THE INVESTOR'S EDGE

C.W. HENDERSON & ASSOCIATES, INC.

Investment Counselors Specializing in Tax-Exempt Municipal Securities

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- **Economic Setting**

Upward revision in fourth quarter Real GDP growth from an initial estimate of +0.2% to +1.4% provided evidence that the economy is rebounding. A firming employment picture, gains in the index of leading indicators and signs of a pickup in the manufacturing sector have added further confirmation. Continued consumer spending coupled with corporate inventory rebuilding are expected to provide the foundation for continued expansion. The housing and autos sectors are expected to remain firm, but are unlikely to provide strong year-to-year comparisons in the coming quarters. Low mortgage rates bolstered housing last year while rebates stimulated auto sales. Capital spending remains a question mark as capacity utilization rates are low and most corporations are unwilling to add to capacity until they witness significant increases in demand. The recovery is expected to build over the course of the year, but quarter-to-quarter growth could be volatile.

The United States has made great advances in the war on terrorism, but the threat of additional attacks, both here and abroad, remains a serious concern. Investor confidence could be strained again if the U.S. suffers another serious attack. Middle East violence is adding to investor apprehension as are the almost daily announcements of corporate accounting irregularities. Investor psychology is likely to be fickle in this unsettled environment.

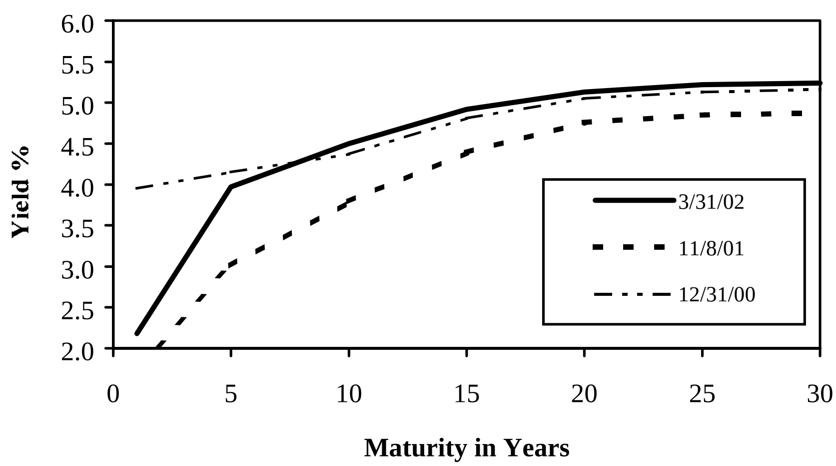
Inflationary pressures should remain docile over the near term. Manufacturers have limited pricing power in a globally competitive world with excess capacity. However, service prices have continued to advance and energy and commodity prices are moving higher. The dollar could become an issue later in the year. The trade deficit is likely to expand as our economy recovers and the payment dollars we shift overseas must be recycled back into our investment markets to maintain currency equilibrium. A falling dollar would increase import prices with inflationary consequences

- **Interest Rate Outlook**

The market is fixated on the Federal Reserve and when, not whether, they will begin to tighten. Prior to September 11 the Federal Funds rate was targeted at 3.50% and it was felt that the Fed was near the end of their easing cycle. The 175 basis points of additional ease was instrumental in reestablishing national confidence in the crisis environment, but now appears unneeded as the economy recovers. We anticipate that the Fed will take part or all of the post-9/11 ease away in the second half. Additional tightening moves seem probable if the economy continues to expand in 2003 as now appears likely. Keep in mind that the Federal Funds rate was at 6.50% at the beginning of 2001.

As shown in the chart below, municipal rates have moved higher across the yield curve since the mid November lows in response to building economic momentum. March witnessed an acceleration in the upward trend with yields in the one to five year sector rising by about 60 basis points while longer rates moved 25 to 40 basis points higher during the month. We anticipate that the curve will continue to flatten in the coming months as the Fed tightens and that rates in all maturities will move higher as the economy expands. Defensive postures are generally called for although we feel that there will be opportunities to periodically lock in attractive yields as rates move irregularly higher. We are generally maintaining portfolio durations at the lower end of our normal operating ranges but are making selective commitments to longer securities in reaction to sell-offs.

AAA Municipal Yield Curve



- **Return Analysis**

The Federal Reserve's aggressive easing caused the yield curve to steepen dramatically last year. Shorter segments of the municipal market recorded the best total return performance in 2001. This action contrasted with the return patterns that are typically witnessed during a recessionary downturn where longer duration bonds outperform.

The 2001 returns of each Lehman Brothers Municipal GO Index are shown below along with the January/February and March 2002 returns.

	2001	Jan/Feb	Mar
1 Year	5.67%	1.20%	(0.68%)
3 Years	6.33%	2.06%	(1.39%)
5 Years	5.98%	2.73%	(2.01%)
7 Years	4.98%	3.21%	(2.18%)
10 Years	4.38%	3.43%	(2.12%)
15 Years	4.57%	3.32%	(2.02%)
Long	4.84%	2.91%	(2.12%)

As shown, positive returns were recorded in all sectors during the first two months of 2002 with longer bonds providing the best performance. However, two-thirds or more of the January/February gains were reversed by the March rate rise. We anticipate a volatile market during much of this year with lower returns in all sectors relative to 2001. Our primary tactic in this environment will be to concentrate on high coupon callable bonds that appear to have limited call probability. These securities are defensive while providing attractive return potential. As noted above, commitments to longer securities will be made selectively.

- **Municipal Supply**

The calendar remains crowded and we continue to expect that new issue volume could reach $300 billion this year. Volume in the first two months totaled $41.3 billion, up 22.8% over last year. The New York Metropolitan Transportation Authority recently announced that they plan to issue the first component of their $14 billion planned financing in early May. Remaining in the wings is the California Department of Water Resources that had to delay their power financing last year. Sales by this entity could total $12 billion. Heavy supply will probably create periodic digestion problems, but strong retail demand should be adequate to absorb the volume of new debt with limited market disruptions.

- **Secondary vs. New Issue Purchases**

The heavy supply expected this year will focus attention on the new issue market. New issue sales establish market levels and define yield spreads between bonds with differing credit ratings. We use this information as references when making purchase selections, but typically do not concentrate on new issue bonds unless an underwriting is having difficulty and we can use our sizable purchasing power to define the structure and pricing of the bonds we want to acquire. Broad investor focus causes new issue sales to typically be efficiently priced. Also, a significant number of new issue securities are priced near par. Par bonds are favored by many investors due to their seeming simplicity and their ability to balance income and remainder interests in split interest trusts. However, these securities are often relatively rich and often have negative convexity characteristics (i.e. they increase in price slowly in a declining rate environment due to the influence of calls, but decline rapidly in a rising rate environment as the deminimus threshold is breached.)

Our focus on purchasing attractively priced securities with unique structures that meet the parameters of our investment strategies causes us to typically shun the new issue sector. We favor bonds with positive convexity structures and typically purchase combinations of premium and discount bonds that, respectively, provide a cushion effect when rates rise and strong appreciation potential in a falling rate environment. These combinations typically provide higher total returns than par bonds, especially in fluctuating markets. Also, the front-loaded barbell portfolio structures we employ have holdings in discrete maturity ranges that meet our strategy parameters. Our ability to purchase securities at below market levels (and sell at premium prices) is enhanced in the secondary market due to the reduced focus of many investors. Typically only about ten to fifteen percent of our purchases are new issue bonds while the vast majority of our activity is in the secondary market.

- **Holders of Municipal Debt**

Individuals continue to be the primary investors in municipal securities. At the end of last year municipal debt outstanding totaled $1.69 trillion. Households and personal trusts held 37.6% of these securities while mutual bond and money market funds, which are largely owned by individuals, held 35.1% of the outstanding bonds. Banks, savings institutions and insurance companies, while still significant market participants, represented only 19.8% of the total market ownership. There is nothing on the taxation horizon that is expected to disrupt the overall ownership structure and we anticipate that personal ownership, directly and through trust or fund intermediaries, will continue to dominate the demand side of the equations.

- **Firm News**

We would like to remind our clients and associates that we are able to deliver this newsletter in a PDF file over the internet. We would be happy to add you to our electronic distribution list if you prefer that delivery format.

We enjoy your inquiries and comments and appreciate your continuing confidence in C.W. Henderson & Associates.

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