

**January 2010**

- **Background and Outlook**

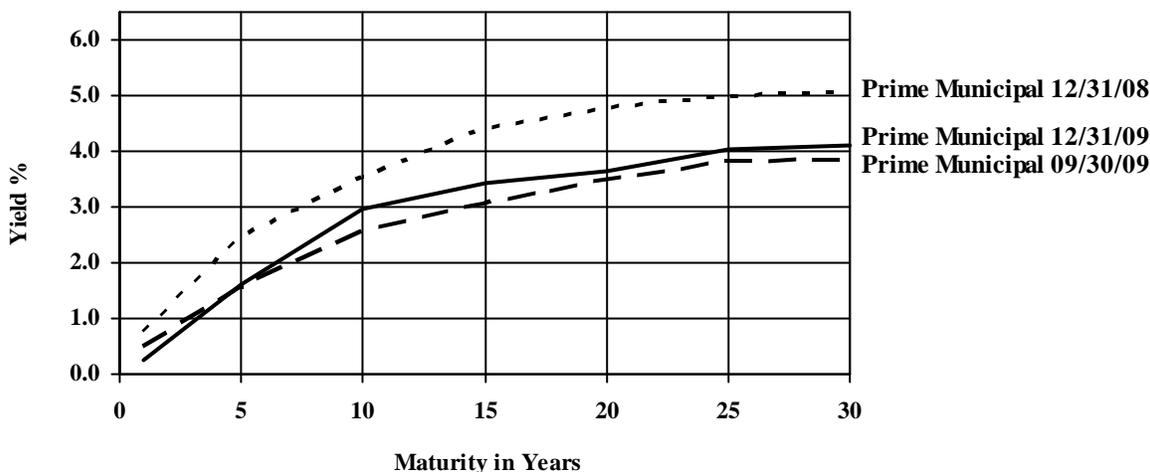
With the return to positive real GDP recorded in the last two quarters it is generally expected that the National Bureau of Economic Research will mark the end of the recession as having occurred late last summer or early in the fall. It is also assumed that the recovery will continue to be less than robust as consumers struggle with limited job prospects, scanty, if any, wage gains and underwater mortgages while businesses deal with fickle demand, stringent credit availability, uncertain health care expenses and the likelihood of increased regulation. We expect economic growth to average about 2.5% in 2010, a subpar performance in light of the seriousness of the downturn. With oil prices well above the levels that existed at the end of 2008, year-over-year CPI comparisons will be pushed higher over the next several months. However, we expect core inflation rates to remain subdued and overall inflation pressures to be controlled near term. Longer term we will be watchful for increases in monetary velocity that, given the bloated monetary base, could translate into rapid monetary aggregate expansion and, in turn, inflationary pressures.

The Federal Reserve again indicated that monetary policy will remain accommodative to counteract economic sluggishness. The federal funds rate will likely be kept near zero for the foreseeable future which will anchor short term interest rates. Steepness in prevailing yield curves could become more pronounced before the Fed acts to lessen its accommodation and move short rates higher. Yields on longer securities have increased over the past several months as the recovery gained momentum and the markets worked to absorb the continuing barrage of massive Treasury financings that totaled \$2.1 trillion last year and is projected to be \$2.45 trillion this year. The yield on the ten year Treasury closed the year at 3.87%, up from 3.20% in early October. We would not be surprised to see further increases in Treasury rates as the economic recovery broadens. Additional pressure on longer rates could also develop if the Federal Reserve stops purchasing mortgage backed and Treasury securities. It was reported last month that the Fed holds in excess of \$900 billion mortgage backed securities along with several hundred billion Treasuries. The Fed's holdings could increase to \$1.25 trillion mortgage backed securities before the program ends in March. We doubt that the Fed's holdings will be liquidated any time soon, but the elimination of the Federal Reserve's purchases will negatively impact the longer taxable market.

The municipal market experienced a modest back up in rates in recent months as reflected in the attached chart depicting yield curve shifts over the year and fourth quarter. Further yield increases are likely as taxable rates move higher, but we expect the tax-exempt market to be sheltered to some extent. With money market fund returns close to zero, there continues to be a strong incentive for investors to move out along the yield curve in search of higher yields. Demand for tax-exempt securities is also being enhanced by the expectation of higher tax rates in the coming years while, at

the same time, current supply is curtailed as taxable Build America Bonds command a growing component of the municipal new issue calendar. A recent analysis projects municipal volume at about \$435 billion this year, up from \$409 billion in 2009, with BABs representing 30% of this year's volume.

### Municipal Yield Curve Shifts



The municipal market was extremely cheap relative to Treasuries at the start of last year. The rush of investors to the safety of the government market in the midst of the financial crisis in late 2008 caused Treasury yields to plunge while rates on other fixed income securities moved higher. Building demand for tax-exempt securities as the financial crisis eased pushed the municipal/Treasury yield ratio dramatically lower over the course of 2009 as shown in the following table. Ratios are now low not only in the context of the past year, but also from a longer term perspective. For example, ten year prime tax-exempt yields generally fluctuated between 80% and 85% of Treasury returns during the decade prior to 2008. Further declines in the municipal/Treasury ratio could develop in the coming months as demand for tax-exempt securities remains strong.

	12/31/09			6/30/09			12/31/08		
	<u>Treas</u>	<u>Muni</u>	<u>Ratio</u>	<u>Treas</u>	<u>Muni</u>	<u>Ratio</u>	<u>Treas</u>	<u>Muni</u>	<u>Ratio</u>
1 Yr	0.42%	0.25%	0.60	0.48%	0.42%	0.88	0.34%	0.75%	2.20
5 Yr	2.65	1.59	0.60	2.55	2.05	0.80	1.55	2.48	1.60
10 Yr	3.83	2.96	0.77	3.53	3.24	0.92	2.25	3.53	1.57
30 Yr	4.65	4.12	0.87	4.33	4.66	1.08	2.68	5.06	1.89

We expect near term tax-exempt rate increases to be contained, but the trend will likely be towards higher yields over the course of the year. Account durations are currently being targeted at slightly below benchmark levels due to our interest rate outlook and the relative richness of the tax-exempt sector. Signs of stronger than expected growth and/or inflationary pressures would prompt us to further increase defensiveness. Barbell account structures remain in place along with our continued focus on high quality securities.

- **Build America Bonds – Here to Stay?**

The Build America Bonds (BABs) program was instituted by Congress last year to provide municipal governments with a mechanism to reduce their borrowing costs during the economic downturn. As currently constituted, municipal governments can sell taxable BABs to finance infrastructure development programs and receive a 35% rebate on the interest expense from the federal government. With longer municipal yields equaling or exceeding Treasury rates last year there was a strong incentive for municipal treasurers to use BABs. As an example, assume a municipality could issue thirty year taxable debt at the end of June at a 175 basis points yield premium over the prevailing Treasury yield. As shown in the table above, the pre-rebate interest cost would be 6.08% (4.33% + 1.75%). After the 35% rebate the net expense to the municipality drops to 3.95%, significantly below the 4.66% yield on prime tax-exempt securities at that time. As tax-exempt yields have fallen below Treasury rates the comparisons have become less favorable, but still advantageous.

The program has been a windfall for municipalities. What about the impact on the federal budget? According to a recent “Bond Buyer” article, the congressional Joint Tax Committee estimated last February that the cost of the BABs rebate program to the Treasury would total \$51 million in 2009 and \$292 million in 2010. These estimates now appear dramatically low. The program has been more popular with issuers than expected and it appears that a meaningful component of BABs buyers are pension funds, public funds and endowments that do not pay taxes rather than individuals and corporations. Through mid-December over \$63 billion BABs had been issued. Assuming an estimated average coupon of about 6.00%, the annual interest expense on these securities is \$3.8 billion and the federal government’s rebate expense is about \$1.3 billion. How much of that amount is being recouped from receipts paid by taxpaying entities is uncertain.

Under current legislation the BABs program will end at the end of this year. However, given its success, it is now assumed that it will be extended, perhaps indefinitely. What is less certain is the rebate rate that will exist going forward. It has been suggested that the rate could fall to somewhere in the 22% to 27% range to make the program revenue neutral to the Treasury. The lower rebate would dramatically reduce the attractiveness of the program to issuers unless tax-exempt municipal rates again move near or above Treasury yields. Our assumption at this time is that BABs will be a significant factor in the municipal landscape this year but diminish in importance going forward after the rebate rate is lowered.

- **Credit Concerns Continue**

Gov. Schwarzenegger’s call for federal assistance in closing the state’s currently projected deficit of over \$20 billion through June 2011 could be the first of such pleas with New York, New Jersey, Michigan, etc. following. State budgets continue to be ravaged by falling sales, income and capital gains tax receipts. According to a report by the National Association of State Budget Officers, combined state budget deficits are projected to total about \$256 billion for the 2009-11 fiscal years. Local governments are also experiencing strains as property tax receipts have declined and, in some cases, state funded programs have been curtailed. Municipal governments have responded with drastic cutbacks that have included service cuts, facility closures, reduced, if any, employee wage increases, mandatory non paid days off, outsourcing of certain municipal operations, etc. Revenue enhancements

are being pursued wherever possible through the imposition of selective tax increases and increased user fees.

What is the prospect of direct federal support for the states? Given the fiscal challenges in Washington, there will likely be a hesitancy to add to their burden. On the other hand, given the loans that have been extended to the banks, auto companies, Fannie Mae, Freddie Mac, AIG, GMAC, etc. a case can be made that municipalities are also appropriate recipients. How much, if any, federal support will be given to the states remains to be seen, but we would not be surprised if some accommodation is provided, possibly through use of unexpended stimulus funds.

Adding to municipalities fiscal woes are underfunded pension plans. Most municipal employee retirement benefits are provided by defined benefit plans. The investment portfolios of many of these plans suffered serious declines as the market contracted. Some ground has been recovered, although in most cases not to the levels of a couple years ago. As funding levels have declined, plan sponsor's ARCs (actuarially required contributions) have risen. To comply with accounting standards, these contributions should be made annually and funded from current revenues. The underfunding of pension plans and other post employment benefits (OPEB – mostly health care) represent serious longer term concerns. Municipalities are attempting to address these issues by altering existing plans or creating separate plans for new workers that pare benefits, raise retirement ages, shift to defined contribution plans, etc. Progress in this area is expected in the coming years, but is dependent on negotiations with various labor groups and is likely to be slow. In the meantime, municipalities will struggle to deal with long term commitments.

Regardless of what transpires in regard to federal support for the states, the situation reinforces the need to maintain high quality standards. We continue to believe that the vast majority of municipal governments will take appropriate steps, painful as they may be, to meet the challenges they face. Municipalities are monopolies that, unlike corporations, do not go away and they must have sufficient financial stability to function adequately on an ongoing basis. Strains are certain to continue for several more quarters and the political process required to balance many constituent demands will be challenging in an environment of limited revenues. However, we feel that established credits will weather the downturn.

- **Firm News**

We are pleased to report that C.W. Henderson & Associates continued to grow in 2009 and ended the year with \$2.7 billion in assets under management. We are extremely grateful for the confidence of our clients and partners in the financial community and will continue to work diligently to retain and enhance that confidence. We wish all of you a bountiful 2010.

Craig W. Henderson

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