*The Investor's Edge*

*C.W. HENDERSON & ASSOCIATES, INC.*

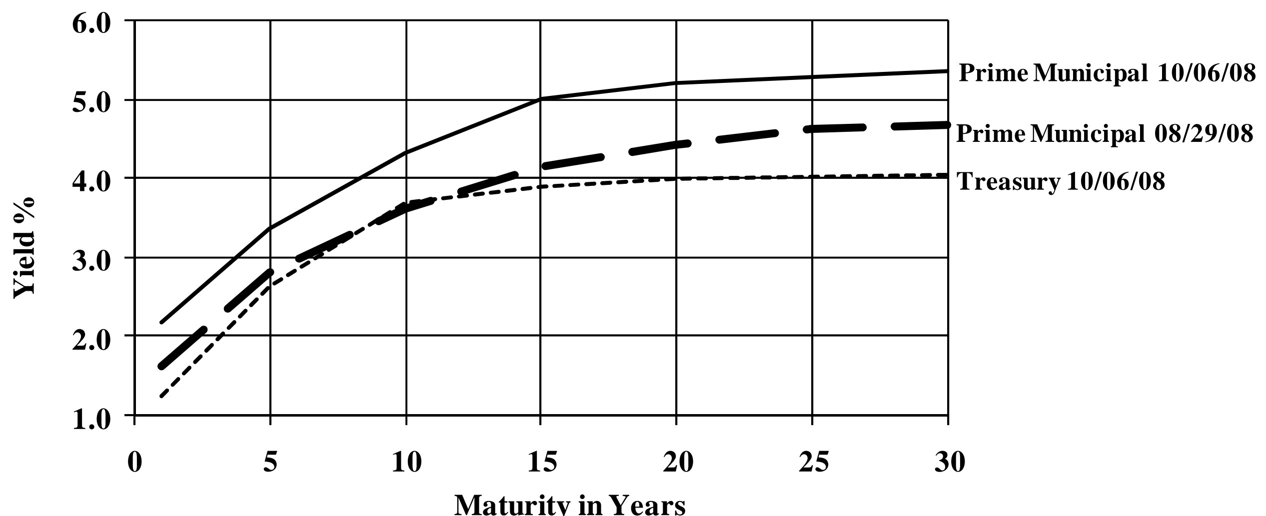
*Investment Managers Specializing*
*in Tax-Exempt Municipal Securities*

- **Background and Outlook** **October 2008**

The municipal market is again extremely cheap. Another dramatic flight to quality has caused Treasury rates to plunge while yields have risen significantly in essentially all other fixed income sectors. In February of this year the municipal Treasury divergence was prompted by auction rate program failures, imploding bond insurers and unwinding of municipal hedge fund strategies. At that time municipal yields exceeded Treasury rates throughout the curve and, at the peak spread, ten year prime municipals yielded close to 115% of like maturity Treasuries.

We're back there again - plus! The ratio of ten year prime municipal rates to Treasury yields is now approaching 125%! In addition to the problems noted above, we are now also coping with restricted liquidity precipitated by the failure of Lehman Brothers, the sales of Merrill Lynch and Wachovia, and the takeovers of Fannie Mae, Freddie Mac and AIG. Bank lending, commercial paper sales and other forms of short term financing have been sharply curtailed throughout the financial system. The "breaking of the buck" by the Reserve Fund caused investors to question the solvency of all but government money market funds and most tax-exempt and non-government taxable funds have experienced withdrawals. Tax-exempt variable rate demand notes that have one and seven day puts are now yielding above 5% while short Treasury yields are less than 1%. The longer municipal market has been severely pressured by the unwinding of tender option hedge programs that have suffered severe losses as high short rates and falling bond prices created negative spreads. As is shown in the accompanying chart, prime municipal rates are again above Treasury yields throughout the yield curve. The chart also reflects the increase in tax-exempt rates over the past month as investors moved to the sidelines. In contrast, intermediate and longer Treasury yields fell by forty or more basis points during this period.

**Municipal Yield Curve Shifts**



Where do we go from here? Our belief is that the credit markets will stabilize and liquidity will be restored over the weeks ahead as the Federal Reserve provides continuing support to the financial system. Increased FDIC guarantees, backing of money market funds, global coordination on lowering rates, etc. should ultimately restore some degree of confidence and prompt increased bank loans, commercial paper sales, etc. Improvements in the credit markets should, in turn, allow the debt markets to regain functionality, especially as the Treasury's reverse auction program becomes operational. Deleveraging and reestablishment of investor confidence will take time, but should evolve.

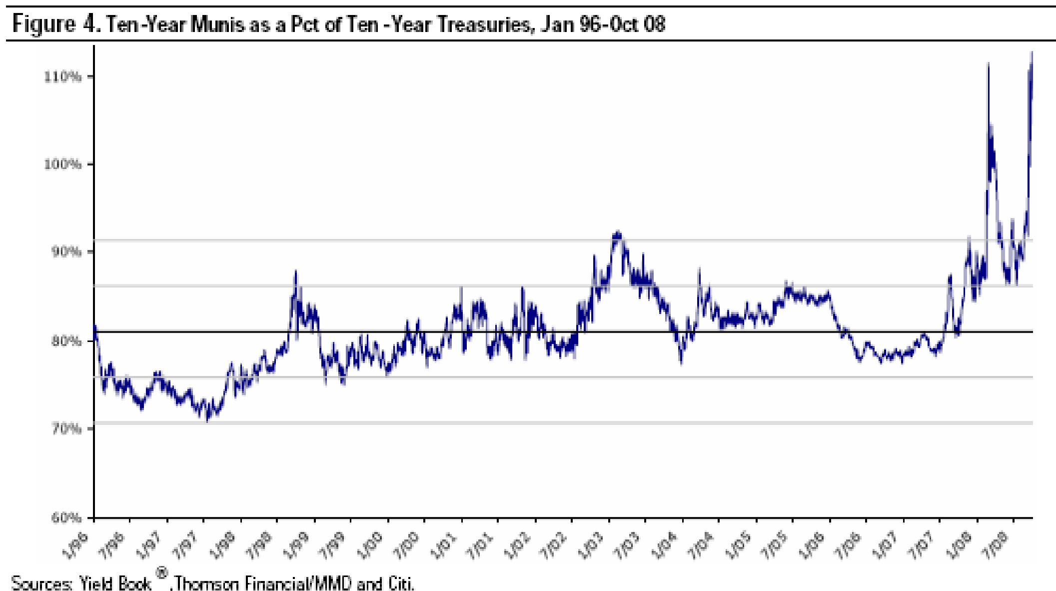
A recession now appears certain to be in the cards. Consumers who have been rocked by high energy prices and falling home values are now also facing the prospect of restricted wage gains and rising unemployment. Reduced domestic consumer spending coupled with limited global demand is impacting business formations, capital spending, R&D, etc. How long the downturn will last is unknown, but it could be protracted. Reduced economic activity, limited wage pressures and falling commodity prices will cause inflation rates to moderate, possibly substantially.

There will be additional spread widening as the economy contracts and credit pressures intensify, but rates on prime credits are expected to decline. Volatility is likely to persist while the markets grapple with unfolding developments. However, from both absolute and relative perspectives, high quality municipals appear undervalued. Restricted liquidity is providing attractive opportunities and we strongly feel that investors who look through the current uncertainty will be handsomely rewarded down the road. We are continuing to purchase high quality securities. Portfolio duration targets of about 4.5 years, slightly extended from neutral positions, remain in place.

- **Just How Cheap Are Municipals?**

As stated above, tax-exempts are extremely attractive on a relative basis and also, we believe, based on fundamentals. The following chart, courtesy of Citigroup and Thomson Financial, vividly illustrates the divergence of the Treasury and municipal markets.

Figure 4. Ten-Year Munis as a Pct of Ten -Year Treasuries, Jan 96-Oct 08




Sources: Yield Book®, Thomson Financial/MMD and Citi.

If a municipal to Treasury yield ratio of 90+% is considered to be a reasonable relationship, municipal yields would have to fall 100 or more basis points to reestablish this ratio. On the flip side, if municipal rates remain static, Treasury yields would need to rise by an even greater amount to reestablish a normal relationship. As the markets stabilize, we anticipate that an adjustment will take place, most likely with municipal rates falling.

Looking at the fundamental picture, we are seeing attractive fifteen year AA bonds with yields apporaching 5.5%. This equates to 8.50% on a tax equivalent basis using the current 35% federal tax rate. However, tax increases for high income earners are anticipated next year. Assuming a return to the 39.6% marginal tax rate (and tax rates could move even higher), the tax equivalent rate rises to 9.10%. If state taxes are a factor, the relative attractiveness of municipals becomes even more compelling. We anticipate that demand will build as investors focus on these relationships, especially retiring baby boomers making asset allocation shifts into fixed income.

- **Maintain Credit Quality Standards**

If an economic downturn develops as we anticipate, several municipalities will encounter budgetary shortfalls as tax and user fee revenues decline. Income, capital gains, excise and property taxes will all be under pressure. Forecasts indicate that FY 09 (most state and local governments are on June fiscal years) is looking difficult and 2010 could be an even greater challenge. Municipalities with significant exposure to the financial services industry are expected to be especially hard hit. Gov. Patterson has already commented on the need for budgetary restraint in New York State.

The current situation is indeed challenging, but not entirely new. Budgetary issues arise in every downturn and, although painful, are dealt with. Reduced capital spending, deferred maintenance, delays in pension fund contributions, reduced aid, curtailments in services, staff reductions, etc. are all measures that can be taken. Municipalities struggle during these periods, but most make the difficult decisions that lead to balanced budgets. The important point to remember is that major municipalities do not go away and must work through the difficult political process to achieve budgetary balance. The viability of municipal governments is dependent on access to the financial markets. Capital projects and other financings cannot be undertaken without investor support. Credible budgets are critical to this process.

Another possible tool is the use of public/private partnership transactions. These long term lease financings can provide significant up front revenues for municipalities that can be partially used to cushion revenue shortfalls. The sale of Midway Airport by the City of Chicago is the latest of these transactions.

Essential service revenue based enterprises may also undergo some pressure but, in most cases, they should weather the downturn reasonably well. Consumers may reduce travel, entertainment and other discretionary spending, but it is difficult to not pay electric or water bills. Likewise, smaller, more fuel efficient cars might be purchased, but for many, tolls cannot be avoided driving to and from work.

All this is not to suggest that credits need not be monitored. During times of stress it is vitally important that quality standards be maintained. We expect that additional credit issues will surface in the coming months. Our security selection process remains focused on using well established credits with defined revenue streams.

- **Auction Rate Security Update**

Last spring witnessed the failure of about 70% of the outstanding auction rate preferred programs as investors backed away from these securities when insurers were downgraded. In turn, underwriting institutions opted to not absorb unplaced securities. Auction rate financings by individual municipal entities have largely been restructured into longer fixed rate securities. However, many of the auction rate preferreds used to provide leverage for closed end tax-exempt bond funds remain outstanding. Some modest progress has been made on restructuring these securities to make them money market fund eligible. The restructured securities have a guaranty from a credible financial institution to support liquidity agreements backing one and seven day put provisions. Only a small portion of the instruments tied to closed end funds have been restructured to date and the vast majority remain illiquid. Additional progress is anticipated, but it is likely to be slow and costly for the fund providers.

- **Firm News**

In the current stressful time we want to assure clients that the staff at C.W. Henderson & Associates is reviewing account structures and holdings. Erring on the side of conservatism remains a cornerstone of our investment philosophy and process. We appreciate the confidence of our clients and friends.

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

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