The Investor's Edge

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Investment Managers Specializing
in Tax-Exempt Municipal Securities

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- **Background**

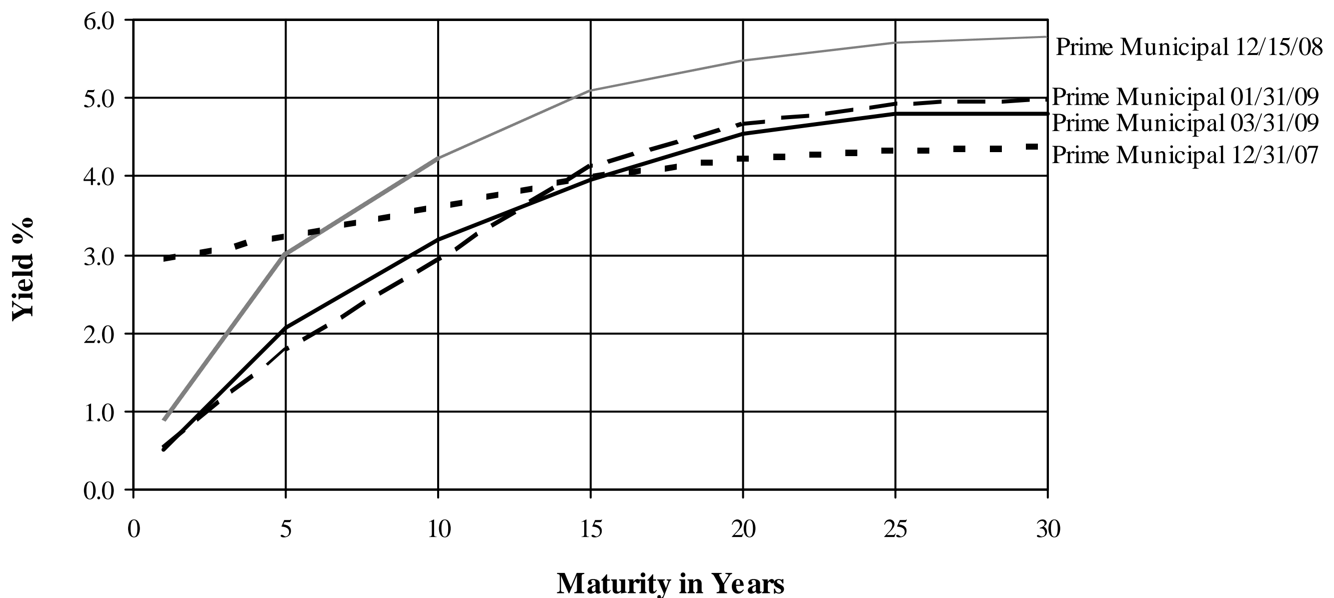
A deepening recession, financial institutions under pressure, market volatility and investor uncertainty continue to underscore the state of the markets. The 6.2% decline in GDP in the fourth quarter of last year was likely matched in the most recent quarter as consumers continued to retrench in the face of accelerating job losses that drove the March unemployment rate to 8.5%. Declines in housing prices and retirement account valuations have further eroded consumer confidence while businesses are reacting to reduced demand with production cuts, plant closings and reductions in retail outlets. Balance sheets of numerous financial institutions remain burdened with unmarketable toxic assets, forcing these institutions to maintain their dependence on Washington support. The viability of General Motors and Chrysler remains tenuous and it is questionable whether they will be able to avoid bankruptcy.

The federal government is countering with massive monetary and fiscal stimulus in an attempt to energize the economy. The Fed is holding short rates close to zero and has ballooned its balance sheet through credit extensions in its effort to support the financial system. Major recipients have been Citigroup, AIG, Bank of America, Fannie Mae, Freddie Mac, and the auto companies through the Troubled Asset Relief Program (TARP). Support for selected life insurers and auto parts suppliers is expanding Washington's network of TARP lifelines. In addition, it was announced last month that the Fed would purchase in excess of $1 trillion Treasury and mortgage backed securities to lower longer rates and ease credit blockages. All this comes before the Troubled Asset Loan Facility (TALF) program ramps up. This latest program is designed to rid financial institutions' balance sheets of $1 trillion toxic asset backed securities. Fiscal policy has added to the effort with the $787 billion Emergency Economic Stabilization Act. A large component of this bill is slated to provide aid to states along with funding numerous infrastructure projects. All in, a $1.7 trillion federal deficit is now forecast for the current fiscal year with additional trillion dollar shortfalls expected in subsequent years.

Drastically reduced housing prices and low mortgage rates are starting to attract first time home buyers while auto production has declined to levels that are barely replacing scrapped vehicles. Potential bottoming in these areas coupled with the huge government stimulus program should be sufficient to eventually arrest the pace of the downturn and lead to positive growth, hopefully by the end of this year. However, the resultant recovery may be less robust than expected as continued uncertainty prompts consumers to increase personal savings rates which, in turn, will dampen the multiplier effect of the fiscal stimulus. Business leaders are also expected to remain cautious in the face of curtailed domestic demand and a struggling global economy that limits exports.

- **The Municipal Arena**

As shown in the attached graph, prime municipal yields declined sharply in late December and January as investors sought refuge in the relative safety of the tax-exempt market. New municipal issuance totaled $83.8 billion in the first quarter, down a modest 1.9% from 2008. Volume had been trailing year earlier levels by a wider margin, but a $6.5 billion State of California sale in late March (increased from $4 billion due to strong demand) narrowed the gap. The California issue provided spreads of about 170 basis points over the AAA scale in the intermediate sector which spurred significant demand. Retail buyers continue to focus their purchases in the one to ten year sector but have also resumed modest bond fund purchases that are providing some support for the longer segment of the market. Other traditional buyers in this space, casualty insurers and hedge funds, remain on the sidelines. The yield curve remains extremely steep with limited demand for longer bonds while short rates remain anchored by Fed policy. We anticipate that this structure will continue for the foreseeable future.



The cheapness of the municipal market relative to Treasuries last fall (the ratio of ten year prime tax-exempt rates to Treasury yields rose above 140%) and the absolute level of municipal rates (ten to fifteen year yields well in excess of 4%) prompted us to target account durations at 4.8 years, about a 20% extension from neutral. Duration targets were shifted back to neutral (slightly over four years) in response to the December/January rally. Quality standards are being maintained. Despite widening spreads, credit quality remains a primary security selection criteria.

- **Longer Term Concerns**

There are three significant longer term risks facing fixed income investors. First, with government rates being suppressed to some extent by the Fed's purchases, what happens when the government's buying program stops? The probability of a spurt in Treasury rates seems likely with yields in all fixed income sectors, including municipals, moving higher in tandem. Second, what is the longer term appetite of foreign investors (e.g. China) for U.S. Treasury securities as we proceed down the path of

trillion dollar deficits? Absorbing this massive supply is likely, at some time, to require higher rates. Third, when the recovery takes hold, will accelerating monetary velocity lead to inflationary pressures? The likelihood of the Fed reversing course at just the right time is low. We are cognizant of these risks, but they do not appear imminent given the current tenuous state of the economy. Longer term they must be monitored and may prompt portfolio duration adjustments.

- **Stimulus and the Municipal Market**

Washington's stimulus program has extended to the municipal sector. A significant component of the $787 billion stimulus bill is being allocated to the states to support education, health care, unemployment benefits, and various infrastructure projects. These funds will not entirely offset the impact of reduced tax receipts at the state and local levels, but will play a significant role in helping these governments manage through the recession.

The stimulus bill also has provisions designed to boost demand for municipal securities. As a first step, the size limit of bank qualified issues has been expanded from ten to thirty million dollars. Banks purchasing these securities can deduct from their taxes up to 80% of the interest expense associated with holding these bonds in their portfolios. Prior to the Tax Reform Act of 1986 commercial banks were the largest holders of tax-exempt securities because of this tax offset, but the $10 million limit imposed by that bill sharply reduced their subsequent purchases of municipal securities. Banks now have the opportunity to expand their holdings which will bolster demand for small municipality debt. Bank qualified issuance has risen significantly and is expected to continue to accelerate in the coming months.

The stimulus bill also gives municipalities, for the next two years, the option of selling taxable debt under the Build America and Recovery Zone programs that are designed to provide funding for renewable energy and qualified school projects. Issuers have the option of receiving a cash payment from the federal government or having investors receive a tax credit. The payment or credit equals 35% of the interest paid on the bonds. The logic for the taxable structure is that these securities may find demand from a broader investment community including pension funds, endowments and taxable bond funds. It remains to be seen if many municipalities will opt to issue taxable securities given potential complexities in attempting to sell municipal securities to a non-traditional market where buyers will be challenged to make corporate/municipal credit quality assessments and value determinations. Other municipal structural features such as level debt service, call features, uncertain secondary trading characteristics, etc. are likely to limit traditional taxable buyers' interest. Overall, we doubt that there will be significant debt sold under the taxable option.

The demise of most bond insurers has left the market largely without third party support and there have been suggestions that the Treasury should step in to fill this void. The situation is especially critical in regard to tax-exempt money market funds. The Treasury is currently providing a guaranty for money market funds since this $3.8 trillion facility (taxable and tax-exempt vehicles) is such a significant component of the investment landscape. Tax-exempt money market funds rely heavily on variable rate demand notes for liquidity. VRDNs typically have thirty year maturities but weekly or daily put features that allow the securities to always be priced at par. They are structured with letters of credit to assure principal repayment and liquidity arrangements to maintain the viability of the puts. Most of the credit and liquidity enhancements have been provided by domestic and foreign banks, some of the same institutions that are now experiencing severe stress. Many banks have exited this market. Whether the government will step in to directly support variable rate debt remains to be seen.

- **Bond Insurer Pressure Continues**

Berkshire Hathaway, the most recent entrant into the bond insurer fraternity was recently downgraded by Moody's to Aa1. As shown in the table below, Moody's now has less than Aaa ratings on all insurers. Assured Guaranty and FSA still carry AAA ratings by both S&P and Fitch. Berkshire Hathaway has a AAA rating from S&P but is unrated by Fitch. Most insurers have negative outlooks which suggest that additional downgrades could be forthcoming. The market is assigning some value to insurance from these three providers, but most investors are primarily focusing on underlying bond quality in making credit determinations. This has always been our approach to assessing quality and attractiveness of insured bonds.

Insurer	Moody's	S&P	Fitch
AMBAC	Baa1/Negative	A/Negative	NR
Assured Guaranty	Aa2/Stable	AAA/Stable	AAA/Stable
CIFG	Ba3/Developing	BB/Developing	NR
FGIC	Caa3/Negative	CCC/Negative	NR
FSA	Aa3/Developing	AAA/Negative	AAA/Negative
MBIA	Baa1/Positive	AA-/Negative	NR
Radian	Ba1/Stable	BBB+/Negative	NR
Syncora	Ca/Developing	CC/Negative	NR
ACA	NR	NR	NR
Berkshire Hathaway	Aa1	AAA/Negative	NR

- **Moody's Negative Outlook**

A negative outlook was recently assigned to the entire local government sector by Moody's. The agency sighted the difficult operating environment facing this segment of the market that includes approximeately 89,000 cities, counties, school districts and special districts. Many of these municipalities rely on property and sales taxes for a significant component of their revenues. Moody's indicated that their credit assessments going forward will include local governments' ability to reduce expenses in addition to traditional measures of credit quality. They did acknowledge that most governmental bodies have the ability to deal with reduced revenues, but municipalities' budgetary vigilance will be critical in successfully navigating through the recession. Moody's assessment reinforces our belief that a strong credit focus is critical when making security selections.

- **Firm News**

We are in the process of updating our website to improve its format and content. We would appreciate your feedback regarding its layout and usefulness. Please visit the website at www.cwhenderson.com and give us comments.

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