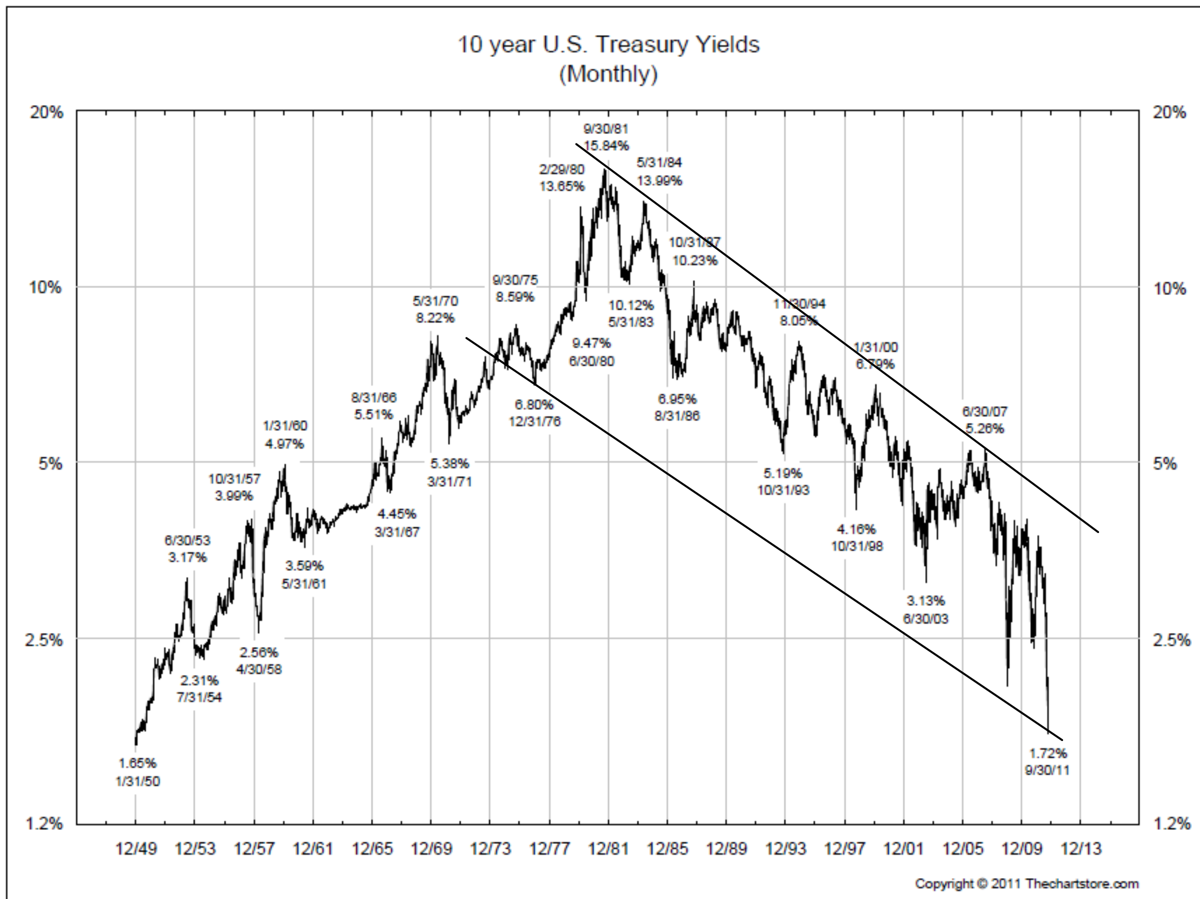
October 2011

- **How Low Can Rates Go?**

The downward interest rate trend that started in the early 1980s continued and accelerated in the closing weeks of the quarter. The bottom line on the accompanying ten year Treasury yield chart had to be moved lower to accommodate the recent rate plunge. Growing signs of economic softness in the U.S. coupled with concern over the Greek debt crisis and its potential impact on the European financial system prompted investors to again shed risk and head for the safe harbor of the Treasury market. The downgrade of the United States by Standard & Poor's in early August appears to have had little, if any, impact on investor demand for Treasury securities. The depth and liquidity of this market remains in place.



The Federal Reserve release at the end of the mid-September Federal Open Market Committee meeting stated that "there are significant downside risks to the economic outlook." In response, the Fed is engaging in "Operation Twist" and will sell $400 billion short Treasuries and reinvest in longer maturity securities to move long rates lower and, in turn, further reduce mortgage rates. The yield on the thirty year Treasury fell by over sixty basis points in the closing weeks of September. Ten year Treasury yields were above 3% early in the quarter, traded at the 2.10% level in mid-September and declined to 1.72% at quarter end. A recent reversal brought the rate back up to 1.92% as of this writing.

Comparisons are being made between the current state of the U.S. economy and Japan's experience after its real estate bubble burst in 1990. The Japanese government has been fighting a "lost decade" of sluggish growth with stimulus and low interest rates. One year U.S. and Japanese government bond yields are similar at about 0.10% while ten year Japanese bond yields are near 1%, substantially below U.S. levels. Could the ten year Treasury rate fall to Japanese levels? We don't anticipate such a move, but is not out of the question if the U.S. economy slides back into a recession. One differentiating factor between the two countries is that inflation in the U.S. is expected to be in the 2+% area this year whereas Japan continues to battle deflation.

Short rates will remain locked at near zero for the foreseeable future. We anticipate that longer rates will be volatile but remain at relatively low levels in the coming months while the economy grapples to regain its footing. At some point there will be a turnaround, both in economic activity and in interest rates. When rates do rise, the upswing could be dramatic. Low nominal rates call for a degree of caution which we have embraced.

- **Operation Twist and the Municipal Market**

As shown in the table below, tax-exempt yields declined fairly steadily throughout the year after peaking in mid January. Municipal rates rose significantly late last year as a glut of Build America Bond financings flooded the market. Sharply reduced supply this year, while investor demand for fixed income investments remained strong in the weakening economy, caused rates to decline and bond prices to move higher. Operation twist has had a more modest impact on the municipal market as evidenced by the slight increase in five and ten year yields since mid September while longer rates declined slightly.

Prime Municipal Yields

	9/30/11	9/13/11	6/30/11	1/18/11
1 Yr	0.26%	0.22%	0.23%	0.40%
5 Yrs	1.02	0.85	1.33	1.92
10 Yrs	2.22	2.06	2.74	3.52
15 Yrs	2.92	2.89	3.47	4.36
20 Yrs	3.37	3.37	3.94	4.87
25Yrs	3.51	3.62	4.28	5.00
30 Yrs	3.54	3.64	4.34	5.04

A more important recent influence in the municipal market is President Obama's proposal to limit the municipal tax exemption for individuals with annual incomes above $200,000 and couples earning more than $250,000 starting in 2013. This obviously clouds the outlook for the municipal market and will limit any rate declines until the issue is resolved. In the interim, the municipal market is likely to remain very cheap relative to Treasuries. The following table illustrates the change in the municipal/Treasury yield relationship over the past few months.

Treasury/Tax-Exempt Yield Relationship

	09/30/11			09/13/11			06/30/11		
	Muni	Treas	Ratio	Muni	Treas	Ratio	Muni	Treas	Ratio
5 Yrs	1.02%	0.86%	119%	0.85%	0.86%	99%	1.33%	1.84%	72%
10 Yrs	2.22%	1.74%	128%	2.06%	2.00%	103%	2.74%	3.21%	85%
30 Yrs	3.54%	2.72%	130%	3.64%	3.34%	109%	4.34%	4.40%	99%

Despite the relative cheapness of the municipal market, we continue to focus on nominal yield levels in making risk assessments. As rates fall, duration extends and potential volatility increases. The continued decline in yields over the year has prompted us to further reduce exposures to longer duration securities in client accounts. Portfolio durations are now targeted at 3.6 years, about 15% below neutral.

- **How Defensive Should Portfolios Be?**

Our primary objective in the management of tax-exempt accounts is to not have a negative total return in any year. To test whether our duration reductions provide sufficient protection, we performed simulations in mid September to measure the impact of various interest rate moves on a typical portfolio. These included parallel curve shifts, rising rates with a flattening yield curve and the potential impact of "operation twist". The various scenarios, time horizons and projected annualized returns are shown below. Portfolio structure remains static during the simulations. Maturities are reinvested, but no other trading is assumed. Benefits accruing from active management are therefore not reflected in the returns. Fees are excluded.

Scenario	Return
• 100 basis point rise, parallel curve shift, one year horizon	-0.88%
• 100 basis point rise, parallel curve shift, two year horizon	2.48
• 200 basis point rise, parallel curve shift, two year horizon	-0.37
• Curve flattening, short rates + 225 bp, long rates +50 bp,	
One year horizon	-0.24
Two year horizon	3.00
• Operation Twist; short rates + 25 bp, long rates – 25 bp	
One year horizon	2.76
Two year horizon	5.05

This analysis suggests that portfolios should be able to absorb significant rate increases without severe principal declines. Active management should provide meaningful enhancements to the returns shown above.

- **Threat to Municipal Tax-Exemption**

Washington is struggling to target budget cuts and revenue enhancements that will pare projected deficits. The twelve member super committee, made up of members of the Senate and House from both parties, is tasked to develop a plan that will produce a $1.5 trillion reduction in the projected deficit over ten years. Failure by the committee to meet a November 23 deadline would trigger $1.2 trillion in automatic cuts with much of the reduction falling on the Department of Defense.

Major tax preferences will likely be on the table as the committee conducts its meetings; mortgage, charitable and employer health care expense deductions. The fact that President Obama's jobs plan included a limitation on the municipal tax exemption raises the likelihood that the super committee will include it in their discussions. Should the committee recommend paring or eliminating any of these deductions, strong lobbying efforts will ensue as affected parties attempt to protect vested interests and limit any inclusion in subsequent legislation. In the case of the municipal exemption, the Government Finance Officers Association, along with various state treasurers and other municipal officials, have raised objections to any proposals that would lead to higher state and local financing expenses. California Treasurer Bill Lockyer has estimated that President Obama's proposal would increase California's borrowing costs by $7.7 billion.

The super committee could add to municipal governmental woes by also proposing reductions in federal outlays that support healthcare, schools and hospitals that municipal governments depend upon. Federal grants to state and local governments are expected to total about $425 billion in fiscal 2012.

Sparring over budget priorities, deductions and appropriate tax rates will continue, and likely intensify, as we move into the election year. We doubt that major changes will be enacted prior to the presidential election. Just as the Erskine Bowles/Alan Simpson debt commission recommendations were ignored, we would not be surprised if the super committee's efforts and recommendations are procedurally sidestepped.

The longer term outlook for municipal tax exemption remains murky. There is general agreement that fiscal discipline and tax reform are needed, but there is little agreement as to how this should be accomplished. Both the Bowles/Simpson commission and the proposal put forth by Representative Paul Ryan call for sharply reduced deductions, including the municipal bond exemption. Whether any such proposal can gain traction is uncertain and probably unlikely. Regardless of what tax legislation ultimately transpires, we strongly doubt that outstanding municipal bond income will be taxed on an ex post basis as proposed by the White House. Such legislation would countermand the implicit contract investors believed to be in place when they invested in "tax-exempt" municipal securities.

- **Firm News**

The decline in interest rates experienced this year has produced favorable account total returns through September. As we pointed out in a recent letter, many municipal holdings now have significant capital gains. Please let us know if tax losses have been generated in other segments of your overall portfolio that can be used to offset gains in the securities we manage. Our goal is to maximize after-tax returns by trading as efficiently as possible.

Our Short Term product continues to provide attractive returns relative to money market funds that are yielding close to zero. Focused strategies provide the potential for enhanced returns with principal stability.

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

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