The Investor's Edge

C.W. HENDERSON & ASSOCIATES, INC.

Investment Managers Specializing in Tax-Exempt Municipal Securities

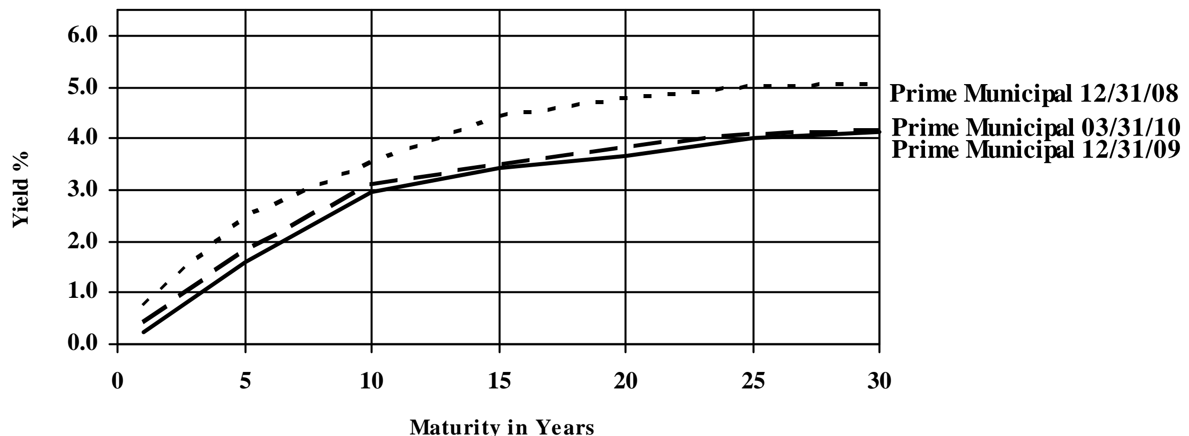
- **Background and Outlook** **April 2010**

Positive real growth in the fourth quarter appears certain to have been extended in the opening months of the current year with gains in industrial production, increases in factory employment and modest upticks in consumer spending. The 162,000 increase in non-farm employment in March, even if the 48,000 temporary census worker hires are disregarded, provided additional good news. However, the drags of high unemployment and a depressed housing sector are likely to restrict economic momentum for the foreseeable future. We continue to look for modest real growth of perhaps 2.5% over the next several quarters. Near term inflation reports are expected to remain benign with limited, if any, wage pressures. Commodity prices have moved somewhat higher as manufacturing activity has improved. The price of oil at near $85 per barrel as of this writing has more than doubled since early last year. Indications from OPEC suggest that increased production should limit additional increases.

Federal Reserve ease is likely to remain in place for at least several more months with a near zero targeted Federal Funds rate. The increase in the discount rate by 50 basis points to 0.75% in February and the completion, at the end of March, of the Fed's $1.25 trillion mortgage backed purchase program represent initial, modest steps to pare accommodation. Additional moves are anticipated in the coming months with an increase in the fed funds rate in the latter part of the year.

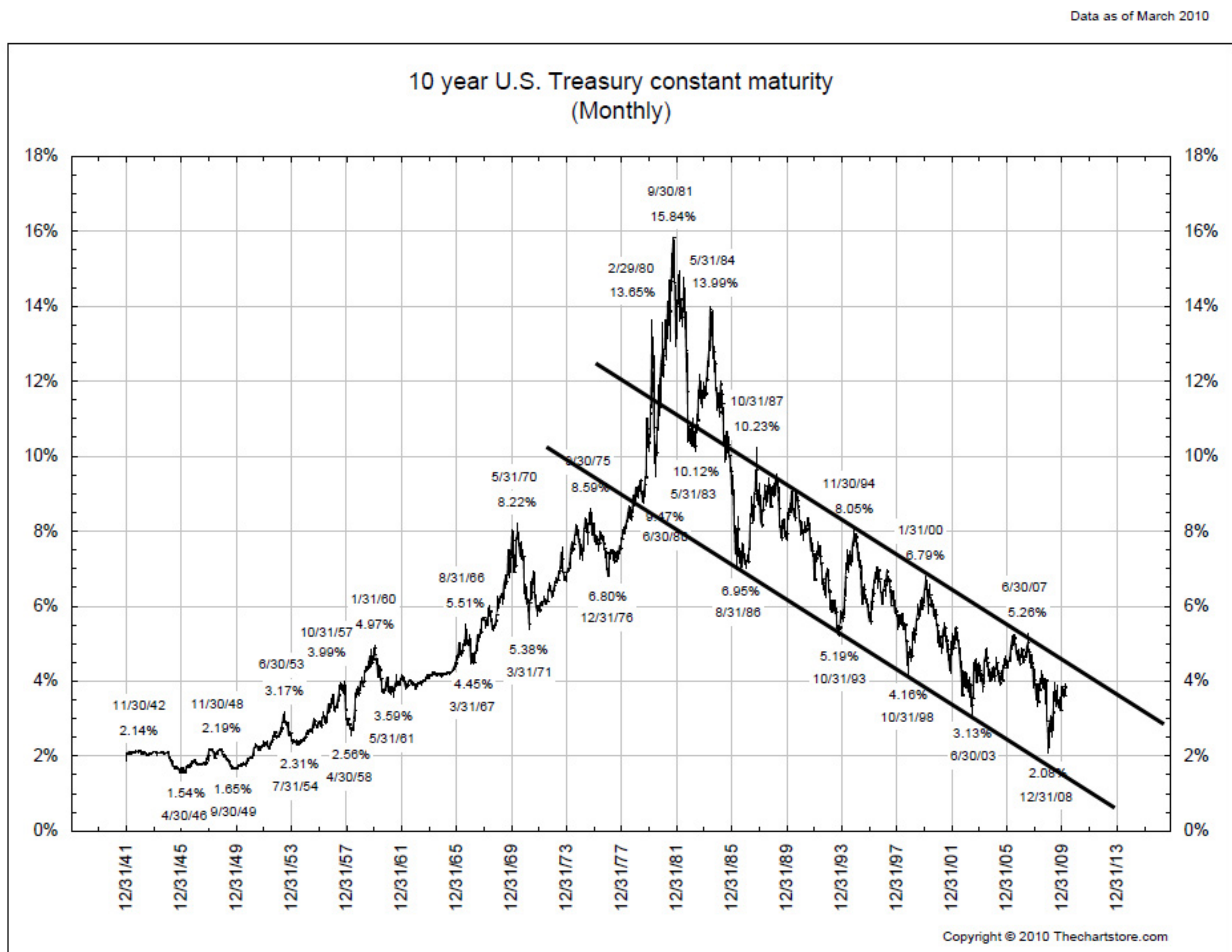
Longer interest rates moved moderately higher in recent weeks in reaction to stronger economic activity. The ten year Treasury yield, which hovered in the 3.60% to 3.70% range during most of the quarter, rose above 3.90% after the March employment report was released. Municipal yields have also edge higher. As shown in the attached chart, prime tax-exempt rates moved up by fifteen to twenty basis points in most maturities during the quarter.

Municipal Yield Curve Shifts



We anticipate additional moderate rate increases as the economy continues to improve, especially as indications of pending Fed tightening emerge later in the year. However, abundant money market fund balances earning near zero returns and investor concern over impending tax increases next year are likely to keep demand for tax-exempt income high and moderate upward yield pressures in the municipal sector. Portfolio duration targets of slightly below four years are being maintained in response to low prevailing nominal rate levels.

Taking a longer term view we remain cautious. The attached chart of the ten year Treasury, courtesy of The Chart Store, illustrates the downtrend in rates that has been in place since the early 1980s. Will benign inflation (deflation) and limited credit demand allow rates to continue to move lower in the downward channel? We are skeptical. Financing massive federal deficits could require higher rates to sustain investor interest, especially if foreign buyers' pare purchase programs. Further, given the massive liquidity the Federal Reserve has injected into the economy, will the FOMC be sufficiently nimble to react in a timely manner if monetary velocity accelerates? We will be watchful for indications of building economic momentum and/or inflationary pressures.



- **Build America Bonds Issuance Strong but Encountering Some Resistance**

New issue supply totaled approximately $100 billion in the first quarter, up over 17% from the year earlier level. Build America Bonds represented approximately 26% of the total as municipalities continued to take advantage of the 35% interest rate rebate provided by the U.S. Treasury. Given the continued steepness of the municipal curve, most BABs issuance continues to be in longer maturities, typically beyond eleven years. Since the program was started in the spring of last year close to $90 billion BABs have been issued.

The State of South Carolina declined to use BABs in a recent $660 million sale due to concern that the 35% subsidy could be encumbered. BABs subsidies have been structured as tax refunds to insulate them from annual appropriations. However, the IRS has indicated that BABs rebates may be offset if a municipality is in arrears in payments to the federal government for other programs. This concern was echoed by the State of Florida which suspended BABs sales until clarity is provided by Washington. The Government Finance Officers Association also commented that many members are concerned about potential offset provisions. The State of South Carolina Treasurer also expressed concern regarding higher rate taxable BABs depleting the State’s debt capacity compared to tax-exempt bonds. The State is constitutionally required to limit it GO debt service to 5% of the previous year’s general fund revenue. Total BABs interest expense must be included, not the expected post-rebate net amount.

Under legislation being drafted by the House Ways and Means Committee, the BABs program would be extended three years through 2013, but the interest rate subsidy would decline to 33% in 2011, 31% in 2012 and 30% in 2013. Final legislation is not yet in place, but some reduction in BABs issuance seems certain as the rebate rate declines. Lowered rebate rates will push the maturity segment where BABs provide an advantage further out on the yield curve to perhaps fifteen years and longer.

- **Municipal Budgets “Ever So Slightly” Improved**

As recently reported by the Census Bureau, state and local tax collections rose above year ago levels in the fourth quarter for the first time in more than a year as gains in property taxes and corporate taxes offset continued declines in other revenues. Tax collections of $360 billion were up 0.8% from the fourth quarter of 2008. A 4.7% drop in personal income tax receipts in the fourth quarter was sharply lower than the 12% and 28% respective drops in the previous two quarters. Sales taxes were off 2.8%, but this compares to declines of approximately 9.5% in the second and third quarters. For all of 2009, state and local governments collected $1.2 trillion in taxes, down 5.6% from 2008.

Despite the slight fourth quarter improvement, budgetary pressure will remain intense for the foreseeable future. About a third of the $787 billion federal stimulus funds were allocated to municipalities and most of this money was used to support operating programs. No new stimulus funds are now available while lowered home values are prompting property reassessments which will impact real estate taxes in the coming quarters. Slow improvements in sales and income tax receipts are anticipated, but not at a sufficient pace to meaningfully improve municipal budgets in the near term.

- **Municipal Governments Working to Pare Labor Costs**

A growing number of governors and mayors are attempting to scale back government workers' salaries and benefits. California has resorted to unpaid furlough days for numerous employees. New Jersey Governor Christie signed three bills that require all state employees to contribute more to their health care insurance. For new government hires the measures limit payouts for unused sick leave, bar part-time employee pension eligibility and eliminate certain previously approved pension benefit increases. In Los Angeles Mayor Villaralgosa is attempting to reopen labor talks with the City's 45,000 municipal employees to reduce labor cost burdens. In Illinois changes are being made that will impact new employees with increased medical co-payments, reduced benefits, inability to double dip and a delay in retirement with full benefits to age 67. Toledo recently negotiated $3.1 million concessions from its firefighters' union, Memphis officials have recommended that health insurance premiums be raised by 15% for current and retired employees and Tampa firefighters approved a new contract that includes no raises this year. Numerous other cities are in contract negotiations. According to the Pew Center, over the past two years seventeen states have reduced benefits for employees or increased the amount that employees must contribute to their pension plans.

We anticipated that efforts to reduce labor costs would develop, but they are happening more quickly than expected. State and local government employees represent 15% of the U.S. work force and it is argued that many are compensated at higher levels than private sector counterparts. Severe municipal budgetary imbalances are forcing municipal officials to confront previously sacrosanct labor costs. Passing the issue to future administrations, as has been done in the past, is ceasing to be an option. Negotiations are certain to be contentious, but it is imperative that municipal labor costs be contained.

- **Moody's Moving to Global Ratings**

Moody's Investors Service announced that it would move in mid April to a global ratings scale that aligns ratings in the municipal sector with corporate debt ratings. Moody's announcement came shortly after Senator Dodd, Senate Banking Committee Chairman, unveiled a redrafted financial regulatory reform proposal that would mandate such changes. A House reform bill passed in December contained similar language. Senator Dodd's bill will require rating agencies to consistently rate municipals as well as other types of debt based on the probability that an issuer of a security or money market instrument will default, fail to make timely debt service payments or otherwise not make payments to investors in accordance with indenture provisions.

Many municipal upgrades are anticipated. It is argued that state and local borrowing costs will be lower due to this effort. We are somewhat skeptical and expect that fundamental credit research will continue to discern relative credit strength among state and local issuers and value debt accordingly.

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