The Investor's Edge

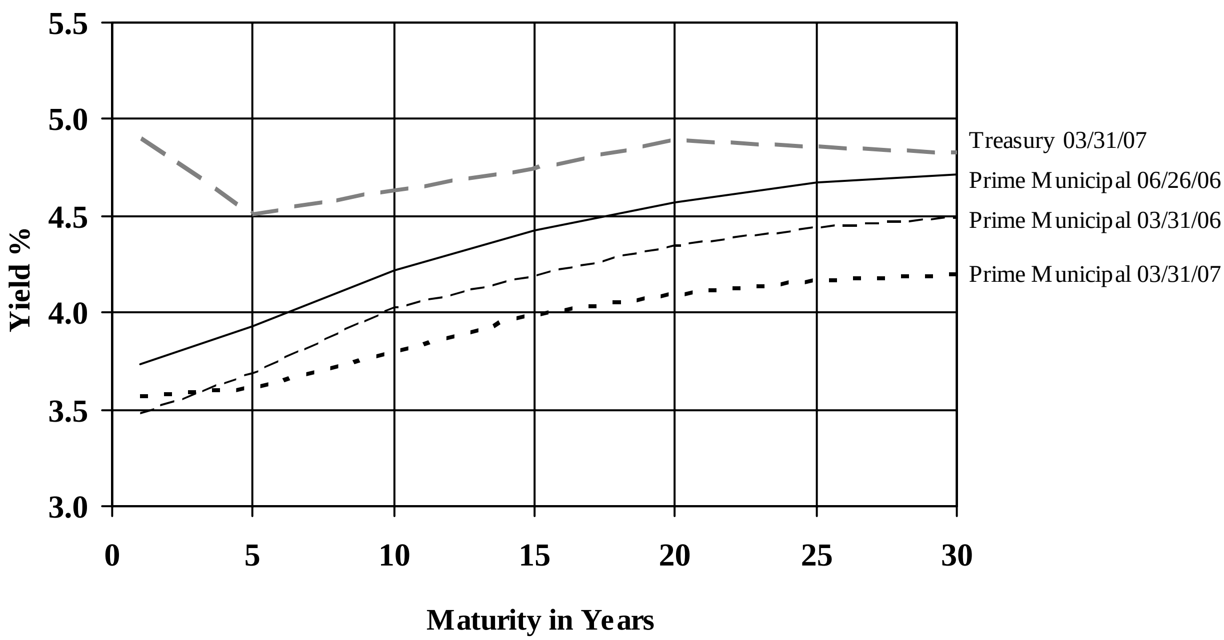
C.W. HENDERSON & ASSOCIATES, INC.

Investment Managers Specializing
in Tax-Exempt Municipal Securities

- **Background** **April 2007**

Interest rate volatility was subdued during the first quarter as municipal yields trended sideways in a relatively narrow range. As an example, the ten year prime municipal yield was at the 3.74% level at the end of the year and closed the quarter at 3.80% while trading in a 3.67% to 3.90% band. The curve steepened slightly with the one to thirty year spread widening to 63 basis points, in contrast to the Treasury curve which remains inverted. Fourth quarter real GDP was revised downward from 3.5% to 2.4% verifying that economic growth has moderated. Despite slowing economic momentum, Chairman Bernanke indicated in Congressional testimony that inflation concerns persist and that the Federal Reserve will remain vigilant in their efforts to constrain price advances. Oil prices generally traded in the $50 to $60 per barrel range until late in the period when prices moved higher in reaction to the British sailors being taken hostage by Iran. The graph below indicates the end of the quarter AAA municipal yield curve as well as curves that existed a year earlier and in late June of last year when yields hit an interim peak. The March 31 Treasury curve is also shown.

<u>First Quarter Yield Curve Shifts</u>

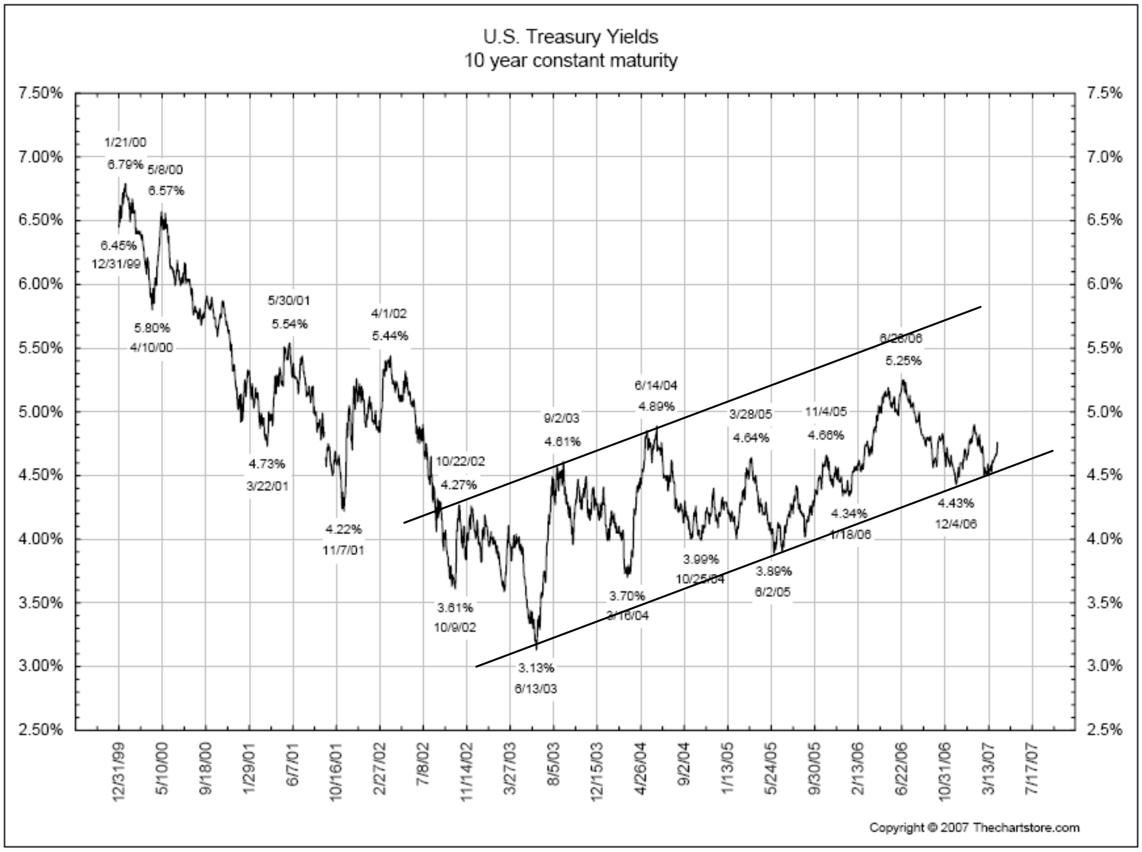


- **Outlook**

The persistence of the housing slowdown coupled with sub-prime mortgage defaults will likely continue to act as a drag on the economy for many more months. In addition, recent increases in gasoline prices are restricting disposable income and affecting consumer psychology. An added concern is that corporations have not ramped up capital spending as expected. Strong profits and cash flow are, to a significant extent, being channeled into stock buybacks rather than plant, equipment and systems purchases. As an offset, continued gains in non-farm employment and the low unemployment rate should provide consumers with discretionary income and sufficient confidence to sustain reasonable economic momentum. However, the total picture suggests a few quarters of subdued activity. We are not in the Greenspan camp suggesting the possibility of a recession in the foreseeable future, but below trend growth is anticipated.

The possibility of slower economic growth has prompted predictions of Federal Reserve ease in the coming months. While this action is certainly possible should growth fall dramatically, our base assumption is that the Fed is unlikely to ease in the near future in the face of continuing inflation pressures. The year-over-year increase in the core CPI through February was about 2.7%, a level clearly above the Fed's stated comfort range. Their concern is amplified by the fact that hourly wages have been increasing at a 4+% annual rate. Moderating productivity gains (1.6% last year compared to a 2.7% annual average since 1995) is complicating their task of reining the price advance. Therefore, as long as economic growth is positive and appears sustainable, our base case calls for the monetary authorities to remain on hold as they continue to assess evolving conditions.

As shown in the chart below illustrating ten year Treasury yields, courtesy of The Chart Store, the upward trend in long interest rates that has persisted since rates bottomed in mid 2003 remains in place. The lower end of the band has been challenged, but a decisive break has not occurred. We mentioned in last quarter's newsletter that we were contemplating adopting a somewhat more defensive posture by moving some longer portfolio positions into intermediate holdings. We have not yet taken this action as slowing economic momentum has prompted us to delay. At this time we are maintaining balanced barbell structures in client portfolios with neutral durations relative to our primary benchmark, the Lehman Brothers Five Year Municipal GO Index.



- **Municipal Supply Surges, Demand Strong**

New issue volume surged during the first quarter to approximately $104 billion. This far exceeded the $70 billion recorded in the same period last year and also topped the record $98.3 billion issuance in the first quarter of 2005. This supply was easily absorbed by the swelling ranks of baby boomer investors who are allocating growing components of their portfolios to tax-exempt investments. The threat of rising tax rates in 2010, when the tax cuts enacted early in the Bush administration reach the legislated sunset date, is providing additional incentive for investors to acquire tax advantaged securities. Unless action is taken by Congress, which seems unlikely with Democratic control, the maximum marginal tax rate will revert to 39.6% in 2010.

- **Hedge Fund Demand**

In addition to the traditional demand for municipal investments, hedge funds are continuing to purchase large components of the available new issue supply as they take advantage of the positive slope in the municipal yield curve. Municipal variable rate demand notes (VRDNs) with seven day puts are currently yielding about 3.65% while twenty year and longer securities provide 4+% returns. While this slope is relatively modest, it is still sufficiently steep to attract hedge fund investments. In these transactions long bonds are first purchased and placed in a trust. The trust issues VRDNs that are sold to money market funds. The proceeds from the sales to the money market funds offsets the cost of the long bonds and effectively finances the transaction at the VRDN rate while the hedge fund captures the spread.

The risk in this trade is that short rates rise and the spread between VRDN yields and the long bond coupon rate is eliminated. If the entire yield curve shifts upward, not only could the VRDN/long bond coupon spread evaporate, but the price of the long bonds would also decline. Unwinding the trades would require absorbing principal losses when the long bonds were sold. To protect the spread provided by the upward sloping yield curve, hedge fund managers typically enter into swaps or other derivative strategies. The cost of the derivative overlays is typically only a fraction of the value of the long bond/ VRDN transaction which provides leverage and the potential for high returns relative to prevailing interest rates.

- **Kentucky Case Update**

As we have reported in recent newsletters, a suit brought in the State of Kentucky argued that it was unconstitutional for the state to tax income from out-of-state municipal securities while exempting income from in-state bonds and was decided in favor of the plaintiffs. The Kentucky decision conflicts with a mid 90s Ohio case that had an opposite decision. The Kentucky case has been appealed to the U.S. Supreme Court. We continue to believe that there is a strong likelihood that the Supreme Court will hear the case since there is now a conflict between state laws. However, as of this writing there has not been an announcement by the Supreme Court as to whether the case will be heard. Given the delay, a decision, if it is ultimately rendered, will not be forthcoming in the near future as had been anticipated. Investors will continue to be faced with this uncertainty for an extended period. We will monitor developments as the situation unfolds.

- **Public Private Partnership Transactions**

Significant interest continues to be generated by various states and local governments in entering into long term lease agreements with private operators. In the first major transaction in 2005 the City of Chicago leased the Chicago Skyway for 99 years and received a $1.83 billion payment. This was followed last year by a 75 year lease of the Indiana Toll Road for $3.8 billion. Subsequently, Chicago leased an underground parking facility for $563 million. It appears that the lure of large up front payments will prompt several more transactions to be forthcoming in the months ahead. Transactions of this type are common in Europe and Australia where pension funds find matching long term liability commitments with these long term investments to be very attractive.

Transportation facilities have been the focus of the transactions done thus far in the U.S. However, there is no reason to limit the types of enterprises that could be involved in long term leases. Port facilities, airports, water and electric systems, hospitals, state lotteries, etc. are all potential candidates. Thus far foreign investment banks have taken the lead in arranging these financings. Wall Street firms are now ramping up to also be players. From an investor viewpoint two questions initially emerge. Will the finances and credit quality of the municipalities involved in the leases be impacted? Will the available supply of municipal securities possibly be restricted? Answers to these questions will evolve as the number and type of transactions expands.

Craig W. Henderson **Thomas L. Mallman**