The Investor's Edge

C.W. HENDERSON & ASSOCIATES, INC.

Investment Managers Specializing
in Tax-Exempt Municipal Securities

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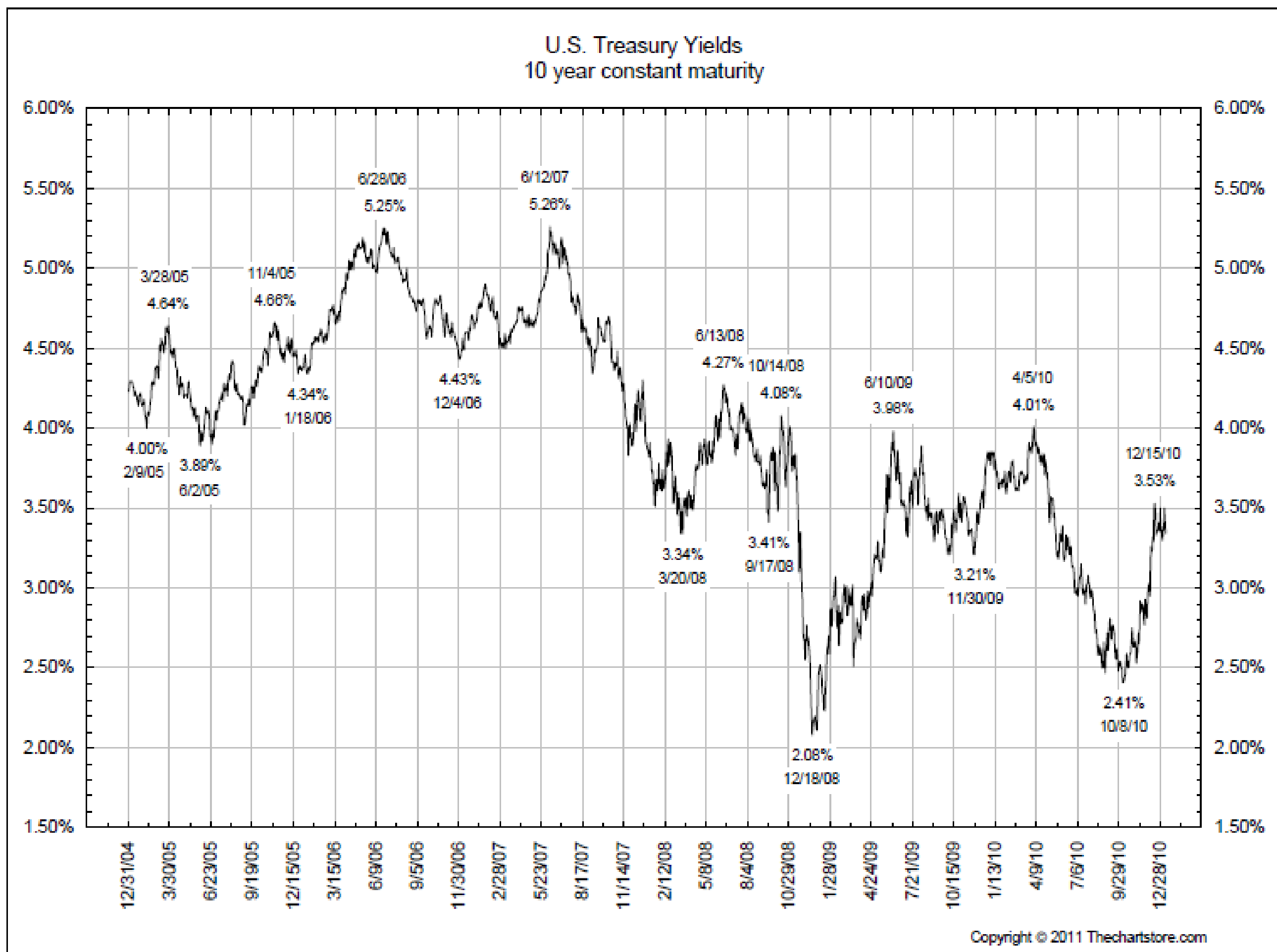
- **Background & Outlook**

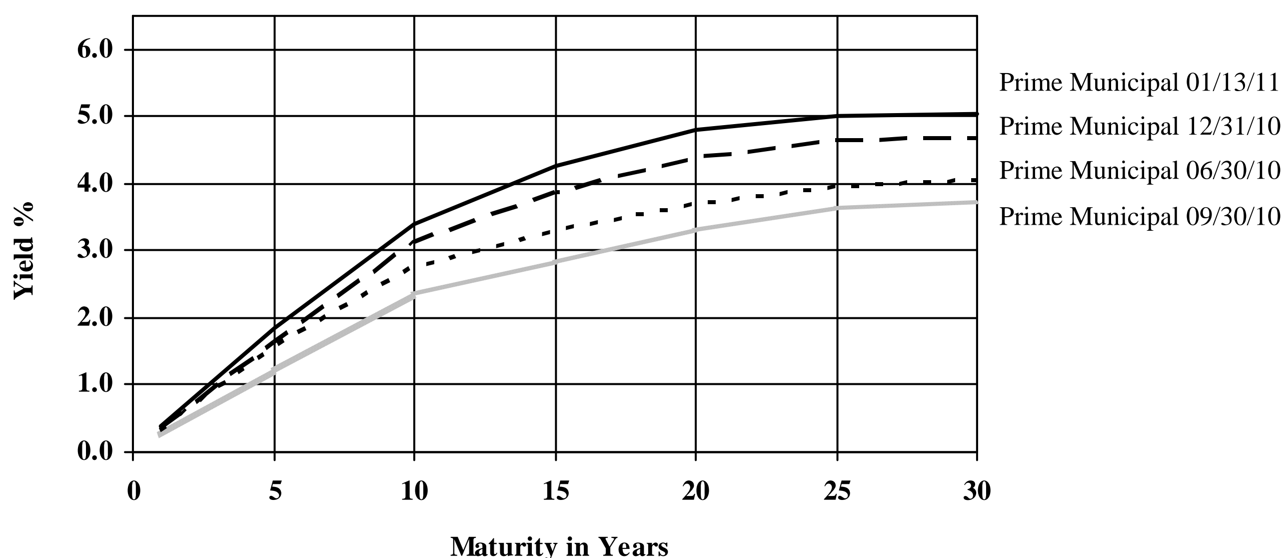
As indicated in the chart below, ten year Treasury yields rose by over one hundred basis points from the lows touched in early October to mid December as signs of building economic momentum emerged. Reasonably healthy holiday sales, stronger demand for autos, a down tick in unemployment claims, expanding exports, etc. suggest that the recovery is gaining additional traction. Confidence was enhanced by the passage of the tax bill in December which provided a much needed degree of clarity to the outlook. The second stage of the Federal Reserve's Quantitative Easing (QE2) program got underway with initial purchases of a planned program to buy $600 billion Treasury securities through June. Demand from the Fed may have moderated the increase in yields, but was insufficient to stem the upward pressure on rates.

Data as of January 7, 2011



Municipal yields followed the Treasury market and also moved upward during the quarter. As shown in the yield curve chart below, ten year prime municipal yields closed the year about 75 basis points above the end of September level and have moved still higher in the new year. Longer rates have been significantly impacted with thirty year yields moving up by 130 basis points. Heightened pressure on long municipal rates was initially prompted by the surge in Build America Bond financings prior to the year-end program sunset. Taxable municipals represented 48% of the new bonds sold in December and for the year BABs sales totaled over $117 billion, approximately 27% of total new issuance. Total volume in 2010 was $432.9 billion, a 5.4% increase over 2009. Long rates have been further pressured in the opening weeks of this year by mutual fund redemptions. The Federal Funds rate remains targeted in the 0% to 0.25% range which is continuing to anchor short rates. The jump in longer rates has caused a significant steepening in the yield curve. The spread between one and thirty year tax-exempt yields increased from 345 basis points at the end of September to 465 basis points currently.

Municipal Yield Curve Shifts



Looking into 2011, we anticipate somewhat stronger growth than we expected a few months ago. Despite continuing drags from housing and high unemployment, lower than expected tax rates coupled with extended unemployment benefits, rising exports as the dollar declines and additional monetary stimulus should boost growth to 3% or a bit higher. We anticipate that the Fed will keep short interest rates locked at close to zero for many months and continue the quantitative easing program until they witness a downward trend in the unemployment rate. Near term inflation pressures are expected to remain subdued, but the combination of continued massive Treasury auctions and building economic momentum could pressure longer interest rates somewhat higher as the year unfolds. Low prevailing short and intermediate tax-exempt rate levels add an additional element of risk. We are maintaining a moderately defensive posture with portfolio durations targeted at 3.6 years, about 10% below neutral.

- **Build America Bonds Program Expires – Big Surprise**

Up until the eleventh hour most market participants expected the BABs program to be extended given its popularity among municipal issuers that were able to lower financing costs through the 35% interest rate rebate from the Federal treasury and an expanded universe of buyers (e.g. pension funds, foundations, foreign investors, etc.). Tax legislation proposed last spring included a provision to extend the program, although with a lowered rebate rate, and it was generally assumed that the end of the year tax bill would have a similar provision.

Financing by municipal governments will now largely move back into the tax-exempt arena where individuals are the primary buyers. It is estimated that 70% or more of outstanding tax-exempt securities are owned by individual investors either directly, through mutual fund holdings or in portfolios constructed by advisors or trustees acting on individuals' behalf. Retail investor preference for shorter maturity securities could cause the tax-exempt yield curve to steepen further in the coming months.

- **Increased Long Rates Impacted Total Returns**

The ratio of thirty year prime tax-exempt yields rose to 105% of the like maturity Treasury rate at the close of the year as the tax-exempt yield curve steepened. The impact of rising long rates on total returns was dramatic in the fourth quarter as reflected in the Barclays Municipal GO Index returns shown below.

Barclays Index	Maturities In Index	4th Qtr Return	2010 Return
1 Year	1 to 2 yrs	0.00%	1.04%
3 Year	2 to 4	- 0.87	1.55
5 Year	4 to 6	- 1.71	3.18
7 Year	6 to 8	- 2.60	4.34
10 Year	8 to 12	- 3.94	3.95
15 Year	12 to 17	- 5.32	2 .21
Long	17+	- 7.43	1 .64

These results provide evidence of the volatility that is inherent in long duration bonds and reinforces the logic behind our use of short and intermediate maturity securities in the construction of client accounts. Seeking to control both credit risk and volatility risk are central components of our investment process.

- **Building Pressure for Public Pension Reform**

State and local governments continue to grapple with budgetary deficits as tax and user fee revenues lag expenditures. The elimination of stimulus funds from Washington will, in some cases, cause municipal financial challenges to become more acute this year and next. Municipal officials have been responding with work force reductions, service cutbacks, mandatory days off, increased service fees, selected tax hikes, etc. Newly elected Gov. Brown has proposed $12 billion cutbacks and tax levies in California while Gov. Cuomo is championing austerity moves in New York including a one year wage freeze. Personal and corporate income tax rates have been increased in Illinois to partially plug the State's deficit.

These steps are encouraging, but operating expense reductions are likely to be insufficient to bring many municipalities' budgets into balance over the next few years. As a result, many governors are also looking to pare pension and health care obligations by reducing benefits, increasing minimum retirement ages, requiring larger medical copayments, etc. New Jersey's Gov. Christie has been at the forefront of this effort which is now spreading to several other states including Indiana, Ohio, Wisconsin, Maine and Mississippi. Besides pension and health care funding reform, some new governors are proposing limits on the formation of new unions, ability of public employees to strike, enforcing right to work rules, etc. Ultimate changes remains to be seen, but momentum is clearly building to limit public employee expenses and influence.

- **Doom and Gloom from Meredith Whitney**

Ms. Whitney is projecting a wave of municipal defaults that will panic investors and precipitate indiscriminate selling of state and local government securities. There is no doubt that many municipal budgets will continue to be stressed this year and next. We also agree that there will probably be an increase in defaults, but we expect that the number will be limited and confined primarily to smaller, non-essential service enterprises. We further agree that this is not a time to reach for yield and reduce stringent credit standards. Caution and diligence in selecting credits is imperative.

Ms. Whitney is also forecasting that the surge in defaults will ultimately require a federal bailout. Given the Federal Government's budgetary challenges and the more conservative newly elected Congress, we doubt that there is much appetite in Washington to take on state and local financial burdens. This sentiment was voiced by Rep. Paul Ryan, Chairman of the House Budgetary Committee, who stated his opposition to municipal bailouts. In addition, Federal Reserve Chairman Ben Bernanke has ruled out Fed support for municipal governments and indicated that the central bank has limited legal authority to assist state and local governments and little will to do so. Municipal governments are left to find solutions on their own and, as stated earlier, most are taking steps to deal with their budgetary challenges. These challenges are significant, but solvable. Default is not a logical solution as debt service expenses typically account for 7% to 10% of municipalities' budgets. Does it make sense to forego these relatively small obligations and jeopardize access to the capital markets?

Despite the media focus, the municipal market is functioning reasonably well. Over $430 billion bonds were marketed last year and readily absorbed. Municipal yields are at somewhat extended levels compared to Treasury rates, but nothing like late 2008 when prime ten year municipals yielded 160% of Treasuries. Actual problems have been minimal. In 2009 and 2010 there were, respectively, ten and five Chapter 9 filings, miniscule numbers compared to the several thousand Chapter 11 filings in the corporate sector. According to Moody's, between 1970 and 2007 there were 54 rated municipal bond defaults compared to 1,707 rated corporate defaults. Of the rated municipal defaults, 78% were securities backed by healthcare and housing projects, sectors that we avoid. Some defaults and bankruptcy filings this year would not be surprising, but we expect the numbers to be well contained.

"Headline Risk" is likely to be with us for the foreseeable future precipitating volatility and, at times, unsettled market conditions. However, the municipal sector remains basically sound. Aiming high on the quality scale and controlling duration should provide steady income flows, limit volatility risk and allow conservative investors to weather the storm. If tax-exempt rates move appreciably higher it could present a very attractive buying opportunity similar to the environment in late 2008.

- **Firm News**

C.W. Henderson & Associates experienced another solid year of growth in 2010. We thank all of our clients and partners for your continued confidence. We will continue to work diligently to maintain and expand that confidence. We wish you all a prosperous 2011.

Craig W. Henderson Thomas L. Mallman CFA

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