

- **Background**

The glass is half empty! Negativism permeates the investment landscape and most investors feel that there are few attractive alternatives for capital commitments. Two plus years of eroding equity valuations, an economic recovery that can't seem to gain footing, lack of confidence in corporate governance, the never ending Middle East crisis, and fears of additional terrorist attacks in the U.S. have ravaged investor psychology. The safe harbor bond market has performed well, but yield declines experienced over the past eighteen months have diminished the attractiveness of fixed income investments.

The dollar's slide has been added to the list of worries. Our massive trade imbalance requires that funds shipped overseas to pay for imports be reinvested in our securities markets to balance capital flows. This recycling process has been in place for several years resulting in significant foreign investments in our markets. A recent "Wall Street Journal" article indicated that approximately 40% of marketable U.S. Treasury debt, 24% of U.S. corporate debt and 13% of outstanding U.S. equities are held by foreigners. A falling dollar makes U.S. investments less attractive to foreigners as the currency depreciation (if not hedged) diminishes their return potential. Massive selling by foreigners is unlikely, but marginal shifts in their investment patterns could limit any recovery in the U.S. equity market and precipitate declines in the fixed income markets. Since the end of April the euro and the yen have appreciated about 9.5% and 7.5% relative to the dollar. The British pound's advance has been more muted, having risen about 4.5% in the past two months.

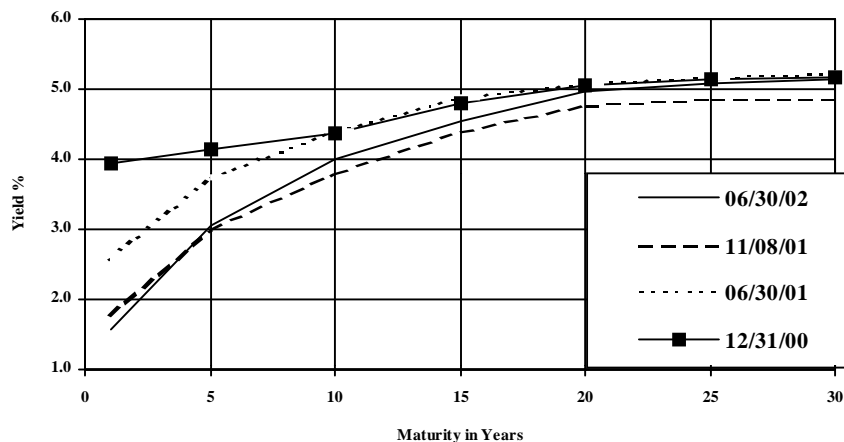
With this backdrop, investors are now worried that the recent drop in consumer confidence and limited capital spending might be precursors of a double dip recession. Estimates of when the Fed will begin tightening have been pushed further into the future and some discussion has surfaced as to whether the Fed may actually need to ease further. Lower interest rates could have the adverse effect of intensifying the dollar's depreciation and sparking longer term inflation fears.

- **Outlook**

Is economic growth likely to experience another downdraft? Although the environment is uncertain, our base case is that the economy will continue to expand at a moderate pace in the months ahead. An accommodative monetary policy coupled with stimulative federal spending in an expanding global economy should be sufficient to maintain economic momentum. Low interest rates have kept housing on a solid footing, the decline in the dollar should stimulate exports and, although the unemployment rate may creep higher in the near term, we expect that employment gains will be evidenced as the recovery intensifies. A pick up in capital spending should follow as the up turn proceeds.

Corporate accounting and governance issues will persist for some time, but will ultimately recede. Increased control and accountability are likely to follow as heightened regulatory and industry oversight develops along with tightened accounting standards. Terrorism is likely to be a continuing concern. Operatives remain active and are intent on inflicting further damage. The success of additional attacks is impossible to predict, but the threat will continue to cloud the economic and investment landscape.

### AAA Municipal Yield Curve



- **Interest Rate Outlook**

The yield curves shown below indicate that current interest rates in the municipal market are approaching the levels seen last November when rates bottomed. Can yields move still lower from current levels? Perhaps, if the stock market continues to decline or world events shock the markets. However, shocks cannot be predicted and we therefore must proceed with our base forecast. This view leads us to conclude that the potential for higher rates in an environment of stronger economic growth significantly exceeds the potential for further rate declines. Federal Reserve tightening before the end of the year is expected and higher rates along the yield curve are anticipated in reaction to a weaker dollar and a steady stream of bond sales by federal, corporate and municipal issuers. We are therefore maintaining our cautious posture and would be inclined to further decrease portfolio durations if rates decline further. We feel that it is important that gains recorded thus far this year not be squandered in a market pullback.

- **Can Value Be Found In A Low Rate Environment?**

With five and ten year AAA municipal securities yielding only about 3% and 4% respectively, and with tight credit spreads, where can investors with cash turn to attain reasonable returns? This question is especially pertinent in an environment where we anticipate that rates are likely to move higher later in the year and principal protection will rise as a priority. Tax-exempt money market funds provide principal protection, but this refuge is not terribly attractive with yields of only slightly over 1%. The prevailing level of interest rates at the time fixed income investments are made will dictate much of investors' return potential. The old adage that one can control their exposure to the market but cannot control the market is especially appropriate at this time. As noted above, we favor defensiveness and duration control in portfolio constructions. Even with this priority, the potential does exist to add value through the use of high coupon bonds with short calls, cushion bonds, housing bonds, curve roll down strategies, etc. to add value while limiting volatility exposure. There is a risk that rates may stay low longer than anticipated, but caution appears most appropriate in the prevailing low rate environment.

- **Municipal Supply**

Municipal bond new issuance thru May totaled \$123.7 billion, up 16.3% from last year. Investors fleeing the stock market have easily absorbed this supply and there seems to be little likelihood that demand will subside in the near future. Reestablishing investor confidence in the equity markets will take time, and the fixed income sector will be the beneficiary in the immediate future. Our estimate that municipal volume will exceed \$300 billion this year remains in place.

- **Municipal Budgetary Restraints**

Economic downturns negatively impact tax receipts and user fees and cause budgetary strains. Almost every municipality has experienced reduced revenues and many have pared spending and/or increased taxes in their attempts to balance their budgets. These strains are symptomatic of the economic environment and take place in every downturn. We anticipate that these budgetary strains will subside as the economy recovers. However, municipal finance officials will remain challenged over the next several quarters to produce sufficient revenues to meet their needs. One expense item that will remain significant is the need for increased security. Budgetary allocations to police forces, strengthening cyber firewalls, etc. will be high priority expenditure items. Acquiring high credit quality securities with reasonably dependable revenue sources should be the focus of municipal investors.

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- **Can Municipal Portfolios Be Protected From Terrorism Threats?**

An attack in a metropolitan area, against a power plant or bridge, disabling a dam, etc. would create disruptions in the area impacted. The degree of disruption would obviously depend on the size and success of the attack. The attacks on the World Trade Center and the Pentagon, and the attempt to detonate a bomb at Los Angeles airport have focused attention on urban centers. Recent news releases have reported on cyber terrorism threats and possible plans to disrupt electrical supplies, create floods by opening up a major dam, interrupting air traffic control communications, etc. There is obviously no way to predict the type and likely success of any such attack. However, the probability that there will be additional attempts seems high. The only portfolio defense appears to be diversification. Geographic diversification heads the list, but limiting exposure to specific types of enterprises is also important. For example, heavy concentrations in bonds backed by bridge tolls, electric revenue generation, airport revenues, etc. would not appear prudent.

This raises the issue of specialty state securities that are in high demand by residents of states that have high state tax rates. Concentrated state exposure increases risk to natural disasters, localized economic declines, etc. Terrorism must now be added to this list. Portfolio representation of more than 50% in-state bonds appears inappropriate.

Investors relying on insurance for protection should also review exposures. It is difficult to predict possible insurance company strains in a multi-default environment. Diversification among insurance providers is also important.

- **Firm News**

C.W. Henderson & Associates has been fortunate to have experienced several new account openings during the first half of the year. We are pleased with the confidence expressed by our clients and remain cognizant of our challenge to provide sound returns within a framework of risk control. We welcome your comments.

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