The Investor's Edge

C.W. HENDERSON & ASSOCIATES, INC.

Investment Managers Specializing in Tax-Exempt Municipal Securities

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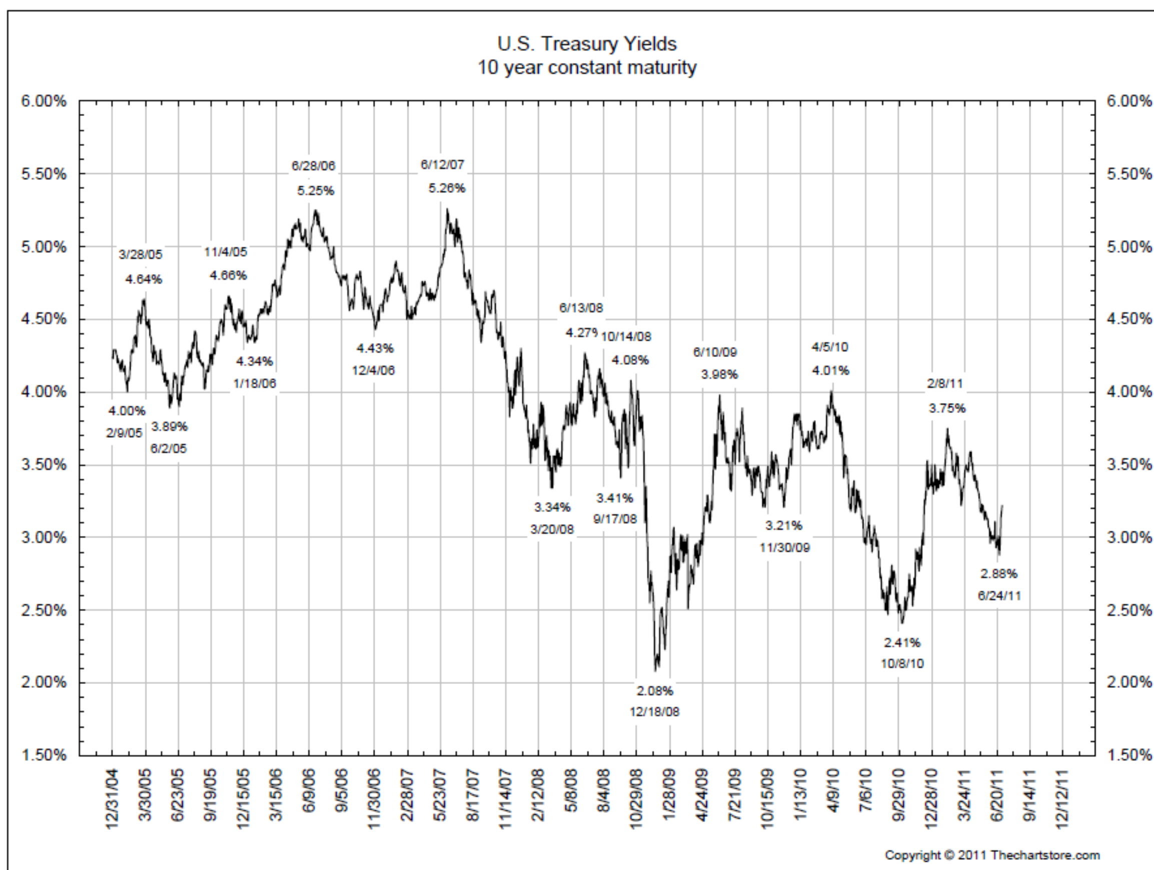
- **Background and Outlook**

Evidence that the economy is continuing to struggle, coupled with a flight to quality in reaction to the Greek crisis, caused interest rates to decline from early February until late June. As reflected in the attached chart, the ten year Treasury yield fell by close to 90 basis points before moving back above 3% at quarter end.

Data as of July 1, 2011



The bond market has also been supported during the first half of the year by the Federal Reserve's second quantitative easing program that absorbed an additional $600 billion Treasuries, approximately 75% of the recent net new issuance. The program ended June 30, but Chairman Bernanke has indicated that a reduced level of support will continue with the Fed reinvesting proceeds from maturities.

Hopefully the current debt limit budget negotiations will result in a long term plan to curtail federal deficits. Still, with trillion dollar plus shortfalls forecast for the foreseeable future, it is uncertain if continued massive government securities sales can be successfully marketed without the inducement of higher interest rates. We would therefore not be surprised by a trend towards higher rates, although flights to quality and the economic drags of high unemployment, housing sector weakness and continued deleveraging could limit any upward rate advance.

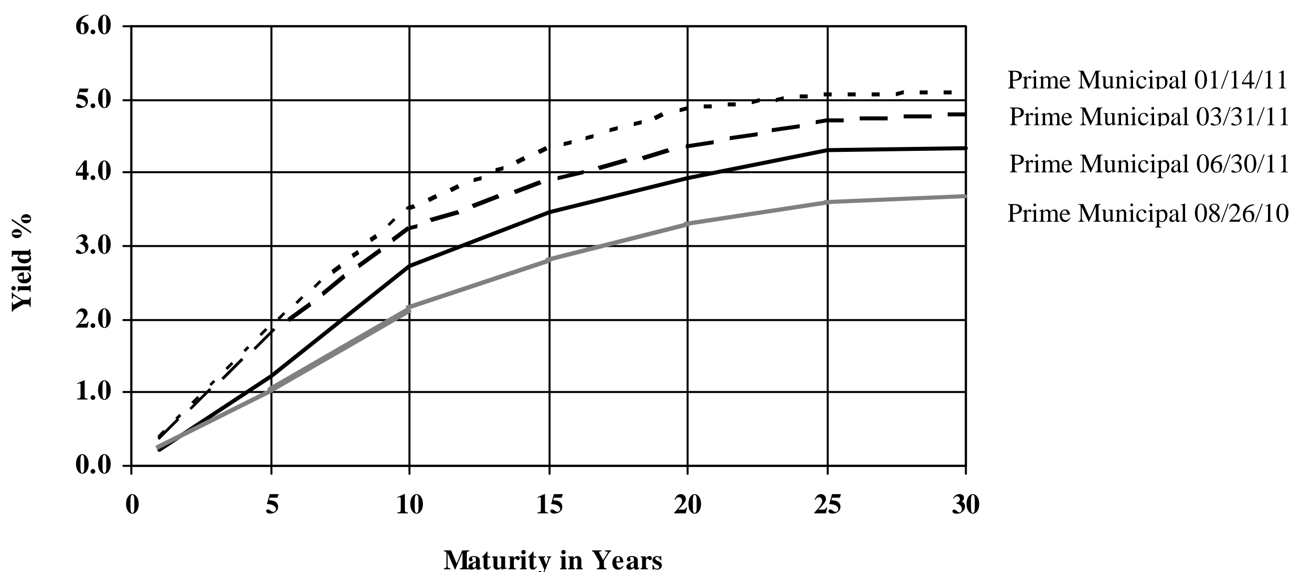
Non-existent real returns at current Treasury yield levels could also prompt investors to demand higher returns. The 3.6% year-over-year rise in the CPI through May overwhelms the current 1.47% yield on the five year Treasury and is also meaningfully above the 2.90% ten year Treasury yield.

The Fed has indicated that monetary ease will remain in place with the targeted Federal Funds rate near zero as long as the economy remains sluggish. The short end of the yield curve will therefore remain anchored and extreme steepness in the yield curve is expected to persist.

As shown in the accompanying yield curve chart, prime municipal rates moved lower during the quarter in consort with the Treasury market and in response to sharply reduced new issuance which, at $115.2 billion, was 44% lower than in the first six months of 2010. Some increase in volume is anticipated in the coming months as municipal officials deal with infrastructure needs, but the supply of new bonds this year is certain to be drastically lower than the $433 billion sold in 2010. The high and low yield levels experienced during the past twelve months are also displayed on the chart reflecting the trading range experienced during the period. Longer maturity bond yields fluctuated within a 150 basis point range.

Low nominal yield levels and uncertainty in the post QE2 environment prompts us to maintain our modestly defensive posture. Portfolio durations remain targeted at 3.6 to 3.8 years, about 10% below neutral.

Municipal Yield Curve Shifts



- **Lure of a Steep Yield Curve**

The combination of minimal returns on short term fixed income investments and a steep yield curve have prompted some investors to consider extending maturities. We feel that this would be unwise. Consider

the current yield curve in relation to the curve that existed four years ago before the financial meltdown. Credit concerns, uncertainty over future tax rates, etc. have kept long rates from declining while short rates are dramatically lower. The Federal Funds rate in mid 2007 was 5.25% and the yield spread between one and thirty year maturity prime tax-exempts was 80 basis points. The current prime municipal curve has a one to thirty year spread of 411 basis points.

	6-30-11	6-30-07
1 Year	0.23%	3.69%
5 years	1.23	3.91
10 years	2.74	4.09
15 years	3.47	4.26
20 years	3.94	4.38
25 years	4.30	4.45
30 years	4.34	4.49
1 to 30 yrs	411 bp	80 bp

Lower coupon bonds have longer durations and, therefore, greater volatility potential and downside price risk should rates rise. In June 2007 the respective modified durations of five and ten year maturity prime bonds were 4.46 and 7.99 years. Current durations on like maturity securities are 4.80 and 8.56 years. Par bonds, purchased at current levels would experience price declines (including the de minimis impact) of about 7% and 10+% should the yield curve shift higher by 100 basis points. A thirty year bond, with a duration of 16.7 years. would experience a significant double digit price decline. A move of this magnitude, or larger, along the entire yield curve would not be surprising.

With the Fed Funds rate at close to zero, it cannot move lower and the next move will therefore, at some point, be to higher levels. In turn, much of the yield curve will also move higher. This may not happen for some time, but the risk is obvious and supports our cautious posture. Adding value through the use of high quality, short effective duration bonds with attractive structures (high coupon bonds with short calls and fifteen to eighteen month maturity bonds that roll down the yield curve) provides a more conservative approach to fixed income management.

- **Municipal Budgets Outlook**

Almost all states and many local municipalities began new fiscal years this month with some having slightly more positive outlooks. State revenues rose by over 9% during the first quarter on a year-over-year basis as tax increases enacted in 2009 and 2010 and the improving economy led to higher income and capital gains tax receipts. Unfortunately, local governments did not fare as well with property taxes, which they are more directly dependent on, falling by 1.7% during the quarter. Recent local government revenues have generally been flat.

The need for fiscal prudence at all levels remains paramount. States are faced with the loss of fiscal stimulus funds while Medicaid expenses are rising. Local governments need to deal with additional property tax declines and reduced state aid. Municipal officials continue to respond with budget cuts and targeted revenue enhancements. Approximately 350,000 municipal employees (1.8% of the total work force) have been cut since the beginning of last year. A National Association of State Budget Officers survey indicates that fifteen states are planning additional labor force reductions this fiscal year and eleven other states are in the process of reducing workers' salaries. Other expense reductions include the closing of non-essential and recreational facilities while various revenue enhancements (toll and user fees increases, higher tuitions at state universities, etc.) have been put in place.

Wisconsin and Ohio have been prominent in the media as legislation was enacted in those states that increased public employee pension and health care contributions and severely curtailed worker bargaining rights. In addition, Minnesota and Colorado have enacted legislation that would reduce retiree cost of living adjustments while New Hampshire and Missouri are advancing right-to-work bills that would allow private sector workers to opt out of unions. The New Jersey legislature passed a bill that reduces pension and health care benefits and Massachusetts lawmakers enacted legislation that would provide local municipalities with increased latitude to force employees to pay more for medical coverage. We anticipate that additional efforts of these sorts will be forthcoming in the months ahead as states and local governments continue to grapple with budgetary challenges.

- **Are Build America Bonds Dead?**

We think so, but proposals continue to be raised in Congress in conjunction with budget negotiations. Most recently, Rep. Sander Levin from Michigan, the ranking minority member of the Ways and Means Committee, indicated in a floor speech that the BABs program should be extended to promote economic growth and jobs creation. It appears that there is limited appetite to resurrect the BABs program in Congress, but with fluid budget negotiations underway there could be surprises.

A cloud over BABs has risen in regard to related party purchases; situations where a public pension fund or state lottery might purchase a Build America Bond issued by its state or local municipality. The question arises as to whether the government entity has effectively loaned itself money with the federal government providing a 35% subsidy. Guidance is awaited from the Treasury Department and the Internal Revenue Service as to whether the subsidy would be extinguished. Since the purpose of municipal bond issuance is to provide funds for infrastructure development, such a transaction seems likely to be considered abusive.

- **Greek Contagion?**

Could a Greek default have a spillover effect on the municipal market? A direct impact appears unlikely. It is very doubtful that municipal pension funds hold Greek securities, but investments and/or letter of credit backed instruments issued by banks in strong European countries (Germany, France) are possible. The institutions, in turn, are likely to have Greek exposure. The largest concern might be in regard to money market funds that invest heavily in instruments with bank letter of credit backing. Many European banks are LOC providers and it is possible that some of these banks could be downgraded. Stand alone portfolios are a better option for large cash balances with intermediate liquidity horizons.

- **Firm News**

We are pleased to announce that Ben Rebecca, a recent graduate of the University of Illinois with a BA in Economics, has joined C.W. Henderson & Associates. He will be working with Clare Retrum, Rob Richards and Shannon McGorry in the Operations/Client Service group to assure operational efficiency and provide excellent client service. Welcome aboard.

Craig W. Henderson Thomas L. Mallman, CFA

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