THE INVESTOR'S EDGE

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Investment Counselors Specializing in Tax-Exempt Municipal Securities

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- **Background**

The economy is languishing and probably recorded close to 0% Real GDP growth in the second quarter. Consumers are wary, manufacturing activity has contracted, capital spending has slowed and the availability of venture capital has been severely curtailed. The third quarter will probably also be sluggish, but we anticipate that the cumulative impact of monetary and fiscal stimulus will serve to reestablish economic momentum as we move through the fall and into the winter. The Federal Reserve has eased six times this year and reduced the Federal Funds rate to 3.75%, a 275 basis point decline since January. The Fed's efforts will soon be augmented by $38 billion of tax rebates that the Treasury Department will begin issuing in August.

Our guess is that many of the rebate recipients will view the money as a windfall and much of it will be spent later this year. The recently enacted tax bill will lower tax receipts by an estimated $71 billion in 2002 and further bolster consumer demand next year. Reasonably full employment (despite the rise in the unemployment rate from a low of 3.9% to 4.5% currently) and a firm housing market should provide a stable foundation for fiscal and monetary stimulus to rekindle growth in the months ahead.

Drags from limited capital spending, and a manufacturing sector that is unlikely to ramp up activity until it sees clear signs of increased demand, are expected to restrain the rate of economic advance over the next few quarters. An elongated "U" shaped recovery is probably most likely.

Energy remains a wild card. High gasoline, natural gas, and electricity prices, coupled with the possibility of brownouts in California (and possibly in other areas) as summer temperatures rise, could diminish consumer enthusiasm and further restrict business expansion plans.

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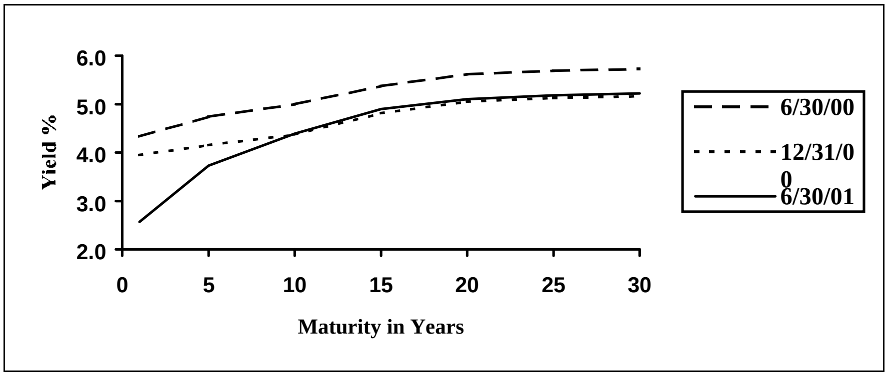
- **Interest Rate Outlook**

 As illustrated in the following graph, the municipal yield curve has steepened significantly since the beginning of the year with the spread between one and thirty year bonds currently at 265 basis points, over twice the 121 basis point spread evidenced at year end. Almost all of the steepening has been due to declining short rates in response to the Federal Reserve's easings. Rates on ten year and longer securities are only slightly higher compared to year end levels. Long rates fell in the second half of last year as the market anticipated the decline in economic activity, but have subsequently been relatively steady. The inability of long municipal rates to move lower in tandem with the decline in short yields this year is due in part to the heavy financing burden that the market is facing, but might also reflect the market's expectation of stronger growth in the months ahead.



The Fed's focus over the next several months will remain on assuring that an economic recovery develops. Therefore, it would not be surprising if they cut the Federal Funds rate one or two more times and bring the level to 3.50% or 3.25%. However, we believe that, barring some surprise, the monetary authorities are near the end of their easing program. Short rates are unlikely to decline significantly further while long rates could creep higher in the months ahead in reaction to a strengthening economy and heavy new issue volume. We do not anticipate any serious near term inflation threats, but strident wage demands (e.g. Delta Airlines' pilot agreement) and higher energy prices could cause the price indicies to trend somewhat higher and, in turn, pressure interest rates.

- **Supply/ Demand**

 New issue volume has been strong during the first half of the year due to heavy infrastructure financing needs and relatively low interest rates. Financing is expected to remain at high levels during the rest of the year, especially given that the California Department of Water Resources is expected to market $13.4 billion bonds (about $10 billion of which will be tax-exempt) in the fall. A similarly sized New York Metropolitan Transportation Authority financing is also anticipated. Municipal new issue volume through June was $129.4 billion and is forecast to be in the $260 to $270 billion range for the full year. In contrast, financing for all of 2000 was just slightly in excess of $200 billion.

Demand for tax-exempts has been reasonably strong despite the heavy supply as investors have switched marginal funds from equities to the fixed income market in reaction to sagging stock prices. This action has been reflected in increased mutual fund cash flows and in demand from individual investors. In addition, declining short rates have diminished money market fund yields and prompted extensions along the yield curve with a resultant increase in the demand for bonds.

- **California: Power Problem**

  California has experienced brownouts, the State has had to purchase significant amounts of power on the spot market and Pacific Gas & Electric has filed for bankruptcy. These are but a few indications of California's energy crisis. This situation is the result of poor planning and bad luck. Poor planning in that no major power plants have been built in the state in many years due to environmental concerns and local restrictions, and due to a poorly constructed deregulation plan. Bad luck in that rainfall in the Pacific Northwest has been extremely limited causing hydro power production, that is typically exported into the California market in the summer months, to be severely restricted. Growing demand for power in the state reached a point at which the supply curve virtually ended, causing prices to spike to astronomic levels. (In essence, marginal demand for power exceeded supply from normal sources).

  As of mid-June, the Department of Water Resources had spent $6.1 billion on power purchases. Funds for these purchases were borrowed from the State's general fund. To stem withdrawals from the general fund, a $4.5 billion bridge loan was transacted that will provide funds for additional near-term power purchases. The bridge loan will be repaid from the proceeds of the $13.4 billion anticipated bond sale.

  We are confident that, longer term, the crisis will subside. There are currently sixteen major power plants under construction in the state that will provide 10,400 MW of additional capacity. However, it will take three to four years to get all of them up and running. In addition, it will rain again in the northwest and hydro power will again be available to the California market. Perhaps of most import, California represents a dynamic segment of the country and accounts for approximately 14% of U.S. GDP. There is no question that the infrastructure needs of the state (including power) must be provided, and that adequate financing will be made available to pay for essential services.

  State of California general obligation bonds were downgraded from AA to A+ by Standard and Poor's Corporation in April and from Aa2 to Aa3 by Moody's Investors Service in mid-May. Additional downgrades may be experienced in the coming months if the crisis intensifies.

  California bonds have cheapened in reaction to the downgrades and due to concerns about the impending California Department of Water Resources sale. A year ago, ten-year State of California bonds were yielding about 20 basis points less than non-California AAA securities due to strong in-state demand for California bonds. Currently these securities are yielding 20 basis points <u>more</u> than out-of-state AAA securities. We would not be surprised to witness additional spread widening and will continue to evaluate the attractiveness of California securities in the weeks ahead.

- **Impact of the Tax Changes**

  As expected, the recently enacted tax bill did not include a meaningful near term decrease in the maximum income tax rate and very few investors are likely to switch from municipals to taxable bonds due to the tax law changes.

- **Impact of the Tax Changes (cont.)**

  One factor that will become more significant is the Alternative Minimum Tax. Unless the current law is changed, it is estimated that over the next ten years the number of returns that will be impacted by the tax will increase from approximately 1% currently to about 11%. This is due to the fact that AMT rates and exemptions that determine the threshold for paying the tax are not indexed for inflation as are the calculations for regular taxable income. Items such as accelerated depreciation, large numbers of personal exemptions, excessive long-term capital gains, exercise of incentive stock options, etc. will cause filers to breach the AMT threshold at an increasing rate in the years ahead.

  Income from private activity municipal bonds issued after August 1986 must be included in the AMT calculation. Since demand for these securities is limited to investors that are not subject to the alternative minimum tax, AMT securities typically yield an additional 15 to 20 basis points over comparably rated non-AMT bonds with like maturities. As the universe of non-AMT investors gets smaller in coming years, the spread on these bonds should widen further and provide increasingly greater value for non-AMT investors. Our annual questionnaire inquires whether each client is subject to the AMT to assure that we include these securities only in portfolios where they are appropriate.

- **Relative Value**

  We are witnessing increased interest in the municipal market as many investors are reevaluating portfolio allocations. Equities should provide good long-term relative value, but intermediate bonds serve to moderate portfolio volatility and provide income stability. We continue to recommend that portfolio asset allocations be reviewed.

  Little has changed in recent months from a relative valuation standpoint. The municipal market continues to appear attractive relative to the Treasury sector with yield ratios of over 80% in ten years and 90+% in the thirty-year sector. With yield spreads between Treasury and Corporate securities narrowing, municipal/corporate ratios are also improving. Municipal credit spreads remain narrow with only about 20 basis points of pickup between ten year AAA and single A bonds. We are continuing to emphasize high grade securities in our clients' portfolio constructions.

  Electric revenue bonds in many areas of the country have cheapened in reaction to California's power crisis. We are monitoring developments, but feel that it is premature to increase exposure to this sector.

- **Firm News**

  The latest person to join C.W. Henderson & Associates is Kim Kluender who is functioning in an administrative role. Her addition will improve the efficiency of the firm and enhance our responsiveness. With Kim on board we now have sufficient personnel depth to support our expansion plans and to continue providing superior client service for the foreseeable future. We are pleased to have her with us.

  If you would like to receive our newsletters over the internet, please provide us with your email address and we will supply them electronically. Have a great summer!

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