C.W. HENDERSON & ASSOCIATES, INC.

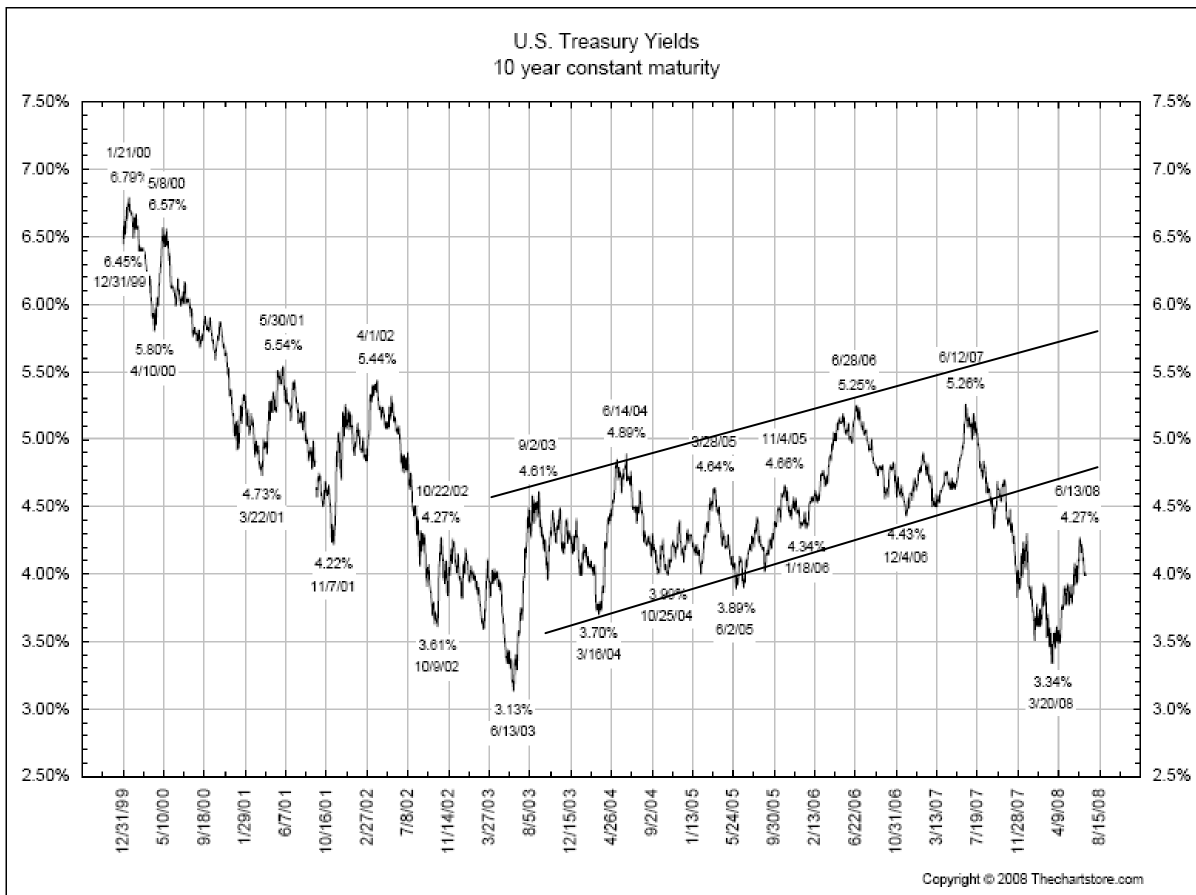
Investment Managers Specializing
in Tax-Exempt Municipal Securities

July 2008

- **Background and Outlook**

The fixed income markets settled down to some degree during the second quarter. Treasury rates moved irregularly higher from the late March lows as investors regained a degree of confidence and allocated some funds away from the safe harbor government market. As shown in the accompanying chart, the ten year Treasury yield rose from the 3.34% low reached in late March to 4.27% in mid June. Sharp declines in the stock market late last month again prompted Treasury buying and the yield on the ten year note fell to near 4% at the close of the quarter.

Data as of July 3, 2008

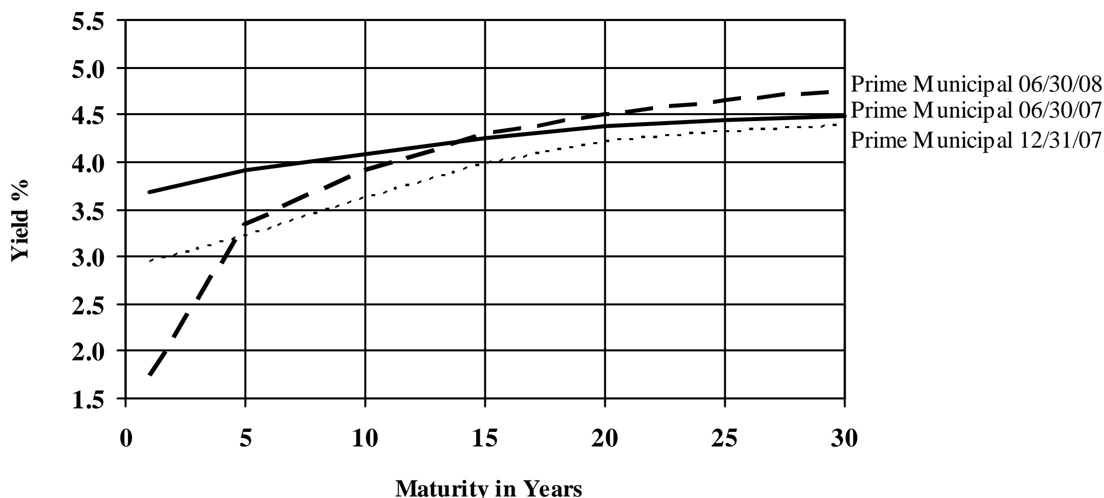


In contrast, municipal rates generally moved sideways during the quarter as demand for tax exempt securities offset, to some extent, concerns over the continued illiquidity of several auction rate programs, additional bond insurer downgrades and concerns over possible municipal government budgetary imbalances in the sluggish economic environment. New issue volume rose sharply from the $85 billion level in the first quarter which brought the six month total to just slightly below the record $231 billion sold in the first half of last year. Prime municipals remain attractive relative to Treasuries with five and ten year tax-exempt yields near 100% of like maturity Treasury rates. These ratios are lower than in February and March when the prime municipal yield curve was above the Treasury curve in all maturities, but current tax-exempt yields remain at very attractive levels relative to governments.

The Federal Reserve lowered the target Federal Funds rate in late April which brought the rate to 2.0%, down from 5.25% last summer, in response to continued sluggish economic activity, the overhang of subprime mortgage debt, and severe stress in the financial sector (e.g. Bear Stearns). They declined to lower the rate again at the late June FOMC meeting, noting their concern over rising inflation both in the U.S. and internationally. We anticipate that price pressures will remain above the Fed's comfort range in the coming months due to high food and energy price pressures. However, a sharp acceleration in the price indices is not anticipated while declining non-farm employment and rising unemployment limit wage increases.

We anticipate, at best, sluggish economic growth in the coming months as the burden of high energy costs and falling home values limit discretionary consumer spending. This is not an environment that is likely to cause interest rates to move significantly higher, despite somewhat uncomfortable inflation levels. The potential for higher tax rates with a new administration and demand for tax-exempt income from retiring baby boomers should keep demand for municipals strong. We are therefore maintaining portfolio durations at modestly extended levels and acquiring high quality bonds as attractive securities become available.

Municipal Yield Curve Shifts



- **Global Credit Ratings?**

Ratings are intended to provide credit quality differentiation among issuers. To some extent, separate systems have been used for corporate, municipal, international, etc. ratings. This approach has recently been challenged by several municipal officials who feel that state and local credits are being unfairly rated in many instances where municipalities are assigned lower ratings than corporate entities that have higher default risk. They allege that lower ratings drive up borrowing costs and/or prompt municipal officials to pay for insurance. They are demanding that a more universal approach be taken in the assignment of ratings. Rep. Barney Frank, Chairman of the House Financial Services Committee, recently introduced a bill that would require rating agencies to assign ratings for all securities on the basis of default risk.

It is assumed that the institution of a global rating system would prompt upgrades in the ratings of several municipalities with many moving to AA and AAA levels. Whether this will truly reduce municipal borrowing costs is uncertain. Yield levels that prompt investors to purchase specific securities are based, to a significant extent, on ratings, but are also influenced by the frequency that an issuer sells debt (liquidity factors), state income taxes, structural features such as calls, puts, sinking funds, etc.

If ratings become truly global the agencies will have to not only consider municipal and corporate debt comparisons, but also differentiate between structured securities, international debt, etc. Are the credit factors associated with the State of California directly comparable to those of General Electric, or a foreign country's sovereign debt, or a credit card receivables asset backed security? Regardless of how the rating agencies move forward, our approach to security selection will continue to focus on high quality securities (as reflected in ratings and our evaluations), liquidity characteristics, structural features and price.

- **Further Pressure on Bond Insurers**

During the quarter AMBAC, FGIC, MBIA, CIFG and XLCA all suffered rating downgrades by one or more of the rating services. In addition, Radian had its rating withdrawn by Fitch. Berkshire Hathaway Assurance Corp. is a new entrant into the field and has secured AAA ratings by Moody's and S&P. Current ratings are shown in the following table:

	Moody's	S&P	Fitch
AMBAC	Aa3 Negative	AA Negative	AA Negative
FGIC	Baa3 On review	BB Negative	BBB Negative
FSA	Aaa Stable	AAA Stable	AAA Stable
MBIA	A2 Negative	AA- Negative	AA Negative
ACA	NR	CCC	NR
Assured Gty	Aaa Stable	AAA Stable	AAA Stable
CIFG Assurance	Ba2 Under Review	A- Negative	CCC Evolving
Radian	Aa3 Negative	AA Negative	Rating Withdrawn
XLCA	A3 Negative	BBB- Negative	BB Negative
Berkshire	Aaa Stable	AAA Stable	

Most of the insurers carried AAA ratings before exposure to subprime asset backed securities eroded their capital positions. Given the numerous downgrades, it is questionable how much reliance investors will put on insurance going forward. Further, if global ratings emerge and many municipal credits are upgraded, there will be even less need for state and local treasurers to look to insurance to lower net interest costs.

- **Auction Rate Update**

Failed auctions in the early part of this year left about 70% of the $330 billion market illiquid. Municipalities have been refinancing their securities, but only minimal progress has been made on restructuring preferred shares of closed end municipal funds. Several large fund companies have been working to replace auction rate securities with variable rate demand notes that can be redeemed through a put rather than being subject to the uncertainty of Dutch Auctions. This restructuring would make the securities money fund eligible which would dramatically enhance liquidity. However the process is moving very slowly and only a fraction of the $60+ billion of these preferred securities have been redeemed thus far. We anticipate that progress will continue to be slow and that many auction rate investors will have to deal with illiquid securities for an extended time unless they are willing to sell holdings at prices significantly discounted from par.

- **Kentucky Case**

On May 19 the Supreme Court ruled 7 to 2 in favor of the Commonwealth of Kentucky and preserved the tax rules of forty-two states that exempt income from in-state municipal bonds but tax income from out-of-state municipals. The opinion stated that the existing practice was an important method for the commonwealth to raise capital for needed public projects and invest in public works that benefit its citizens. It was further stated that the commonwealth's action did not discriminate against out-of-state entities (the commerce clause in the U.S. Constitution that was the basis for the suit), but rather that the tax policy had the effect of favoring the commonwealth and local governments by providing lower borrowing costs for public projects. It was concluded that a ruling that found Kentucky's actions unconstitutional would have represented judicial interference with the commonwealth's sovereignty and its relations with its citizens.

- **Firm News**

We are pleased to announce additions and changes to the C.W. Henderson & Associates team. David Beck joins us from Bear Stearns where he spent twenty-three years and was the head municipal trader in the Midwest. In addition, Dave oversaw new issue underwriting in thirty-three states. His market acumen, knowledge of credits and ability to discern value will provide significant depth to our trading operation. Matt Andrews has moved to the trading desk where he will work with Dave and Monika Bhasin and focus on account reviews and strategy implementation. Shannon McGorry has taken Matt's place on the client service team. Shannon recently graduated from Miami University in Oxford, Ohio where she majored in finance. We are delighted to welcome Dave and Shannon to our team. With these additions we feel that we are well positioned to continue to grow and provide current and future clients with excellent investment service. As always, we appreciate the support and confidence of our clients and friends.

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

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