local governments with fewer resources with which to meet their budgetary challenges.



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How vulnerable is the municipal bond market?

Most municipal bond issuers are financially sound and taking the difficult, but necessary, steps to balance their budgets. Defaults may occur, but they are expected to be minimal and isolated to weak credits. The municipal bond market represents nearly \$3 trillion in assets with more than 100,000 issuers. Those issuers are very diverse, and this is a market that is not well-suited to generalizations. Meaningful improvement in the management of budgets at every level of government will be required. As the economy shows signs of sustainable improvement, budgetary stresses will begin to show signs of improvement. Tax revenues are up for the third straight quarter in most categories, with states reporting increases in both sales and income taxes. Municipalities are likely continue to feel the pressure of reduced property tax revenues until the housing market improves.

The Aquila Group of Funds

There are good quality municipal credits available in the market. The research and credit analysis conducted by experienced fund managers who know the local markets and issuers provides investors with a valuable service in this market environment. Our portfolio managers are actively engaged in monitoring economic and fiscal developments. Our municipal bond funds invest in investment-grade securities, or those deemed to be of comparable quality, and typically maintain an intermediate maturity profile. Within this structure, the portfolio manager attempts to reduce credit and interest rate risk in pursuit of the objectives of delivering a high level of income exempt from state and federal income tax, along with preservation of capital.