- **Background and Outlook** **July 2009**

The employment picture continues to deteriorate, but there are a few signs suggesting that the economy may be groping for a bottom. Industrial production, while still declining, is contracting at a slower pace, auto sales are showing signs of bottoming and housing starts, while at very depressed levels, appear to be stabilizing. However, any recovery, if and when it develops, is likely to be modest at best. High unemployment and limited (if any) wage gains will continue to impact consumer sentiment and spending. In addition, cratered retirement savings accounts and depressed housing values are likely to foster continued high savings rates. With consumers on the sidelines there is little incentive for businesses to meaningfully expand industrial production or add to inventories while reduced risk appetites and tightened lending standards are expected to curtail business formations.

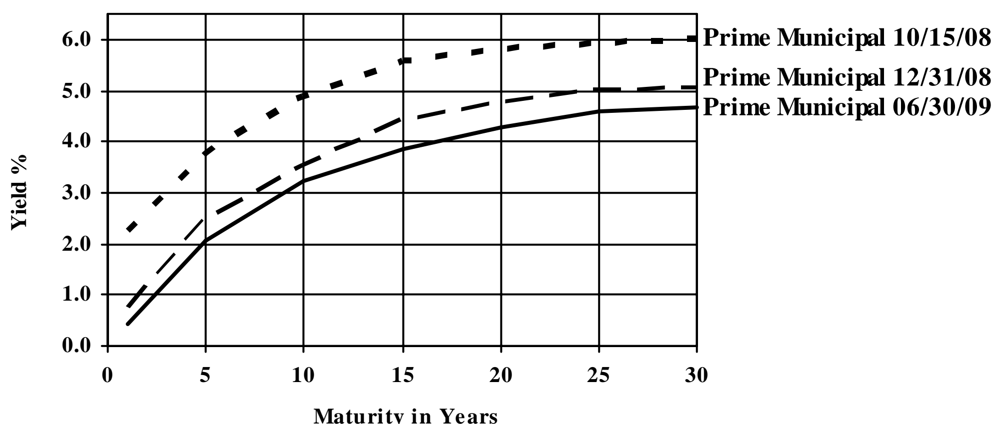
The Federal Reserve is expected to remain very accommodative in this environment and keep short rates near zero for the foreseeable future. In addition, the Fed has indicated that it intends to continue its program of purchasing up to $1.3 trillion longer Treasury and mortgage backed securities. The objective of this effort is to keep mortgage rates low to stimulate refinancing activity and, hopefully, entice first time home buyers. As shown in the attached graph, courtesy of The Chart Store, ten year Treasury yields ranged from 2.08% in late December when the flight to quality was pervasive, to an interim high of 3.98% last month. A broad trading range between three and four percent seems possible over the near term as investors monitor economic developments while balancing risk aversion with the desire for acceptable returns.

Longer term we feel that interest rates will be biased towards irregularly higher levels as the Treasury continues to market huge amounts of debt needed to finance federal deficits that are forecast to total $1.8+ trillion this year and exceed a trillion dollars annually for the next several years. Inflation does not appear to be a near term concern given the weakness in the economy, but could become an issue in a year or two as monetary velocity accelerates in conjunction with increased economic activity. As shown in the table below, ten year prime municipal yields are currently at about 92% of like maturity Treasuries, sharply reduced from the extreme ratios that existed last fall when the flight to quality drove Treasury rates dramatically lower while municipal yields moved higher.

	10/15/08	**12/18/08**	**3/30/09**	**6/30/09**
10 Year Treasury	4.02%	2.08%	2.66%	3.53%
10 Year Municipal	4.86%	3.85	3.18	3.24
Ratio	120.9	185.1	119.5	91.8

With the muni/Treasury yield ratio now at a more normal level, any pressure on Treasury yields should also be reflected in the municipal sector. Rising tax rates may temper the movement towards higher municipal yields, but tax-exempts will not be immune should the general level of interest rates move higher. We continue to target portfolio durations at slightly over four years as we have for the past several months. Durations were reduced early this year after yields declined from the extended levels that prevailed late last fall. Signs of economic strengthening or whiffs of inflation would likely prompt us to move durations lower.

Municipal Yield Curve Shifts



- **Build America Bonds – Larger Market Presence Than Anticipated**

As noted in our last newsletter, the federal stimulus package enacted earlier this year included a provision wherein state and local governmental entities can issue taxable securities this year and next and receive a 35% interest expense rebate from the federal government for the life of the bonds. We initially thought that these Build America Bonds (BABs) would have a limited reception from taxable investors. We expected that taxable buyers' general unfamiliarity with municipal credits and their aversion to small issues with serial maturities and restrictive call provisions would seriously limit their appeal.

So far we have been wrong! Through last month 130+ BABs issues have been marketed with a combined market value of about $15.3 billion. The State of California's $5 billion issue was by far the most significant sale while another fifteen issues were larger than $100 million. The remaining issues have been relatively small. All of the large issues were structured with one or two long bullet maturities, typically in twenty-five or thirty years. In contrast, many of the smaller sales were structured with conventional, intermediate serial bonds.

The appeal to issuers arises from the fact that long municipal yields exceed Treasury rates. Bond funds, casualty insurers and hedge funds are the primary buyers of long municipals. Bond funds have recently experienced cash inflows, but other institutional buyers have largely been on the sidelines. Individual investors, the current major buyers of tax-exempts, tend to focus on ten year and shorter maturity bonds.

In late April the New Jersey Turnpike Authority sold $1.38 billion BABs that mature in 2040 at a yield of 7.41%. After the 35% rebate the net cost to the Authority is 4.82%. At the same time the Authority sold a $375 million tax-exempt issue which was structured with a portion of the bonds maturing in 2040 that were priced to yield 5.35%. The apparent net savings by using BABs was 53 basis points. However, the tax-exempt bonds were structured with a ten year call whereas the BABs are non-callable. The value of the call is debatable, but has been estimated to be worth as much as thirty or more basis points, potentially diminishing the apparent savings attributable to BABs.

BABs sales are continuing and estimates suggest that these vehicles could represent 15% or more of the municipal market this year and next. Whether they remain viable financing vehicles longer term remains to be seen. The rebate program will have to be extended by Congress beyond next year which at this point is uncertain. It is expected that marginal tax rates will be increased late next year, probably back to 39.6%. Increased demand for tax-exempt securities as tax rates rise is likely to cause the municipal curve to shift downward to some degree relative to the taxable curve which would diminish the advantage of taxable financing if the 35% rebate is maintained. Further, municipalities could become wary of depending on the federal government for rebate subsidies for twenty-five or thirty years. Rebates are considered tax refunds and therefore not subject to annual appropriations. However, might BABs' interest subsidies precipitate reductions in aid grants or other revenue sharing programs? Indenture provisions could also be complicated as the full cost of the taxable interest expense must be included in calculating debt service coverage ratios, additional bonds tests, etc. For now BABs issuance is relatively strong, but the future is uncertain.

- **Credit Issues Intensify**

Almost every state is facing severe fiscal pressure as income, capital gains and sales tax receipts fall while demands for services increase as unemployment moves higher. With sharply reduced revenue projections, municipal officials are downsizing workforces, eliminating services and, where possible, imposing higher user fees and selected taxes. Crunch conditions are expected to continue in 2010 and possibly longer as unemployment moves higher.

California's challenges are especially acute. Faced with a $26+ billion (and growing) fiscal 2010 deficit in a $92 billion general fund budget, the governor and legislature are scrambling to find additional revenues and slash expenditures. The state is honoring priority payment obligations (debt service falls in this category along with aid to schools, Medicaid payments, salaries, etc.) but has resorted to IOUs for non-priority items (vendor payments, tax refunds, certain social programs, etc.)

Fitch Investors Service recently reduced their State of California credit rating to BBB. Moody's and Standard & Poor's continue to rate the state single A, but all of the agencies have negative outlooks.

States cannot declare bankruptcy and, given that California is the 8th largest economy in the world when viewed on its own, it is clearly "too big to fail." There is no option other than for the state to develop a plan to gain control over its budget. The process will continue to be contentious, painful and extremely difficult, but in the end there is no alternative to a workable plan. Washington may be asked for assistance, but we expect that the federal government is unlikely to be supportive. The U.S. Treasury is dealing with a gaping deficit and is likely to be hesitant to expand it, especially given that significant aid has already been provided to the states through the stimulus program. Also, if California is given assistance, how many other governors and mayors will be close behind with similar requests?

Municipalities are monopolies that do not go away. They must continue to function and provide essential services to their constituents. Fiscal responsibility is critical for these entities to function effectively. Having access to the capital markets to raise funds for interim cash flow financing and long term capital projects is also critical. That access will be denied unless municipalities honor debt service payments on their outstanding obligations. Budgets will continue to be strained for the foreseeable future, but we feel that responsible governmental officials will take the painful steps necessary to maintain fiscal integrity as the recession drags on.

- **Firm News**

Municipal budget stress has prompted us to enhance our credit oversight. We continue to feel that the rating agencies do a credible job reviewing basic credit factors such as debt levels, tax collections, debt service coverage ratios, etc. Recessions always create budgetary challenges and the current downturn is proving to be the most extreme in the post WWII period. Our focus on using AAA and AA rated credits has intensified and we are closely monitoring single A exposures. In addition, we are pleased to report that Michael Belsky, who recently left as the head of Fitch Investors Service to join the six member Governmental Accounting Standards Board, has joined us as a consultant to perform a comprehensive review of client account holdings. In addition to reviewing basic credit factors, emphasis is being given to derivative exposures along with funding levels of pensions and other post employment benefit obligations. Minimizing credit risk remains a primary objective of C.W. Henderson & Associates. Thank you for your continued confidence and support.

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