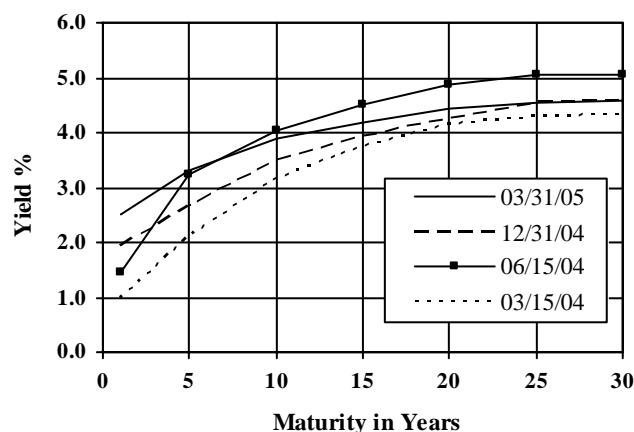


- **Background**

The Federal Reserve continued their tightening in the first quarter with two additional quarter point hikes in the Fed Funds rate that brought the target level to 2.75%. The yield curve flattened in response as longer rates remained in a narrow trading range during January and February. Volatility increased in March in response to a jump in oil prices to the \$55 area, Chairman Greenspan's comment during Congressional testimony that the lack of a response in longer rates to Fed tightening was a "conundrum", and indications that inflation is trending higher. The core CPI was reported to have risen by 2.4% for the twelve months ended in February, the highest level since August 2002.

The accompanying graph indicates the prime municipal yield curves that existed at year end and at the end of the first quarter. Also shown are the mid March and mid June 2004 curves that mark the points when longer rates reached the lowest and highest levels recently experienced. The rise in short rates is clearly evident throughout this entire period. The one to thirty year spread in prime municipal yields has fallen from 359 basis points last June to 208 basis points currently. More flattening is anticipated.



Municipal new issuance was surprisingly strong during the quarter with preliminary data indicating that a record \$96.6 billion bonds were sold, up almost 12% from last year. Refunding issues were very strong while new money financings were up modestly.

- **Outlook**

The economy began the year with a firm wind at its back after RGDP advanced 3.8% in the fourth quarter. However, a further jump in oil prices coupled with less than robust employment gains and a lethargic stock market have dampened consumer spirits as evidenced in a decline in consumer sentiment. Despite these drags, we still feel that there is sufficient momentum to produce a RGDP advance in excess of 3% this year spurred by acceptable consumer spending combined with increased exports and gains in capital spending.

We also anticipate that inflation will continue to move higher as the year progresses. A dramatic rise is not expected given fierce global competition, moderating monetary aggregate growth and an arrestment in the dollar's decline. However, with productivity gains moderating, it seems likely that additional price pressures will be evidenced as the economic cycle matures.

Commentary after the March Federal Open Market Committee meeting reflected the Fed's concern that inflation pressures are building. With a growing economy providing support, the monetary authorities are likely to continue to advance the Federal Funds rate until they achieve neutrality. What constitutes a neutral monetary posture? Assuming an advance in the core CPI to about 3% and a Fed goal of perhaps a 1% real return, neutrality would be achieved with a 4% Fed Funds rate. Based on this assumption, we expect that the Fed will continue to tighten, at a measured pace, throughout most of the year. We don't believe that longer rates will be immune from this pressure. The spread between the Fed Funds rate and the ten year Treasury yield is currently at 170 basis points. A flattening in the curve to perhaps 125 basis points while the Fed tightens to 4% suggests that the ten year Treasury yield could rise to the 5.25% area from 4.47% currently. Smaller yield adjustments are likely to be experienced in the municipal market, but the trend should be the same.

We continue to maintain lower than normal durations in our clients' portfolios in anticipation of rising rates as the Fed continues to tighten. Barbell structures remain in place with larger than normal components of short effective duration bonds. Premium bonds with good call protection are favored in the long bond component of the barbell. These cushion securities have reduced price risk in a rising rate environment and increased insulation from de minimus risk.

- **Impact of a Flatter Curve**

Shown below is the current prime municipal yield curve and the curve that existed in mid-March of last year. Also shown for each time period are the yield increases that would create zero total returns, over a one year horizon, if bonds with the various coupons and maturities were purchased at par. In essence, these are the yield to maturity increases that would cause the price of each bond to fall by the amount of the coupon as the maturity of the bond shortens by a year. These calculations provide risk sensitivity measures along the yield curve that we actively monitor to assess risk/reward tradeoffs. Our primary goal in managing client portfolios is to avoid negative total returns in any year and these measures provide input to our portfolio structure decisions.

<u>Maturity</u>	<u>Current Curve</u>	<u>3-15-04 Curve</u>	<u>Yield Increases That Produce Zero Returns</u>	
			<u>Current</u>	<u>3-15-04</u>
3 Yrs	2.97%	1.52%	157 BP	78 BP
5 Yrs	3.28	2.12	80	56
7 Yrs	3.56	2.59	68	48
10 Yrs	3.85	3.18	52	42
15 Yrs	4.14	3.73	40	35
20 Yrs	4.38	4.16	35	33
30 Yrs	4.56	4.31	29	27

A 100 basis point risk sensitivity for the five year segment of the curve would require yields in this maturity to rise to 3.70%. At that level, all else being the same, we would be more inclined to consider portfolio duration extensions.

- **Tax Reform?**

President Bush's domestic agenda has focused on Social Security reform during the opening months of the year and this initiative is likely to remain his priority over the near term. Whether he will be successful in instituting changes remains to be seen. Tax law reform is also on his second term agenda and we anticipate that tax proposals will emerge later in the year. The Administration would like a dramatic revision in the code that would replace the current system with perhaps a consumption based tax, but the likelihood of enacting any radical changes seems highly improbable. Any adjustment to the progressive nature of the system (and perceived fairness) would be a hard sell. Also, radical changes to the myriad of preferences and complexities in the code would be extremely difficult to effect given the special interest sponsorship that supports each of them.

Still, with yawning deficits, the administration and congress are under pressure to take action, and the municipal exemption is a tempting target. The President's FY 2006 Budget Proposal indicates that the estimated revenue loss to the federal government due to tax-exempt interest on municipal debt will exceed \$34 billion next year. Eliminating tax-exempt financing would help with the federal deficit, but would obviously have a severe counter impact on state and local budgets.

Elimination of the tax-exemption is not going to happen, but some additional restrictions on the municipal market are possible. The congressional Joint Tax Committee made recommendations in January that included the elimination of advance refunding bonds, prohibiting stadium financings for professional sports teams, reducing the benefit that casualty insurance companies gain by holding municipals and eliminating a 2% de minimus provision that allows corporations to purchase municipals and deduct the financing costs. Elimination of advance refundings would have a dramatic impact on the market by curtailing new issue volume. The supply of refunding bonds in any year depends on the level of interest rates relative to outstanding coupons, whether negative arbitrage exists, etc. Over the past ten years refunding issues have averaged 22.6% of total annual new issue volume.

We doubt that the municipal market will be affected significantly if a tax bill emerges. However we will monitor developments and assess any potential impact.

- **Call Risk**

Most municipal bonds issued with greater than ten year maturities are structured with call features that provide the issuing municipality with an option to retire the bonds at periodic call dates. If bonds are sold in a high interest rate environment and rates subsequently decline, municipal officials will often sell refunding bonds. The proceeds from refunding issues are used to purchase U.S. government securities that are held in escrow to pay debt service on the original bonds until they mature or can be called. In some instances escrows are established to pay debt service until maturity even though call features continue to exist. There is sometimes an assumption that the escrowed-to-maturity feature will eliminate call risk, especially if an issue is refunded and the refunding issue is also refunded. IRS rules do not allow more than two refundings of any issue. However, if calls are not defeased, the options remain in effect and investors must be cognizant that the issuing municipality retains the right to call bonds.

This issue was highlighted in February when New York City called \$430 million escrowed-to-maturity bonds with 6% to 8% coupons and 2012 to 2019 maturities. These bonds could not be refunded and it was generally assumed that the bonds would remain outstanding until maturity. However, with low prevailing interest rates, New York City opted to sell taxable bonds to raise funds that were used to call the older bonds. Some investors, assuming that the calls were ineffective, evidently paid significant premiums for bonds and suffered serious principal losses. Our approach, unless we are certain that a call feature has been defeased, is to always assume that the bonds can be called and adjust bids appropriately.

- **Firm News**

Defensiveness pays off! The Lehman Brothers Five Year GO Municipal Index had a negative 1.11% return in the first quarter while our traditional composite, based on preliminary calculations, had a gross return of -0.06%. Our short-term composite had a positive 0.31% gross return while the Lehman one year index had a zero return. Our dual priorities are to limit principal risk and seek to maximize tax-exempt income for our clients.

Craig W. Henderson

Thomas L. Mallman

Jeanhee Hoffman