The Investor's Edge

C.W. HENDERSON & ASSOCIATES, INC.

Investment Managers Specializing in Tax-Exempt Municipal Securities

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- **Background and Outlook**

The tentacles of the housing implosion have spread throughout the investment markets and precipitated extreme volatility and a flight to quality. As indicated in the chart displaying ten year Treasury yields, courtesy of The Chart Store, investor preference for the safety of the government market caused rates in this sector to plummet further during the quarter. The 3.41% level recorded at the end of March was 185 basis points lower than last June.

Municipal rates moved in the opposite direction. Turmoil among bond insurers unnerved many investors who had viewed the insurers' AAA ratings as being essentially ironclad and many of these buyers have moved to the sidelines. Also, liquidity and credit issues at many investment banks caused these institutions to limit market commitments. At the same time, failed auction rate programs and hedge funds unwinding arbitrage trades have added huge supply to the market. As shown in the yield curve chart, prime municipal yields, while down from the late February peak, are higher than Treasury rates throughout the yield curve – an unprecedented relationship! The table below illustrates the shifting relationship between the two markets. The ten year prime municipal/Treasury yield ratio peaked at 119+% at the end of February when numerous hedge funds were unwinding leveraged carry trades. The "normal" 80% to 85% ratio has been turned upside down.

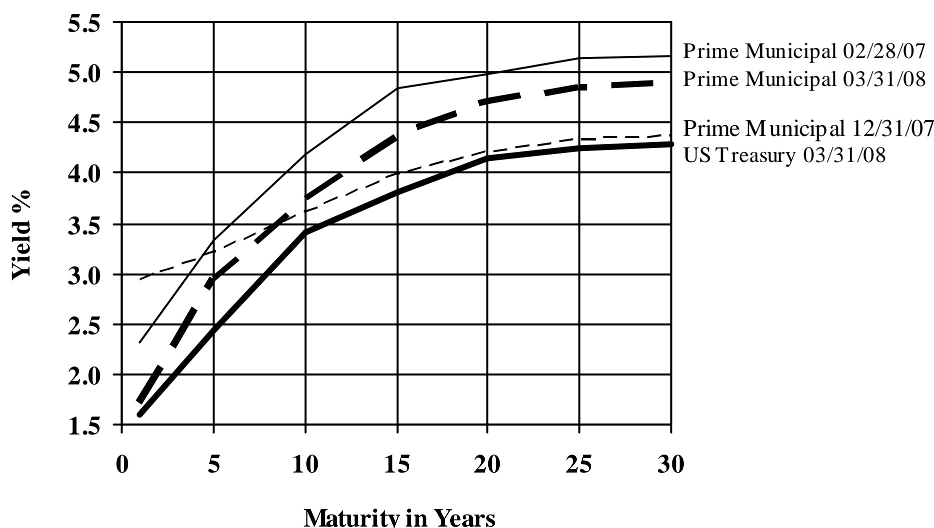
	Treasury	Prime Muni	Ratio
6-12-07	5.26%	4.21%	80.0%
12-31-07	4.03	3.61	89.6
1-31-08	3.64	3.34	91.2
2-29-08	3.51	4.19	119.4
3-31-08	3.41	3.73	105.7

The Federal Reserve has been combating credit disruptions by injecting massive liquidity into the system. The federal funds rate has been lowered 300 basis points to the 2.25% level since September and the discount rate has been reduced from 6.25% to 2.50%. In addition, the Fed expanded their playbook with direct support to Wall Street to curtail the threat of spreading delinquencies resulting from the Bear Stearns collapse. The Fed-backed sale of Bear Stearns to J.P. Morgan was supported by an unprecedented $29 billion government backed loan. The Fed's focus will remain on keeping the economic ship afloat. GDP growth is believed to have slackened from the paltry 0.6% rate recorded in the fourth quarter and most forecasters believe that the U.S. has entered into what could be a protracted recession. Additional Fed ease appears likely while inflation and dollar concerns have been relegated to the back burner.

We expect the economy to struggle for much of the year, and perhaps longer, as housing prices painfully adjust to market clearing levels. Rising unemployment and subdued consumer spending are expected to offset the impact of rising exports fostered by dollar weakness. Inflation is likely to moderate in response to slackening demand.

The economic setting and the relative cheapness of the municipal market have created an attractive opportunity to purchase longer, high quality tax-exempt securities. We are extending portfolio durations to the 4.6 to 5.0 year area, about 10% longer than "neutral".

Municipal Yield Curve Shifts



- **Current Status of Bond Insurers**

As has been noted, the tax-exempt market is being buffeted by credit and liquidity concerns. The disruptions started when it became apparent that several bond insurers had significant exposure to subprime housing credits along with CLOs, CDOs, etc. As these credits deteriorated, insurers suffered

capital erosions which prompted rating reviews. Of the major insurers (Ambac, FGIC, FSA and MBIA) only FSA, which never ventured beyond the municipal arena, remains unscathed. Weakened insurers have worked to bolster their capital positions through reinsurance and capital infusions. The actions of some insurers have been insufficient which precipitated rating declines. The ratings of several insurers remain under review and additional downgrades could be forthcoming as indicated in the following table. Except for ACA and Radian, all of the insurers had carried AAA ratings by one or more rating agencies.

	Moody's	**S&P**	**Fitch**
Ambac	Aaa Negative	AAA Negative	AA Negative
FGIC	A3 Review for Poss Downgrade	A Negative Watch	BBB Negative
FSA	Aaa Stable	AAA Stable	AAA Stable
MBIA	Aaa Negative	AAA Negative	AAA Negative
ACA	NR	CCC	NR
Assured Gty	Aaa Stable	AAA Stable	AAA Stable
CIFG	A1 Stable	A+ Stable	AA- Negative
Radian	Aa3 Negative	AA Stable	A+ Evolving
XCLA	A3 Negative	A- Negative	BB Negative

Our assumption at this point is that FSA and Assured Guaranty will prosper and that Ambac and MBIA will take necessary steps to maintain their ratings. The future of the others is uncertain. Berkshire Hathaway's entry into the market will fill some of the void, but it is questionable whether bond insurance will have the degree of acceptance going forward that it had in the past. Over 50% of the securities sold in the new issue market during the past ten years were issued with insurance. Insured municipal bond funds had been marketed as "AAA" funds but are now offered only as "insured" funds. We expect that the popularity of these vehicles will diminish as investors place less reliance on insurance in their security selection.

- **Variable Rate Securities**

The insurers' problems had a secondary effect in the short term tax-exempt markets. High quality variable rate demand notes are eligible instruments for municipal money market funds because of their credit worthiness and the liquidity provided by seven day put features. SEC rules require that 95% of the assets in a municipal money market fund carry highest rating agency ratings. If notes carried these ratings solely because of insurance and have subsequently been downgraded, they can no longer be held, and puts must be exercised by fund investment advisors. Several banks provided liquidity agreements that support these put arrangements. These banks have been forced to absorb downgraded securities. It should be noted that many VRDNs remain outstanding and continue to be used by fund managers, but credit scrutiny has intensified.

Auction rate securities have been far more troublesome. These vehicles which comprised a $330 billion market do not have put features, but depend on remarketing through Dutch Auctions at preset intervals (typically every 7, 28 or 35 days) to provide liquidity. Investors that need liquidity communicate their intent to withdraw funds prior to an auction and are replaced by new investors. Remaining and new auction participants indicate the rate levels each requires for them to remain in the program and the highest rate that clears the market is provided to all investors. In the past, if situations arose where there

was insufficient demand to clear the market, sponsoring brokers stepped in and absorbed the remaining securities. As noted, market disruption early this year caused many investors to exit the municipal market. With fewer bidders for auction rate securities, the program sponsors were challenged with absorbing larger components of these deals at the time many of their capital positions were under pressure. Most stepped back. In excess of 70% of the auctions have failed and liquidity has evaporated.

Most of the auctions (perhaps $200 billion) represented financings by municipalities that favored the short variable rate markets. As these auctions failed, rates on several of the programs adjusted to dramatically higher levels. The affected municipalities have been restructuring this debt into variable rate demand notes or longer maturity instruments. These refinancings are expected to be completed in the next few months.

More challenging are the $65 to $70 billion auction rate programs used by closed end bond funds to create leverage. The default reset rates on these programs are not as onerous as in the previous case so there is little incentive for fund managers to collapse these programs. However, the holders of the auction rate securities have no liquidity and are unable to gain access to needed funds. Steps are likely to be taken to address this problem, but no solution is anticipated for some time – well past the critical April 15 tax date! In the interim there have been reports of offers to provide liquidity at discounts (as much as 20%) below par.

- **Unraveling Hedge Fund Trades**

We noted in our last newsletter that several hedge funds had capitalized on the positive slope in the municipal market during the past several years by financing purchases of long municipals in the lower cost short term market. Swaps and short Treasury positions were put in place to offset certain risks in these trades. Returns were enhanced through the use of significant leverage (up to ten times). The strategy became so popular that much of the supply of longer maturity bonds sold in the new issue market over the past several years was purchased by hedge funds. The rally in the Treasury market while municipals weakened caused the strategy to unravel. Losses were reported late last year and fund managers began to unwind trades. Hedge fund sales intensified this past quarter which was a major force that pushed long municipal rates sharply higher in February.

- **Where Does The Municipal Market Go From Here?**

Eventually a more normal market will return, but not until much of the $200 billion bulge of auction rate refinancings, coming on top of normal new issuance ($429 billion last year), and the unwinding of hedge fund trades is completed. Several bond insurers will remain under a cloud and the illiquidity that many auction rate investors are facing will take time to be resolved, and likely involve litigation. Also, the slowing economy will stress some municipalities as tax receipts decline. However, the municipal market has proven through the years to be an attractive and safe place to invest. Only government securities have been more secure. As conditions stabilize, discerning investors will return to the market, especially if higher tax rates appear on the horizon. In the interim, high yields, uncertainty and volatility are creating exciting investment opportunities. We feel confident that our use of high quality securities and our active management process will continue to serve our clients well.

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