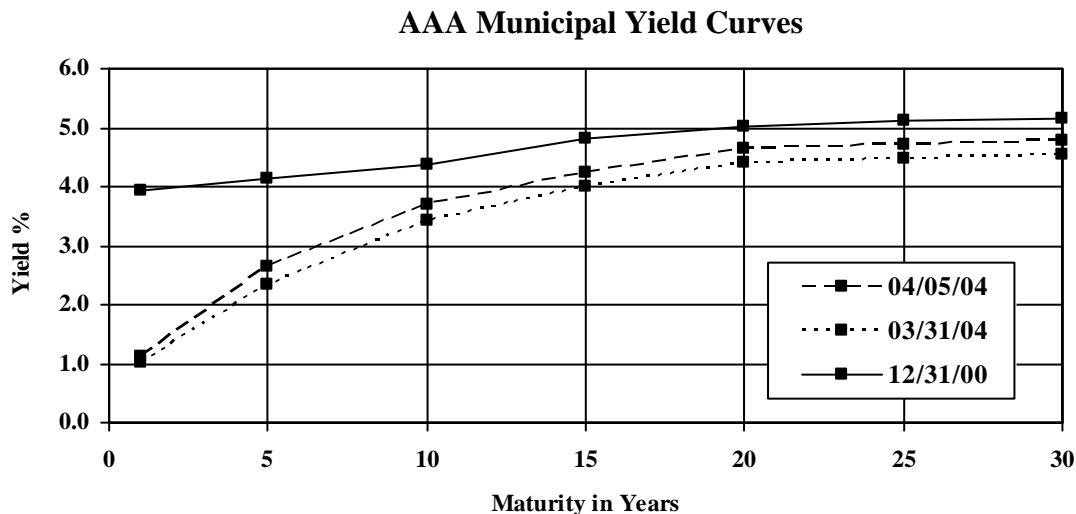


- **Background**

Municipal rates essentially trended sideways during the first quarter with modest volatility. Indications of stronger economic activity were offset by disappointing reports of tepid non-farm labor growth in December, January and February. High productivity and moderate increases in core inflation strengthened the case for inaction by the Federal Reserve and forecasts generally called for monetary policy to remain on hold throughout the year. Also shaping the landscape were the Democratic primaries, turmoil in the Middle East, battles in Afghanistan and Iraq, the railway bombing in Madrid and a Saudi cutback in crude oil production. The safe harbor Treasury market rallied in this environment with yields on five and ten year securities falling by over forty basis points during the quarter. Municipal yields were all but unchanged at the end of the quarter compared to year end levels. Equity averages retreated modestly in the uncertain environment.

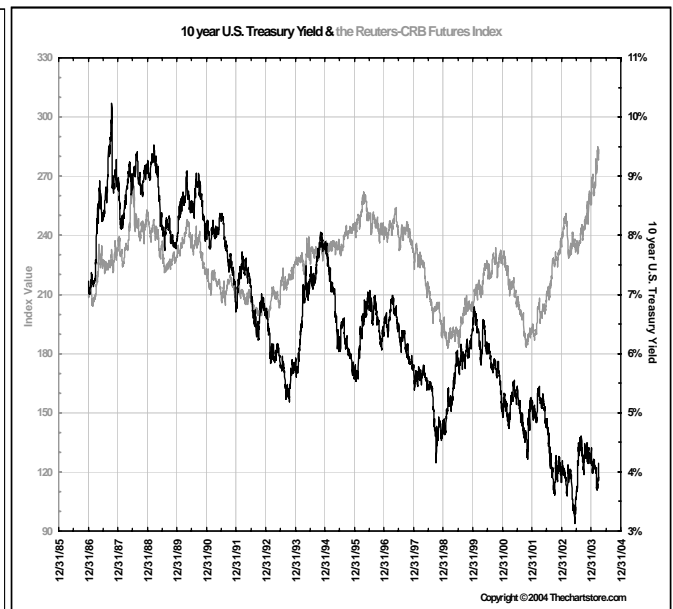
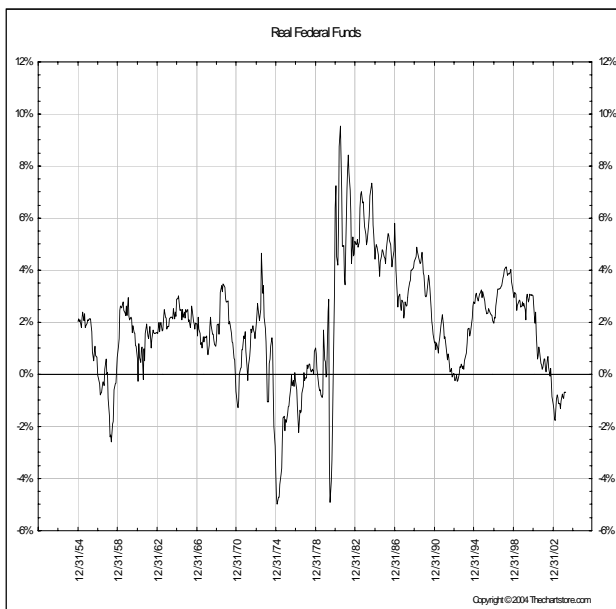
The labor picture brightened with the release of March data that indicated a 308,000 increase in non-farm employment and upward revisions of the January and February numbers. Five and ten year Treasury yields adjusted forty to fifty basis points higher in response to the announcement while municipal yields moved twenty to thirty basis points higher. The graph below illustrates the municipal yield curves that prevailed at the end of the quarter and on April 5 after the March labor announcement. The yield curve that prevailed at the end of 2000, when the Federal Reserve was targeting the Fed Funds rate at 6.5%, is also included to provide perspective.



- **Outlook**

The world economy is forecast to grow 4.75% this year led by continuing strong growth in China and other parts of Asia and sustained momentum in the U.S. Growth of this magnitude is likely to further pressure commodity prices and could extend the rise in the price of gold beyond the current \$420/oz level. Saudi cutbacks are expected to keep oil prices firm. Strong growth is likely to also provide producers with some pricing flexibility. Productivity is expected to remain strong, but we would not be surprised to witness signs of emerging inflationary pressures as the year progresses.

We anticipate that the Fed will remain on hold while awaiting additional employment data. One strong labor report does not constitute a trend and core inflation statistics currently remain under control. However, continued strong growth should ultimately force the monetary authorities to take action. Our belief is that economic developments, rather than the election, will determine the Fed's game plan, and tightening moves before November should not be ruled out. As shown in the first chart below (courtesy of The Chart Store) the real funds rate is negative and has been for some time. Chairman Greenspan is likely to become increasingly less comfortable with this situation as economic growth continues. The second chart illustrates the disparity that has developed between commodity prices and interest rates. This divergence is also unlikely to persist. We believe that it is more likely that we will witness rising rates in the near term rather than falling commodity prices.



We are continuing to maintain defensive portfolio constructions in our clients' accounts. Portfolio durations are below benchmark levels and we are emphasizing high coupon securities with defensive characteristics when adding to portfolio holdings. High quality and liquidity remain cornerstone attributes in our security selection process.

We remain mindful that successful terrorist attacks could drastically alter our outlook for higher rates, especially if an attack occurs in the U.S. A major shock could cause the economy to stumble and investors would retreat to safe harbor investments. However, shocks cannot be forecast and prudence calls for portfolios to be constructed in accord with the outlook considered most probable. In our view, that outlook calls for continued growth, rekindling inflation and rising interest rates.

- **Structural Risk Factors**

As mentioned last quarter, the steep yield curve has provided arbitrage opportunities to finance at low short rates and invest in longer, higher yielding instruments and pick up significant spreads. Although impossible to quantify, numerous trades employing this strategy are in place and many are leveraged. A flattening yield curve will prompt hedge funds to unwind these positions with resultant selling pressure as happened in 1994 when the Fed tightened.

Treasury sales could also intensify in a rising rate environment as mortgage backed funds sell government securities. Treasuries had been purchased to arrest portfolio duration shrinkage as mortgage rates fell and mortgage refinancing accelerated. An opposite response by fund managers will take place as rates rise.

Foreign investors and central banks currently hold approximately 36% of outstanding Treasuries. The U.S. trade deficit equals 5% of GDP and is forecast to move higher. We are therefore highly dependent on foreign investments in our securities markets to offset our trade deficit. Should any slackening in foreign demand develop, both the dollar and U.S. interest rates will be pressured.

The Treasury market is likely to be most sensitive to the above developments, but other fixed income sectors will also be impacted. We anticipate that municipal-Treasury spreads will widen in a rising rate environment. However, principal declines are likely in both sectors.

- **Negative Total Return Threshold**

Our primary objectives in the management of our clients' portfolios are to preserve principal values and maximize tax exempt income. Our goal in regard to the first objective is to avoid total return losses in any year. The rates shown below reflect the current AAA municipal yield curve and the curve that existed as of December 31, 2000 before the Fed began to ease. The columns next to each yield curve indicate the rate increases in each maturity that would be required, over a one year horizon, to produce price declines from par that would offset the coupon returns and produce zero total returns. As is apparent, shorter bonds are far riskier in the current low rate environment.

<u>Maturity</u>	<u>April 5, 2004</u>		<u>December 31, 2000</u>	
	<u>Yield</u>	<u>Zero Return Yield Increase</u>	<u>Yield</u>	<u>Zero Return Yield Increase</u>
3 years	1.90%	98 BP	4.10%	221 BP
5 years	2.60	70	4.15	117
7 years	3.10	58	4.25	83
10 years	3.65	45	4.40	61
15 years	4.21	42	4.80	49
20 years	4.60	38	5.05	43
30 years	4.75	31	5.15	36

- **United Airlines Lease Bonds**

The U.S. Bankruptcy Court – Northern District of Illinois, that is overseeing the UAL Corp. bankruptcy, ruled that United Airlines does not need to make payments on \$248 million special facility revenue bonds that financed facilities used by the airline at San Francisco International, Los Angeles International and JFK airports. The judge ruled that these bonds were secured by financing arrangements rather than by “bone fide” leases where United Airlines as lessor would retain rights, responsibilities and some ownership interest in the assets. Under the ruling, United must make payments on \$261 million of debt related to facilities at Denver International Airport because of differences in the structure of the leases backing the DIA debt. Approximately \$600 million of United Airlines debt related to equipment leases at O’Hare International Airport was not included in the ruling.

Although the decision is likely to be appealed, the court’s ruling places corporate backed municipal securities under a cloud. If leases with a corporate lessor can be abrogated in bankruptcy, there is obviously somewhat less security in this type of financing than had been presumed.

C.W. Henderson & Associates does not purchase securities backed by corporate leases. Investments in lease backed municipal securities are only made in bonds where the lessor is a strong municipal entity with both the ability and willingness to honor its debt obligations.

Craig W. Henderson

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