The Investor's Edge

C.W. HENDERSON & ASSOCIATES, INC.

Investment Managers Specializing
in Tax-Exempt Municipal Securities

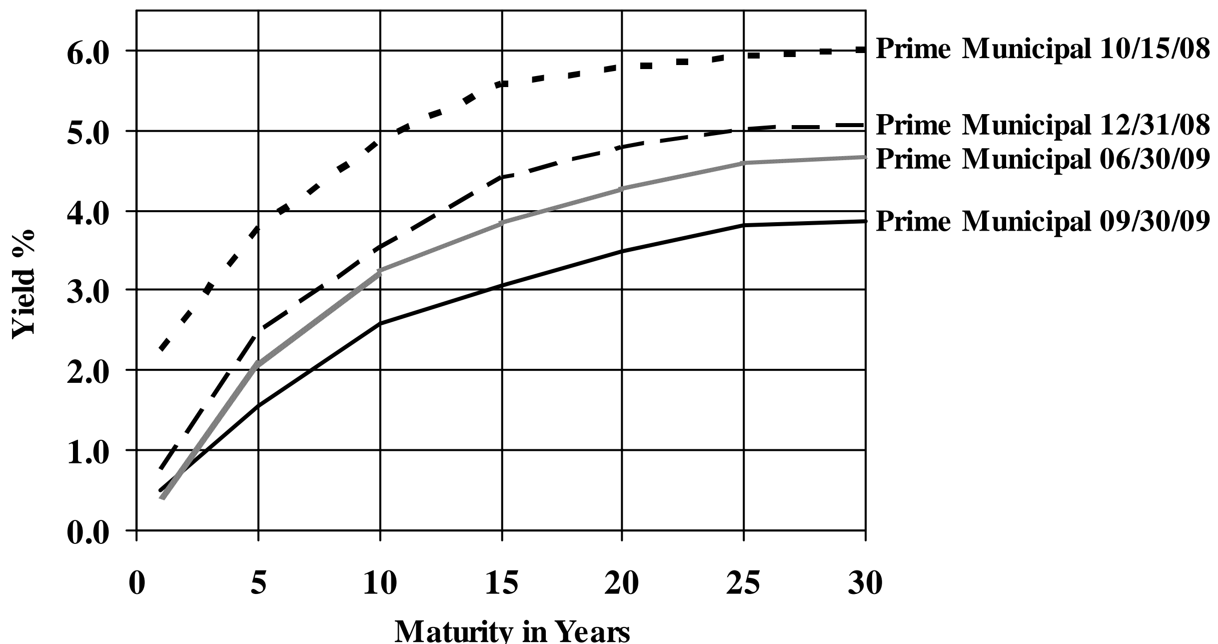
October 2009

- **Background and Outlook**

The economy appears to be gaining some traction and modest positive growth is likely in the coming quarters. The Treasury has ended the "cash for clunkers" program, will soon remove money market fund guarantees and is paring various other support programs. Indications from the Federal Reserve suggest that their purchases of Treasury securities may be reduced. Despite glimmers of economic hope, the environment remains fragile with consumers burdened by underwater mortgages and high unemployment. The FOMC is maintaining the targeted federal funds rate at close to zero, where it is likely to remain for the foreseeable future.

Emboldened investors have moved back into the stock market and, with money market funds and other short term instruments yielding close to nothing, investors have also moved out along the yield curve in search of return in the fixed income markets. Municipal bond funds have enjoyed strong inflows in recent months that have buoyed the long end of the market while individual buyers have focused their purchases on intermediate maturity bonds. As demand has been building, the supply of tax-exempt paper has been restricted by a growing segment of issuers opting to market new offerings as taxable Build America Bonds. As shown in the attached graph, the prime tax-exempt municipal yield curve has shifted sharply lower over the course of the year in reaction to the demand/supply imbalance.

Municipal Yield Curve Shifts



The following table illustrates the strength of the municipal market as yields declined. Total returns of the Barclay's Municipal GO Index maturity segments over the past quarter, nine months, and twelve months were exceptional across the maturity spectrum.

Barclay's Municipal GO Index Returns

	1 Year	**3 Year**	**5 Year**	**7 Year**	**10 Year**	**15 Year**	**Long**
3rd Quarter	1.01%	2.13%	3.97%	5.16%	6.71%	7.97%	11.18%
Year to Date	3.12%	5.16%	6.93%	7.81%	10.29%	14.26%	18.52%
12 Months	4.61%	7.63%	10.87%	12.42%	14.94%	18.77%	19.67%

"Sticker shock" hit early in October and the market has back tracked. Investor reticence to low prevailing yields led to new issue unsold balances. In addition, dealers have become reluctant to take on new inventory. Trading desks have had a very profitable year thus far and there is a strong desire to maintain those profits. As a result, there has been a back up in rates of thirty to fifty five basis points along the curve. We pared back our exposure to longer holdings earlier in the year as the market rallied and portfolio durations are currently slightly shorter than our benchmark. Our posture remains somewhat cautious, but we are not in a rush to reduce long bond positions further from already conservative constructions. We have used recent periods of market strength to upgrade credit quality, reduce negative convexity and control de minimis risk.

Near term we anticipate continued volatility, but do not expect a dramatic surge in rates. Inflation is not an immediate concern as the economy grapples with high unemployment, limited, if any, pay increases, underwater mortgages, tepid consumer demand and trouble in the commercial real estate market. At the same time, demand for yield will prompt investors to continue to extend along the yield curve during market selloffs. The expectation of higher tax rates is also wetting investor appetites for tax-exempt income.

The recent backup in rates caused the tax-exempt market to cheapen relative to Treasuries. The table below indicates the ratio of ten year prime municipal yields to ten year Treasury rates since last fall. The current 89% level falls in the "more normal" 85% to 95% range that prevailed during most of the decade prior to last year's market disruption when investors fled to safe haven Treasury securities as bond insurers stumbled, auction rate programs froze, credit default swaps and various mortgage backed instruments unraveled, several major financial institutions failed, etc.

	Current	**9-30-09**	**6-30-09**	**12-31-08**	**10-15-08**
10 Yr. Muni	2.99%	2.61%	3.24%	3.53%	4.86%
10 Yr. Treasury	3.35%	3.31	3.53	2.25	4.02
Ratio	89%	79%	92%	157%	121%

Our longer term view is cautious. Massive government deficits will need to be financed and Treasury auctions could ultimately be met with waning demand from both domestic and foreign investors. While not on the near term horizon, accelerated dollar weakness and higher inflation appear possible as the economy regains its footing. Evidence of such developments would cause us to accelerate portfolio duration reductions.

- **Municipalities Continue to Face Budgetary Pressure**

Most municipalities continue to struggle with significant revenue declines from falling sales taxes, double digit drops in income tax receipts and, with housing prices depressed, property tax reassessments. Balancing budgets this year has been a significant challenge and FY 2010 might be even more difficult. Municipal officials are responding to declining revenues with budget cuts, layoffs, non-paid days off, increased user fees, selective tax increases, etc. Although painful, we fully expect that necessary steps will continue to be taken to assure that budgets are balanced and fiscal integrity is maintained. From a credit standpoint, municipal investments are expected to remain the second (behind government securities) most secure segment of the financial markets.

Despite our overall confidence in the fiscal integrity of municipal governments, we strongly urge that credit standards not be sacrificed. Some investors have pursued yield in recent months by purchasing lower quality securities which caused spreads between AAA and single A credits to narrow by thirty to forty basis points. Spreads to BBB and high yield credits contracted more significantly. We feel strongly that lowering credit standards in the current environment is inappropriate. Spreads could easily widen again (possibly significantly) as budgetary challenges persist. We prefer to seek added returns through the use of securities with unique structures and employment of active management strategies, not by altering credit standards.

- **Update on Build America Bonds**

Approximately 30% of the new issue municipals sold over the past few months have been issued as taxable Build America Bonds (BABs). As shown in the attached table, long tax-exempt municipal yields are currently almost on top of Treasury rates. The relative cheapness of long tax-exempts has provided an incentive for municipalities to lower their net interest expense by issuing BABs and receiving a 35% interest rate rebate over the life of the issue. Of the $285.2 billion new bonds marketed through the first nine months of the year, $48.2 billion have been taxable, up 115% from last year. Clearly, the goal of Washington to lower state and local governments' financing costs during the current period of financial stress has been realized, perhaps to a greater extent than had been anticipated when the program was initiated. Some issues have been structured with long BABs and tax-exempt securities in shorter maturities where comparisons favor tax-exempt bonds. Demand for BABs has been good and the expected aversion to the use of taxable municipals by non-traditional buyers (pension funds, endowments, etc.) has not been significant. Also, investors do not appear to be dissuaded by ten year calls that are typical in municipal structures.

Municipal/Treasury Yield Relationship

	Municipal	**Treasury**	**Ratio**
5 Yrs	1.83%	2.29%	80%
10 Yrs	2.99	3.35	89
15 Yrs	3.40	3.69	92
20 Yrs	3.69	3.88	95
25 Yrs	4.01	4.17	97
30 Yrs	4.07	4.20	97

The authorization by Congress for municipalities to issue BABs currently extends through next year. Given the program's success, there is speculation that it will be extended. If it is, there is no assurance that the rebate will remain at 35%. Given the federal government's budgetary woes, it has been suggested that the interest rebate might be pared to perhaps 20% or 25%. Whether BAB financings would then remain attractive is uncertain. Certainly some marginal supply would shift back to the tax-exempt arena if the rebate is reduced.

Secondary market liquidity for BABs has been somewhat limited. We anticipate larger than normal bid/ask spreads for these securities until the future of the program is clarified by Congress.

As a side note, tax-exempt yields have also been influenced by an increase in bank qualified financings. To stimulate demand for small municipality issues, banks had been allowed to deduct the financing charges associated with these securities if issue sizes were $10 million and under. To create additional demand, the maximum bank qualified issue size was increased to $30 million this year and next. Through September, $24.4 billion bank qualified bonds were issued, a 105% increase from the first nine months of last year. These securities tend to trade at somewhat lower yields than comparable credits due to the broader universe of potential buyers.

- **Credit Work Continues**

We mentioned Michael Belsky in our last newsletter. Mike joined the Governmental Accounting Standards Board last spring and left Fitch Investors Services where he headed the municipal group. Mike joined C.W. Henderson & Associates on a consulting basis to develop an even more comprehensive credit review process. This work is now well advanced with our data base of holdings mapped by cusips which allows us to receive immediate notice of any changes in rating agency outlooks or ratings. In addition, a reference library of rating agency reports has been created along with municipal Treasurers' contact information should we desire to research specific credits more thoroughly. Mike has also developed a process to analyze securities that we inherit with new accounts which has aided us in the liquidation of marginal credits. Going forward we will explore using our expanded research capability to monitor market sectors that we have not traditionally used and evaluate the potential to add value to portfolios while rigidly maintaining credit quality and liquidity standards. We will provide updates on our credit function as further steps are implemented.

Craig W. Henderson   Thomas L. Mallman, CFA

This newsletter may contain material received from the outside sources that we consider reliable.
However, no representation is made to its completeness or accuracy.
C.W. Henderson & Associates, Inc. All rights reserved.