

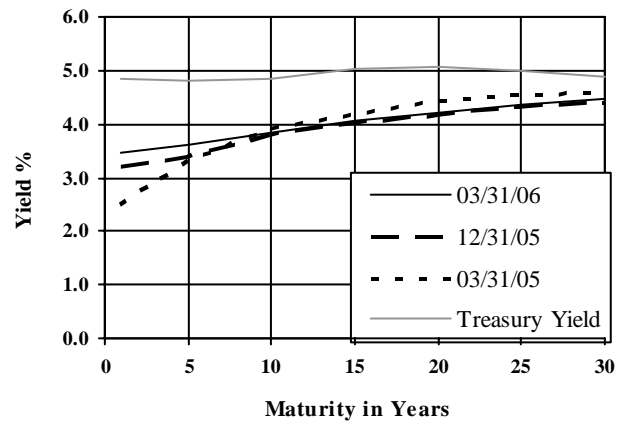
• **Background**

Economic momentum rebounded in the first quarter to an estimated 5% annualized rate in contrast to the tepid 1.7% Katrina impacted fourth quarter. Growth this quarter has been propelled by solid employment gains (approximately 200,000 monthly increases in non-farm payrolls). Consumer sentiment advanced in response as did consumer spending. In addition, corporate capital spending is also on an uptrend. The Federal Reserve made their fourteenth and fifteenth quarter point tightening moves at the January (Mr. Greenspan's last) and March (Mr. Bernanke's debut) FOMC meetings, bringing the targeted Federal Funds rate to 4.75%. The futures market is now predicting that another move in May is all but assured and that additional tightening beyond May is possible.

The Treasury curve, which remains extremely flat, moved higher across the maturity spectrum in response to Fed tightening. Ten year Treasury yields advanced by about 45 basis points to the 4.85% level at the close of the quarter.

As shown in the accompanying chart, short municipal rates also moved higher during the quarter, but tax-exempt yields beyond ten years were essentially unchanged. The spread between one and thirty year municipal yields is currently about 100 basis points, down from about 120 basis points at year end. In contrast, the one to thirty year Treasury spread is negligible, as it has been for some time.

**AAA Municipal Yield Curves**



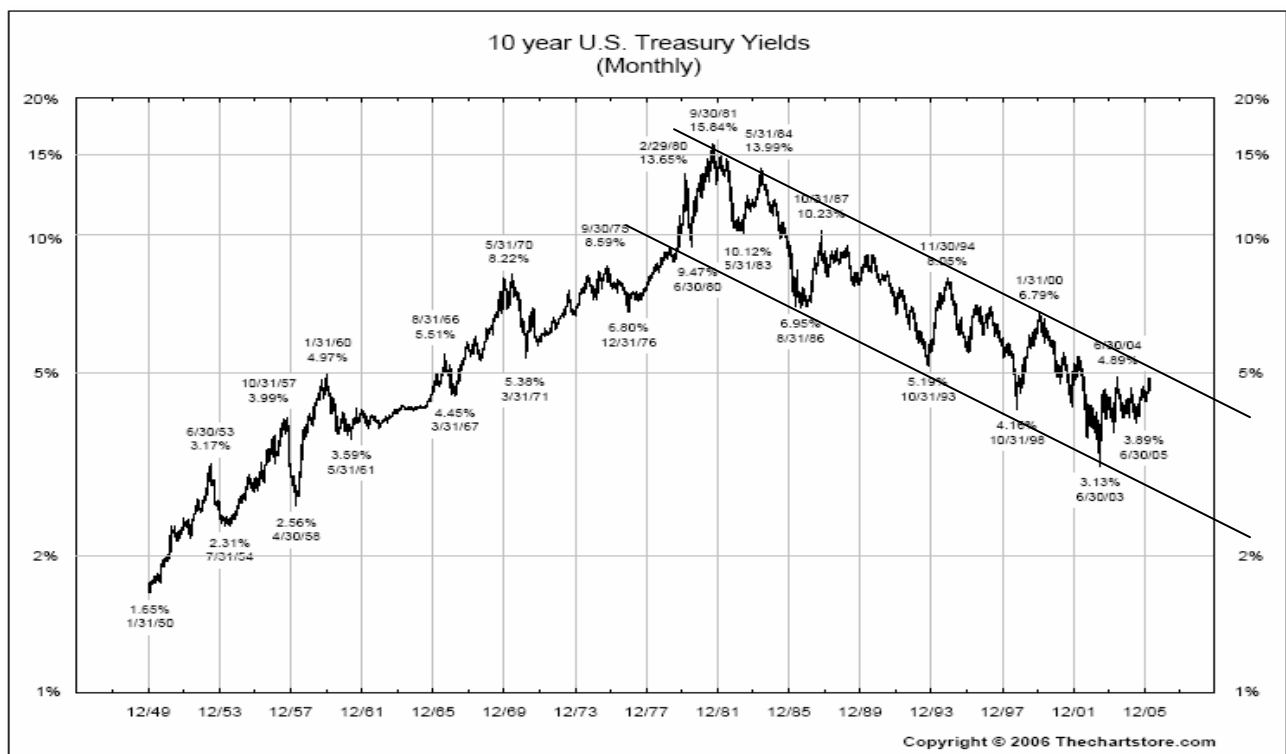
• **Outlook**

Economic momentum is certain to moderate from the first quarter pace as the year progresses. The question is how much? Projections of softening consumer spending have thus far proven to be premature but it seems that, sooner or later, we will witness some retrenchment. The cooling of the housing boom is reducing the wealth effect euphoria and the road to quick profitability through home ownership is becoming less assured. In addition, an estimated \$1 trillion of adjustable rate mortgages will reset at higher levels over the next eighteen months and home equity loan financing is becoming increasingly more expensive as short rates move higher. Energy prices are also restricting consumer disposable income.

Economic momentum is being spurred by wage growth and corporate spending. These factors will dampen the impact of a consumer slowdown, but we doubt that they will totally offset it. Therefore, our assumption is that economic growth will slow as the year progresses and probably total about 3% for the year.

As we suggested last quarter, we expect that the Fed is getting close to the end of their tightening. Inflation remains relatively subdued although some wage pressures have appeared as the unemployment rate has fallen and intermediate goods prices have moved higher. However, global competition remains intense and consumer price increases have been modest. Signs of a falloff in consumer spending or waning job growth would probably cause the Fed to pause while they monitor economic developments. Whether this occurs at a 5% Fed Funds rate or at slightly higher levels seems of limited consequence.

Upward pressure on long rates may continue in response to stronger global growth. The question is how much? The enclosed chart, courtesy of The Chart Store, provides a long term view of the bond market as represented by ten year constant maturity Treasury yields. The long term downtrend in rates remains in place, but could be breached to the upside. A significant breakout would probably require a jolt such as a spurt in inflation, a sharp decline in the dollar, waning international demand for U.S. securities, etc. None of these potential events currently appear to be on the immediate horizon. Therefore, our more favorable view of the market continues and we are making opportunistic additions to the long components of clients' barbell constructed portfolios.



- **Municipal Supply/Demand**

Municipal new issuance fell dramatically during the first quarter compared to the first three months of 2005 with volume this year off by over 29%. A sharp reduction in refunding activity was the primary cause. Also impacting volume is the fact that state and local tax revenues increased by about 10% in 2005 in conjunction with improving economic conditions. Further, some thirty-six governors are up for reelection or replacement this year which, in many cases, is prompting them to focus on their political futures rather than infrastructure needs. There will probably be some rebound in new issue volume later in the year, but not to the levels seen last year. We continue to expect a volume decline of about 15% this year compared to 2005.

On the flip side, demand remains strong. Mutual funds, casualty insurance companies and individuals have all been committing funds to the market. This picture is also unlikely to change dramatically over the course of the year. Strong demand with limited supply provides a favorable backdrop that further bolsters our view of the municipal market.

The municipal market significantly outperformed the taxable sector during the first quarter. Ratios of prime tax-exempt to Treasury yields in five, ten and thirty years at the end of March and at the end of the year are shown in the accompanying table.

**Ratio of Prime Municipal to Treasury Yields**

<u>Maturity</u>	<u>3-31-06</u>	<u>12-31-05</u>
5 Yrs	75.6%	77.9%
10 Yrs	79.2	86.6
30 Yrs	91.2	96.9

We may experience a modest reversal of this trend later in the year if taxable yields decline, but the municipal sector is expected to continue to perform well on a relative basis due to strong supply/demand fundamentals. Looking out several years, demand for tax-exempts should continue to be strong as baby boomers approach retirement and shift their investment objectives to increased cash flow and reduce the components of their portfolios structured for capital appreciation. Municipal securities are expected to remain preferred fixed income investments.

- **Alternative Minimum Tax Considerations**

The alternative minimum tax will become an increasing burden for taxpayers in the coming years unless it is modified or eliminated. According to "Barron's" an estimated twenty-six million taxpayers will be subject to the AMT this year compared to five million last year. It is estimated by the IRS that approximately 35% of all taxpayers will be subject to the AMT by 2010. Total elimination of the tax is unlikely since it is projected to raise approximately \$914 billion over the next ten years. Therefore, while there may be some adjustments, it is unlikely to go away.

Income from private activity municipal bonds cannot be deducted on an AMT payer's federal tax return. These bonds should obviously be avoided by anyone subject to the AMT. Another onerous aspect of the AMT for municipal investors is that deductions for state and local taxes (along with personal property taxes, real estate taxes, etc.) are not allowed in federal tax calculations. Therefore, AMT subject residents of states with high state taxes do not get a federal tax offset when buying out-of-state municipal bonds.

To illustrate, assume that a state has a top marginal income tax rate of 10% and a resident is not subject to the AMT and has a 35% marginal federal tax rate. If this individual purchases an out-of-state municipal, the effective tax rate paid on the bond's income is 6.5%. The bond is exempt from federal taxation, but the investor must pay 10% of the income to the state. However, the taxes paid to the state are deductible on the individual's federal return resulting in a 3.5% offset.

If the resident is subject to the AMT, his/her federal tax rate will be 28%. Municipal income remains non-taxable by the federal government, but the 10% tax paid to the state is not deductible and the investor does not receive an offset on his/her federal taxes.

There is obviously a strong incentive for high tax state residents to purchase in-state bonds. However, having only bonds from one state does not provide geographic diversification. Consider the risk of an all Louisiana municipal portfolio at the time of Katrina!

Our approach is to typically limit in-state bonds to 50% of a portfolio's allocation to reduce geographic risk. In the out-of-state components of these portfolios we look for general market bonds with unique characteristics that can provide enhanced returns that more than offset state taxes, and for cheap (higher yielding) general market bonds that provide reasonably competitive returns on an after-state tax basis.

The use of short U.S. Government agency bonds that are exempt from state taxation (e.g. Federal Home Loan Bank securities) can also be considered by an AMT subject investor. In this instance, income from the agency bonds is taxed at a 28% federal AMT rate, but exempt from state taxation. However, many agency securities have onerous call features and floating rate notes are often constructed with disadvantageous rate adjustment structures. When rates are steady or declining, bonds tend to get called. In a rising rate environment coupon resets often lag. Agency securities must be closely reviewed before implementing this type of strategy.

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