The Investor's Edge

C.W. HENDERSON & ASSOCIATES, INC.

Investment Managers Specializing in Tax-Exempt Municipal Securities

January 2009

- **Background and Outlook**

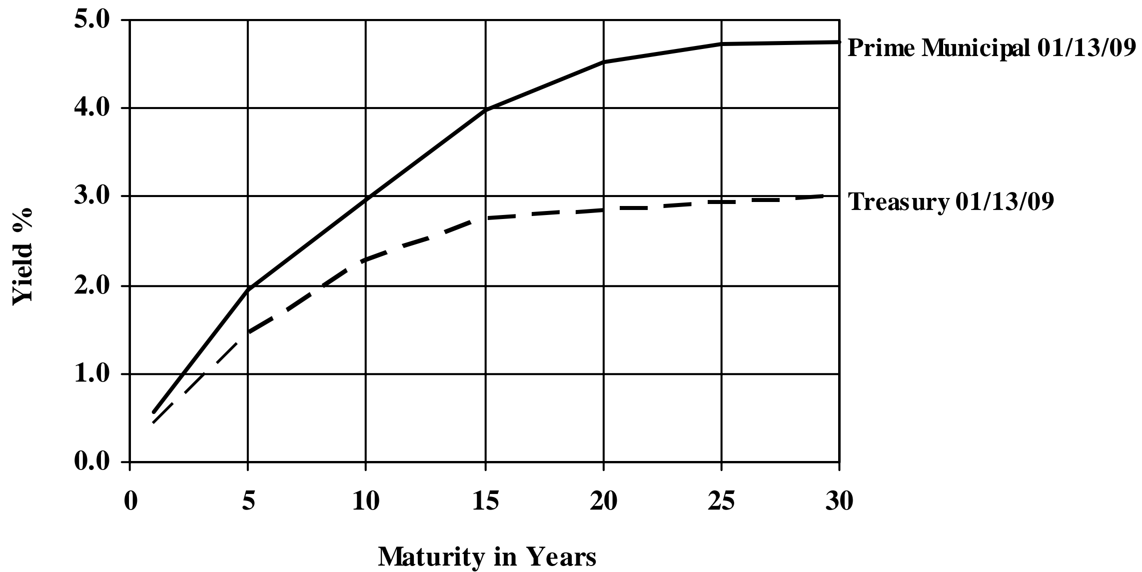
The National Bureau of Economic Research confirmed in late November that the U.S. is in a recession that started in December 2007. Accelerating economic retrenchment was clearly evident during the second half of last year with increasingly negative GDP reports reflecting sharp erosions in industrial production, consumer sentiment, commodity prices and employment along with the continuing cascade in the housing sector. Declines in energy prices provided a glimmer of relief, but were insufficient to more than marginally offset accelerating deterioration in the labor market where over two and a half million jobs were lost last year. These trends are continuing and possibly accelerating. Negative growth is anticipated much of this year, and, if consumer retrenchment intensifies, possibly longer.

Federal authorities have responded with massive stimulus. Rebate checks early last year provided an opening dose, but the big guns were brought out later with the bailouts of Freddie, Fannie and AIG along with direct support to banks, the TARP program, loans to the auto manufacturers and GMAC and massive monetary ease. The Federal Reserve's balance sheet has ballooned as guaranty programs have been put in place and liquidity pumped into the system. The targeted Federal Funds Rate was 4.25% at the beginning of last year and is now zero to 0.25%! Three month Treasury Bills are yielding less than a tenth of one percent and government rates remain extremely low in all maturities.

More fiscal stimulus is on the horizon with President-elect Obama planning to commit an additional $800 billion along with targeted tax cuts to get the economy back on track, and there may be significant additional pump priming beyond that. The federal deficit this fiscal year is now projected to be $1.2 trillion (8.3% of GDP), and that is likely to prove to be conservative. Inflation concerns have totally evaporated from the near term outlook and there is general agreement that massive pump priming is needed. The prospect of rising prices in a couple years is a worry, but not now.

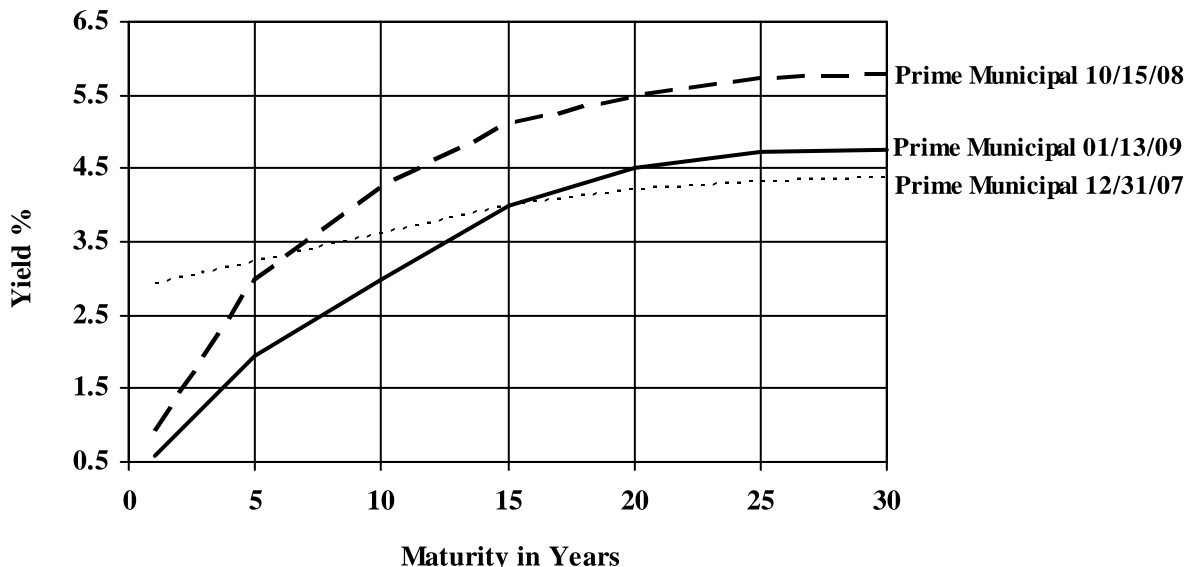
Investor sentiment remains depressed. Severe equity and hedge fund losses, on top of the erosion in housing values, have prompted a dramatic shift in sentiment towards conservatism and risk aversion that continues to stimulate demand for Treasury securities. As is shown in the accompanying chart, ten and thirty year Treasury securities are trading at respective yields of 2.29% and 3.00%. Government yields have shifted upward by twenty to thirty basis points over the past few weeks, but still remain significantly below prime municipal rates throughout the yield curve. The ratio of ten year prime tax-exempt to Treasury yields, while reduced from recent extremes, remains extremely wide at 130%. It is uncertain when this relationship will "normalize" with Treasuries again out-yielding municipals.

Yield Curve Comparisons



Volatility has been high, but the trend has been towards sharply lower municipal rates over the past few months. The second chart illustrates the tax-exempt yield curve that existed in mid October, when municipal rates hit an interim peak, and the current curve. The yield curve at the end of 2007 is also shown to provide perspective on the movement in rates and curve steepening that transpired during the year. Yields on ten and fifteen year securities (where we typically add exposure in constructing long components of the barbell structures in client portfolios) have dropped sharply with yields on many securities we purchased over the past few months having fallen by well over a hundred basis points with, in some cases, dollar price gains of fifteen or more points! The rally has been fueled by building interest in municipals from buyers searching for conservative investments that provide an alternative to ultra low yielding (and taxable) Treasuries. Also, investor confidence has been emboldened by reports that the incoming Obama administration is looking to bolster spending on infrastructure projects which will benefit many municipalities. Direct Washington financial support to state and local government budgets is also expected.

Municipal Yield Curve Shifts



Although volatility is likely to remain high, the rally in the tax-exempt market could extend further in the weeks ahead as individual investors search for alternatives to low money market investments and cross over buyers take advantage of the relative attractiveness of the municipal market. We had targeted portfolio durations at about 4.8 years, about a 20% extension from neutral. The recent rally has prompted us to revisit this stance and we are now shortening durations by reducing exposure to longer bonds.

- **Supply and Demand**

Anchored by extremely low short rates, the municipal yield curve remains very steep with a 400+ basis point spread between one and thirty year maturities. Lack of institutional demand for tax-exempt securities from hedge funds that suffered serious losses over the past year, mutual funds that continue to experience withdrawals and casualty insurers that are under profitability pressure is causing longer rates to remain elevated. Retail demand tends to be concentrated in ten year and under maturities where buying has been reasonably consistent.

The volume of new offerings totaled $390.6 billion last year, down 9% from the record $429.9 billion issued in 2007. Given the many disruptions experienced during 2008 (insurer implosion, non-functioning auction rate market, credit concerns, etc.) this drop appears fairly modest. Current estimates suggest that this year's volume could be similar to the 2008 level. Refunding issues could pick up given the drop in tax-exempt yields experienced over the past few months. With municipal budgets under pressure, city and state treasurers will be searching for expense reductions, and opportunities to lower net interest costs on outstanding debt will be pursued if escrow accounts can be put in place. We expect that general obligation financings will represent a reduced portion of the new issue market this year. Declining tax receipts will likely deter voters from approving project financings, and incurring additional debt service expense, unless tax bases are expanded.

We also anticipate that lower quality issuers will have increased difficulty coming to market. Heightened quality concerns have pared demand for lower rated paper and spreads have widened. Early last year the spread between AAA and single A credits was 30 to 40 basis points whereas it is now closer to 125 basis points. Spreads on BBB and below investment grade paper have ballooned far more dramatically. Obtaining quality improvements through the use of bond insurance is also difficult. Only three insurers (FSA, Assured Guaranty and Berkshire Hathaway) now have any credibility and the cost of their backing has increased. Investor acceptance of insured bonds, regardless of the insurer, has diminished - especially where underlying credit quality is at all questionable.

- **Thoughts on Credit Quality**

Investors have become rigidly focused on safety. Write offs, emergency capital infusions, bailouts, forced mergers, bankruptcies, etc. of what were seemingly sound financial institutions (e.g. Merrill Lynch, Lehman, Bear Stearns) have devastated confidence. This has extended to the municipal sector where news reports have focused on state and local budgetary pressures. Municipal officials are grappling with falling tax revenue and struggling to balance their budgets. Will this lead to impairment of debt service payments and, possibly, municipal bankruptcies? There will be stress for the foreseeable future, but we expect that the vast majority of municipal entities will weather the storm with limited disruptions.

In the post war period the number of defaults of bonds rated single A or above (which is all that we buy) has been negligible - a fraction of a tenth of one percent. New York City and Cleveland ran into trouble rolling short term notes in the 70s, but both recovered when the respective securities were restructured with their states' assistance. The major default of the 80s was Washington Public Power Supply System that failed on $2.25 billion of debt issued for nuclear power plants that were ultimately determined to be unneeded to meet electric power demand in the northwest. The threatened bankruptcy by Orange County, California in the early 90s stemmed from the treasurer's gross mismanagement of the county's short term investment pool, not insufficient tax collections or reductions in other revenue sources. This situation was resolved through debt restructuring and belt tightening. More recently, the Jefferson County, Alabama sewer system ran into trouble through, as reported, "the copious use of interest rate swaps." Final resolution of this situation is still pending.

The current economic environment is clearly very difficult. Does this mean that the post war experience is irrelevant and the 30s, when over 17% of outstanding debt defaulted, provides a better reference period? We don't think so. First, given the significant government stimulus that is forthcoming, we don't anticipate GDP declines anywhere near the 25+% experienced in the 30s. Federal Reserve liquidity, infrastructure projects, and expected direct assistance to states and local governments for education, health care and other needs will provide significant support. Also, keep in mind that municipalities cannot go away and must continue to function and provide services to their citizens long into the future. Access to the capital markets for short term and capital project financings is critical to their ability to operate. Municipal officials will work diligently to balance their books and meet debt service obligations. Governors and mayors in the 30s understood this, and by the end of that period less than 1% of outstanding debt had not been made whole, including interest on interest.

- **Lessened Liquidity**

As we reported in a special memo last month, the number of brokers and dealers operating in the market has diminished due to failures and mergers of financial firms. Further, the risk appetites of the remaining players have been significantly reduced, resulting in the curtailment of capital commitments to trading desks. Liquidity has been impacted which is being reflected in wider bid/ask spreads. Whereas institutional spreads of ¼ point used to be typical, in many cases these have widened to a point or more, especially for lower quality securities. Still, the overall market is functioning adequately with new issues selling briskly and reasonable trading in the secondary market. Obtaining strong bids when we liquidate securities has become somewhat more challenging and responding to requests to raise cash has, at times, taken longer than in the past. Advance notice would be appreciated if funds need to be withdrawn from accounts.

- **Firm News**

Despite the extreme market turmoil, 2008 was a good year for C.W. Henderson & Associates. Our focus on credit quality and conservative portfolio constructions remained in place and positive returns were realized in both our short term and traditional products. Growth was strong and we ended the year with over $2.3 billion in assets under management. We sincerely appreciate the confidence of our clients, associates and friends.

Craig W. Henderson Thomas L. Mallman, CFA

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