The Investor's Edge

C.W. HENDERSON & ASSOCIATES, INC.

Investment Managers Specializing in Tax-Exempt Securities

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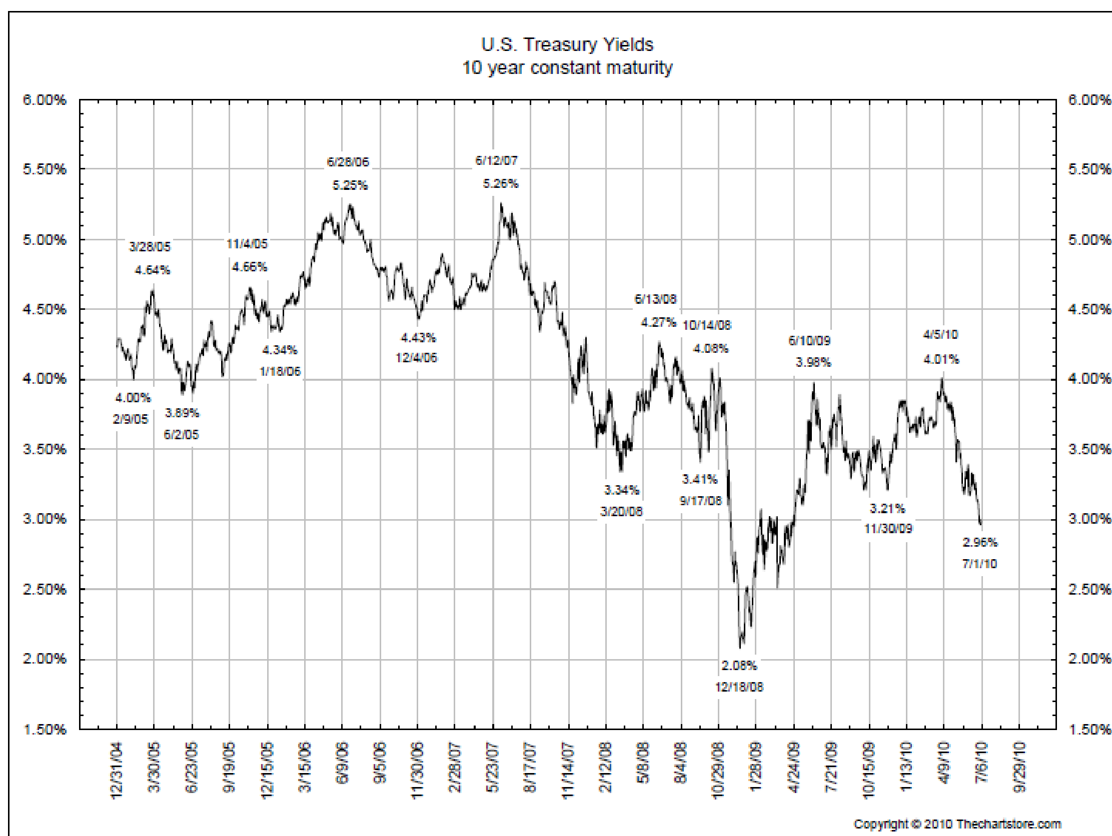
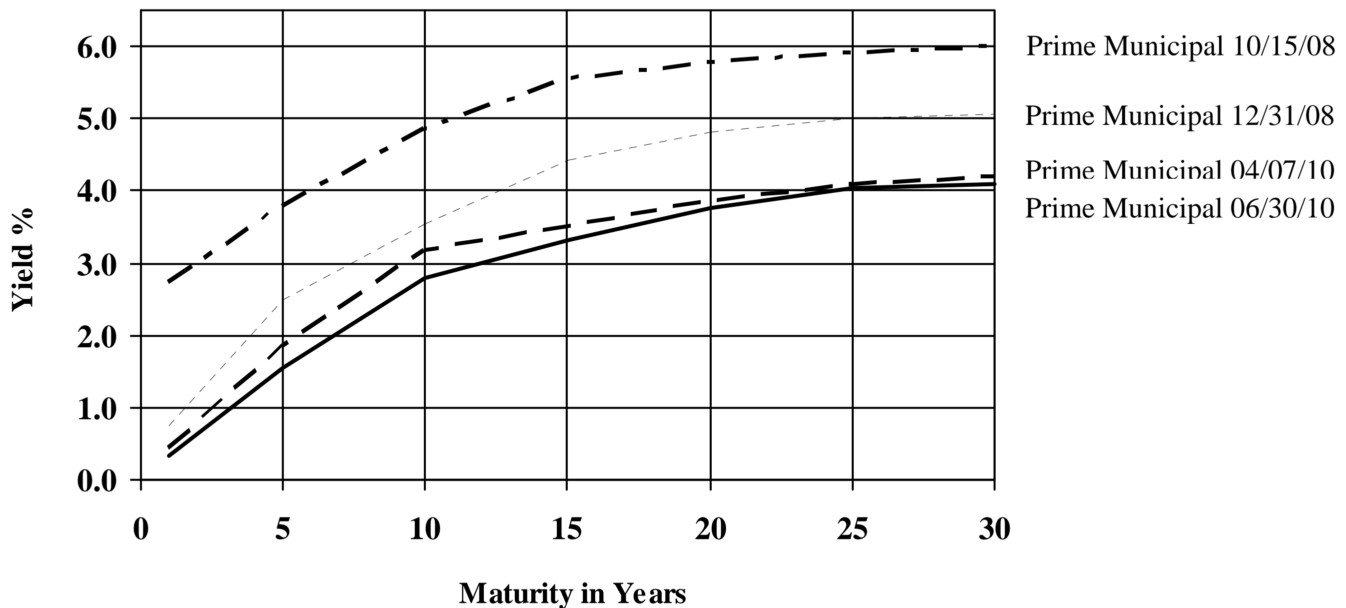
BACKGROUND AND OUTLOOK

The yield on the ten year Treasury closed the quarter below 3%, down from over 4% in early April. Investor preference for the safety of the U.S. Treasury market was initially prompted by concern that the Greek debt crisis would spread to other European countries and possibly broaden even further. Investor skittishness was intensified by uncertainty over the impact of the Gulf oil spill and signs of sluggish U.S. economic activity. The U.S. domestic economy remains burdened with high unemployment, tepid, if any, wage gains, limited demand and a depressed housing market. The expectation of higher taxes and an expanded regulatory environment further cloud the picture. We anticipate that the economic recovery will continue but remain muted with perhaps two to three percent RGDP growth in the coming quarters. Limited demand and a lack of pricing power should keep inflationary pressure at bay and the Federal Reserve on hold for the balance of the year if not longer. Low short rates and a steep yield curve are expected to persist near term.



As is typical, municipal yields followed the Treasury market during the quarter, but the drop in tax-exempt rates was more subdued. Whereas the ten year Treasury yield fell by over 1%, municipal rates dropped by a more modest 40 basis points during this period. As reflected in the following yield curve chart, municipal rates fell significantly in late 2008 and most of last year but have subsequently remained in a relatively narrow band. End of June yield levels are essentially the same as those that existed at the end of last year.

Municipal Yield Curve Shifts



Strong demand for tax-exempt income will persist as investors seek alternatives for near zero yielding cash reserves and a shelter from increasing tax rates. Firmness in the municipal sector is being bolstered by the reduced supply of tax-exempt paper as taxable Build America Bonds command a significant component of the new issue calendar. With prime ten year tax-exempt municipals yielding close to 90% of Treasuries, the tax-exempt market is attractive on a relative basis. However, absolute rates remain low which prompts a degree of caution. Signs of stronger than expected growth or evidence of kindling inflation could send rates abruptly higher. We therefore continue to target portfolio durations at 3.8 years, modestly below our 4.2 year norm.

Build America Bonds Update

During the first half of the year $200 billion new municipal bonds were sold with BABs representing $50.9 billion of that total. Since the program was initiated in the spring of last year, BABs issuance has exceeded $100 billion. The 35% interest expense rebate paid by the U.S. Treasury has provided municipalities that issue BABs with reduced financing costs.

The program currently has a December 31 sunset. In May the House passed the American Jobs and Closing Tax Loopholes Act which included a two year BABs extension, but with a reduction in the rebate rate to 32% in 2011 and 30% in 2012. Legislation is currently stalled in the Senate where it has been tabled due to deficit concerns. We expect that action will be taken prior to year end to allow for continued BABs financings, but the program's future is currently uncertain.

Other issues also cloud the BABs outlook. There have been charges that some municipalities have borrowed excessively to take advantage of "cheap" financing. Moody's Investors service recently reported that state tax supported debt increased 10.3% in 2009, more than double the 5.1% and 4.7% increases in 2007 and 2008. Moody's noted their concern that increased debt service expenses associated with a debt buildup could potentially reduce issuers' ability to pay other bills and, over time, burden available resources.

It has been suggested that some BABs issues were underwritten with higher than necessary yields as evidenced by bonds trading higher in the secondary market shortly after being issued. Reports of "flipping" have prompted the IRS to announce that they intend to audit selected issues. Given that BABs were a new financing vehicle last year and that demand from institutional buyers not familiar with the municipal market was uncertain, it is not surprising that early issues, at least, were priced to sell.

Instances have arisen where portions of BABs rebate subsidies have been withheld by the U.S. Treasury. These situations have risen in cases where a municipality owes the federal government money in conjunction with other programs such as Medicaid, transportation funding, etc. This "netting" process prompted the State of Florida to recently suspend BABs sales. The state previously issued $1.4 billion BABs in 2009 and early this year with expected rebate payments from the federal government over the lives of these bonds totaling $600 million. The Government Finance Officers Association has indicated that numerous other borrowers have expressed concern over the netting uncertainty.

Future BABs Issuance?

Under normal circumstances the tax-exempt yield curve is steeper than the Treasury curve as investors seek compensation for call risk, downgrade risk and the possibility that tax law changes could lessen the appeal of the tax exemption provided by municipal securities. Ten year prime municipals typically yield 80% to 85% of Treasuries while thirty year tax-exempts trade at 90+%, and at times, over 100% of the Treasury yield. Most BABs have been structured with long maturities where the reduction in interest expense is most advantageous.

A recent example illustrates the interest cost advantage issuers are currently finding with BABs financings. Last month Cook County, IL (Aa1/AA) sold $165 million tax-exempt bonds and $308 million BABs, both with 6-23-2010 dated dates. The tax-exempt securities mature 11-15-2033 and were structured with a 5.25% coupon and priced at 104.393 to yield 4.71%. The BABs mature 11-15-2034 and were priced at par with a 6.229% coupon. Assuming the 35% rebate from the U.S. Treasury is not encumbered with offsets, the net yield on the BABs is 4.05% which represents a significant 66 basis point advantage relative to the tax-exempt pricing.

When call features on the two issues are compared, the BABs advantage decreases. The tax-exempt sale was structured with a ten year par call while the BABs have a "make whole" call feature. If the BABs are called, Cook County would have to compensate investors at a premium price that discounts all future interest payments at the prevailing Treasury rate at the time of the call plus 35 basis points. This could result in a huge call premium. At current levels, all of the future 6.229% coupon payments out to 2034 would have to be discounted at roughly 4.35% to calculate the call premium. In instances where parallel BABs issues were sold, one with a stated ten year call and one with a make whole call, issues with ten year calls have required 40 to 45 basis points of additional yield to stimulate demand.

Rising marginal tax rates next year should cause tax-exempt yields to decline to some degree relative to taxable rates as the value of tax sheltered income increases. Coupling this effect with a reduction in the BABs rebate rate, as proposed in the House bill, is likely to reduce the appeal of BABs financings. In the Cook County example discussed above, a 30% rebate rate would adjust the net yield to 4.36% from 4.05%. Should the municipal curve also decline by thirty basis points relative to the taxable curve due to higher tax rates, the BABs advantage disappears. It seems likely that BABs issuance will decline after this year.

Pension Plan Changes

With operating budgets under pressure it is becoming increasingly difficult for many municipalities to make required pension fund contributions. The problem has been compounded by declines in plan asset values and the realization that plan return assumptions are, in many instances, too high. These realities, coupled with growing public dissatisfaction over income disparities between public and private workers, are forcing municipal officials and unions to reexamine existing contracts. Illinois has reduced benefits and increased the eligible retirement age for new employees while New Jersey, Vermont, Iowa, Minnesota, California, Colorado and Wyoming are working to pare benefits to existing as well as new employees. Higher employee contributions, lower cost-of-living adjustments, increased age and service requirements, inability to "double dip", etc. are being discussed. We expect that negotiations will be confrontational and arduous but in most cases necessary adjustments will be agreed upon that maintain the integrity of existing plans.

FIRM NEWS

We are pleased to announce that Dan Thorpe has joined C.W. Henderson to enhance our credit research effort. Dan completed his MBA at the Kelley School of Business at Indiana University this spring. Prior to graduate school he worked for five years as a municipal bond trader and analyst in Boston. He received his Bachelor of Arts in Economics from Boston College in 2003. Dan is working closely with Mike Belsky who joined the Firm on a contract basis in early 2009 after leaving Fitch Investors Service. Mike has developed a more formalized approach to our credit research effort which will be further enhanced with Dan on board. Mike's other professional endeavors include membership on the Governmental Accounting Standards Board and serving as Mayor of Highland Park, Illinois. Maintaining high credit quality in client portfolios is fundamental to our investment management process. Dan will add to the integrity of that process.

Craig W. Henderson   Thomas L. Mallman

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