The Investor's Edge

C.W. HENDERSON & ASSOCIATES, INC.

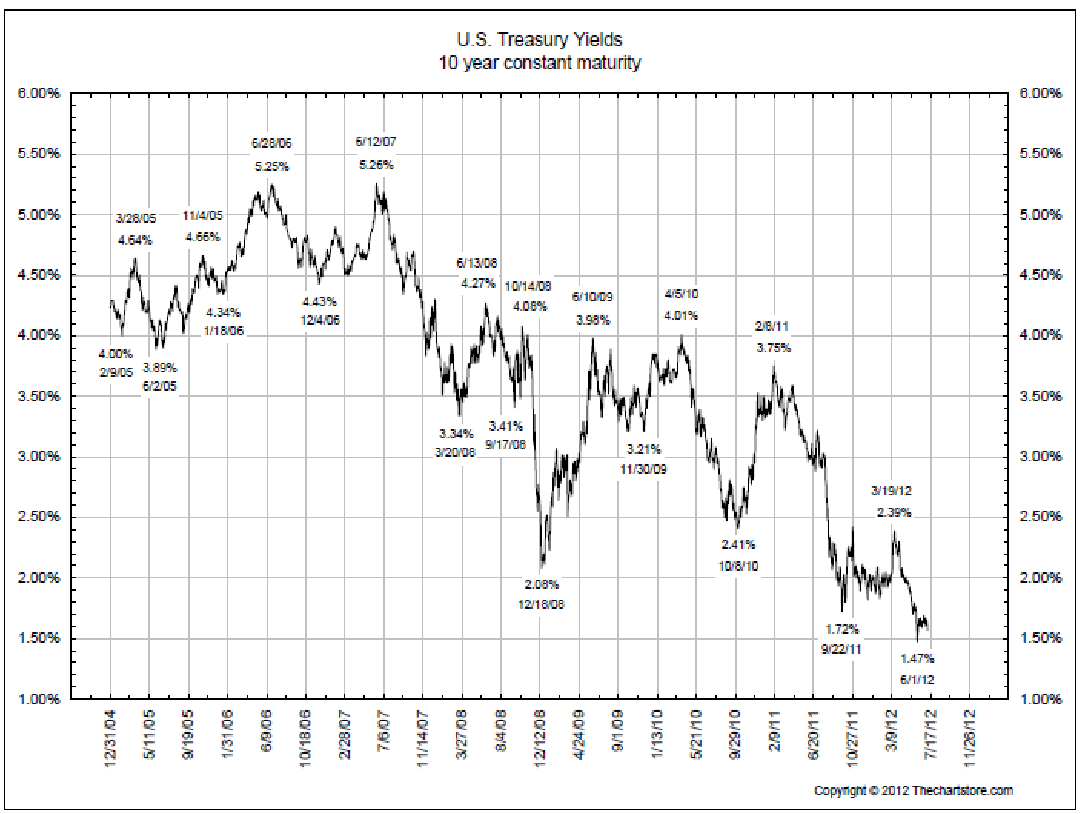
Investment Managers Specializing in Tax-Exempt Municipal Securities

July 2012

- **Review and Outlook**

At the time we wrote our April newsletter the ten year Treasury was trading at slightly above 2%. Based on our expectation of modest economic growth and the assumption that investors would eventually tire of committing funds to investments providing negative real returns, we suggested that interest rates would probably not move significantly lower and more likely trend higher over time. That wasn't quite right. Renewed Euro Zone pressures coupled with additional signs of sluggish U.S. growth (e.g. downward revision of first quarter GDP, slow growth in retail sales, less than expected job gains, etc.) have prompted investors to again favor the safe harbor Treasury market. The ten year Treasury yield fell to 1.47% at the beginning of June before reversing modestly to the current 1.55% level. The following chart illustrates the trend in Treasury yields over the past several years and clearly depicts the most recent decline.

Data as of July 6, 2012



Are further rate declines in the cards? We don't believe so unless economic activity retreats substantially and deflationary concerns emerge. The probability of this scenario seems low. Additional Euro Zone shocks are perhaps likely and will continue to unsettle the markets. However, much of this uncertainty is already embedded in expectations and current interest rates. The threat of the "fiscal cliff" of higher taxes and reduced federal spending at the start of next year is also real, but we expect that Washington will move to dampen these potential economic drags. Comprehensive budget and tax reforms seem improbable in the face of the upcoming election, but continuing resolutions that maintain the status quo until after the presidency and makeup of Congress are determined would not be surprising. While fiscal policy is somewhat uncertain, monetary policy remains accommodative. Short rates will be maintained near zero for several more quarters while Operation Twist has been extended and Chairman Bernanke has indicated that the Fed will take further action if it is called for. Given the recent sluggish job growth, QE III could be in the Fed's playbook.

Our interest rate outlook is therefore not significantly different than it was three months ago. Short rates will remain anchored by Fed policy, the yield curve will remain steep and longer rates will experience moderate volatility as investors react to U.S. and global economic developments. Modestly higher rates would not be surprising, but a sharp move to higher levels is not likely while growth remains sluggish.

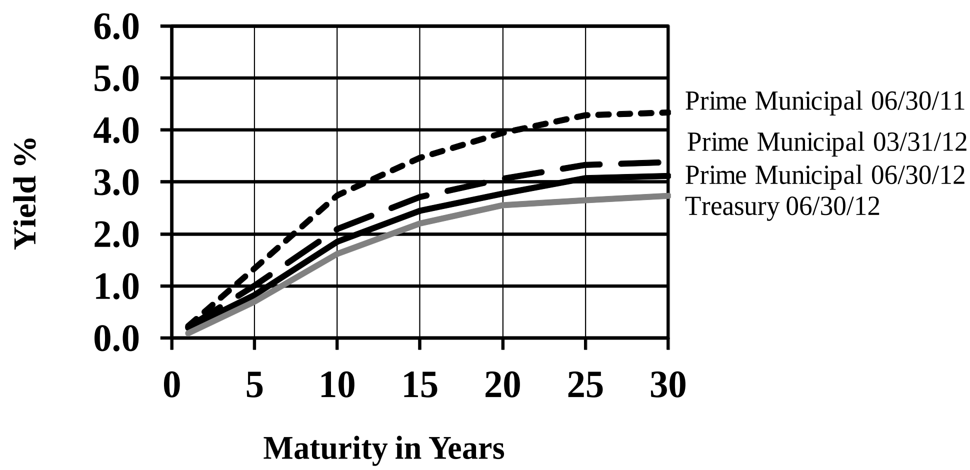
Longer term we remain bearish and anticipate that the thirty year downward trend in rates will ultimately reverse. Massive federal deficits, that have pushed the ratio of U.S. debt to GDP to near 100%, cannot be financed indefinitely at low interest rates that provide negative real returns. At some point borrowers will demand higher returns, especially if inflation accelerates.

Our posture remains unchanged. We continue to target portfolio durations at 3.6 years, about 15% below neutral. Despite the sluggish economic setting and Federal Reserve ease, low nominal rates argue for a degree of caution. High quality standards are being maintained. Continued emphasis on credit research is paramount to us.

- **Prime Municipal Rates Exceed Treasury Yields**

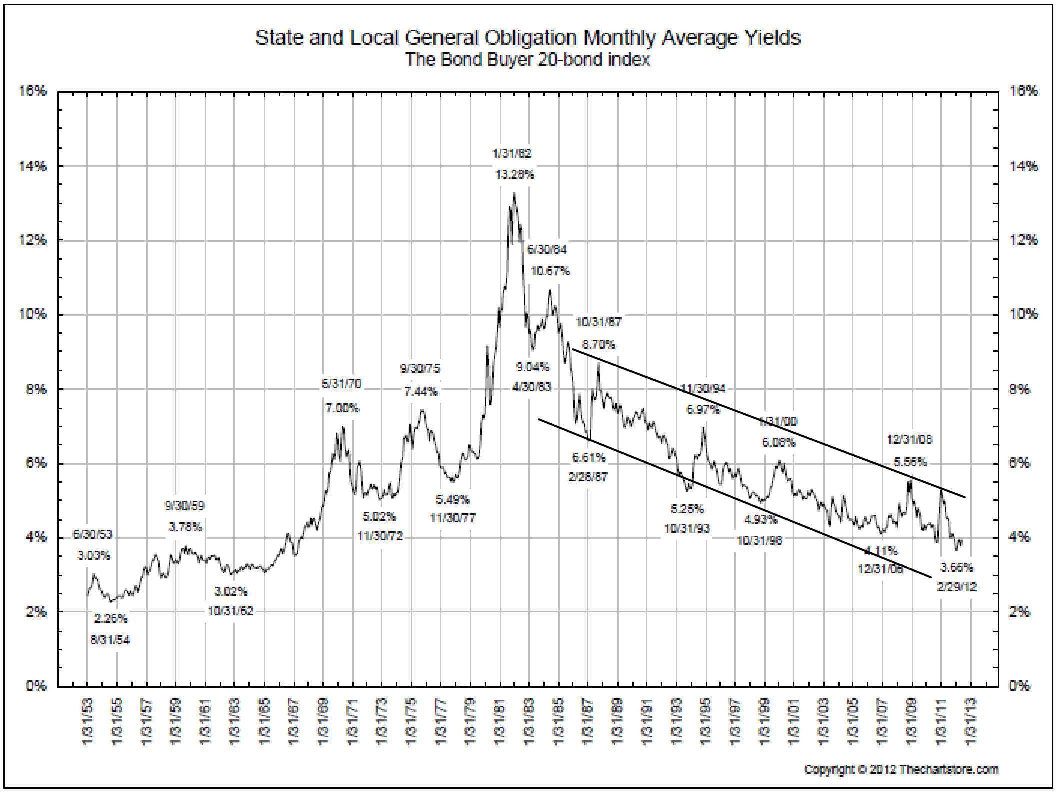
The following chart contrasts the quarter end prime municipal yield curve with those that existed a year ago and at the end of the first quarter. The downward rate drift is obvious and follows the trend of the Treasury market. The prevailing June 30 Treasury curve is also shown which, in all maturities, is lower than the prevailing municipal curve. Historically, prime ten year tax exempts have yielded about 85% of the Treasury rate. The current ratio is about 120%! Why the current disparity? Three reasons we believe. First, Treasuries are the preferred refuge in uncertain times. The flight to quality combined with the Fed's intervention have pushed government yields to extreme levels. Second, there is significant uncertainty as to possible changes in the tax law next year. What will ordinary income rates be? Will all municipal income remain exempt? Third, lingering credit concerns persist despite most municipalities having done a reasonably good job dealing with budgetary challenges. The outperformance of the Treasury sector is expected to be part of the landscape for some time.

Municipal Yield Curve Shifts



We have often included a chart illustrating ten year Treasury yields extending back many years. The following chart of municipal yields, as reflected in the Bond Buyer Index (BBI), shows a similar pattern. The BBI consists of longer and somewhat lower average quality securities than we purchase. However, the trend evidenced in this chart is of primary importance. Like the Treasury market, we expect that the downward rate trend will ultimately reverse. Investors with conservative portfolio constructions will be rewarded when the reversal is experienced.

Data as of June 2012



- **Refunding Issues Predominate**

From 2002 through 2010 new issue volume averaged approximately $395 billion per year. Ten year prime municipal rates generally ranged from four to five percent during this period while longer rates were higher. With rates now significantly lower, municipal issuers are refunding many of their higher yielding outstanding bonds. According to Thomson Reuters data, close to two thirds of the $192 billion new bonds sold in the first half of the year were refunding issues. We anticipate that this trend will continue for several more months as municipal officials work to lower expenses. The ability to refinance at lower rates is a long term credit positive.

New infrastructure projects are likely to be significantly limited until economic growth reaccelerates. Issuing bonds that require tax increases for other than urgently needed projects is extremely difficult in the current environment where constituents are struggling with high unemployment and pinched household budgets. Limited numbers of referendums are being put before voters.

- **Stockton California Declares Bankruptcy**

Stockton, with a population of about 300,000, opted to seek Chapter 9 protection as it deals with a $700 million debt load and a projected $26 million operating deficit for the fiscal year that started July 1st. The city initiated a redevelopment plan in the early part of the last decade that included a sports arena, a minor league ball park, a

650 space parking facility, a marina and the purchase of a new City Hall. The construction was financed with a series of debt issues starting in 2003. Rapid population growth for several years that started in the 90s caused an increase in home ownership and expanded property taxes. This growth emboldened city officials who felt that refurbishment of the downtown would attract additional people and further increase tax receipts.

Unfortunately, the housing bust derailed the City's plans. Severe housing price declines caused property tax receipts to fall precipitously as did sales taxes as unemployment rates soared to the 15% to 18% range. Generous employee pension and health care expenses have added additional burdens. The City has reportedly laid off 25% of its police force, 30% of the fire department and 43% of the non-public safety staff. Still, the City is not able to meet its obligations or come to agreement with creditors. Like Vallejo, California that emerged from bankruptcy not long ago, restructuring Stockton's finances will likely be a protracted process.

Are more Stocktons on the horizon? Possibly a few, but we think the incidence of significant bankruptcy filings will be rare. Most municipalities did not engage in spending sprees and have subsequently made the hard choices needed to deal with the strains caused by the economic downturn. Stockton's filing clearly illustrates the need for credit discipline. Reaching for yield is not appropriate, especially in the current market with credit strains and narrow spreads.

- **Altered Pension Reporting Rules**

Late last month the Governmental Accounting Standards Board (GASB) approved two new accounting regulations for state and local public employee pension plans that are an attempt to provide increased transparency, consistency and comparability among plans. The first regulation, that becomes effective in mid 2013, provides guidance regarding pension fund calculations. The second regulation requires governments with defined benefit plans to recognize their long term pension obligations as a liability and goes into effect in 2014. It is expected that the new regulations will, on average, increase the size of "reported" unfunded pension liabilities.

State and local pension plans were relatively well funded in the early part of the last decade, but the drop in asset values in 2008 caused the health of many plans to decline dramatically. Unfunded pensions, if large, can represent a severe burden for municipalities with high required annual contributions. We evaluate pension plan funding in our credit analysis process and generally consider 70% funding to be a threshold for credit approval.

Pension plan assessment is complex and involves many assumptions: mortality rates, inflation rates, wage growth, investment returns, etc. We will be evaluating these variables in regard to existing and future holdings.

- **Firm News**

We are pleased to announce that Brent Engel has joined C.W. Henderson to enhance our credit research effort. Brent is a 2005 graduate of the University of Richmond. Prior to joining us he worked in the investment banking group at Lehman Brothers and as an analyst at Citadel Investments. Brent is working with Dan Thorpe to review potential new bond purchases, monitor existing holdings in client portfolios and review bonds received in newly opened accounts. Credit research is fundamental to our risk management process. We are delighted to have Brent on board.

Craig W. Henderson **Thomas L. Mallman, CFA**