The Investor's Edge

C.W. HENDERSON & ASSOCIATES, INC.

Investment Managers Specializing in Tax-Exempt Securities

July 2006

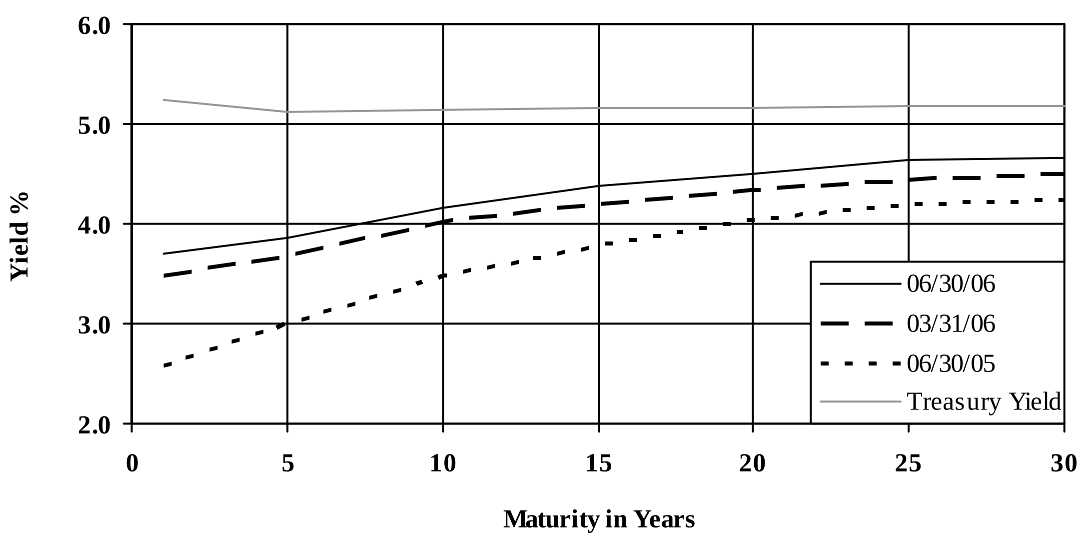
- **Background**

Chairman Bernanke has now presided over three FOMC meetings and has thus far followed his predecessor's game plan by moving the Fed Funds rate higher at a ¼% per meeting rate. The last move took place on June 29th when the target rate was moved to 5.25%. Other short rates have adjusted higher in tandem with the Fed moves. Longer Treasury rates also rose during the first half of this year after trading in a relatively narrow 60+ basis point band during the previous eighteen months. The ten year Treasury yield peaked at 5.24% in late March and closed the second quarter at 5.14%, up from 4.39% at year end and 4.85% at the end of March. Strong economic growth in the first half played a part as did a weaker dollar, rising oil prices and core inflation readings that have crept above the Fed's 2% comfort zone.

Municipal rates also moved higher, but not nearly to the extent that taxable rates rose. As reflected in the accompanying graph, ten year prime municipal yields rose by only fourteen basis points during the quarter and ended the period at the 4.16% level. A sharp 15% decline in new issue supply compared to the first half of last year, while retail and casualty insurance company demand remained strong, was the primary cause of the smaller move in tax-exempt rates.

The municipal curve flattened further during the quarter. The one to thirty year spread is currently 94 basis points compared to 166 basis points a year ago and the dramatic 311 basis point spread in June 2003 when rates bottomed. The upward slope of the municipal curve continues to contrast with the Treasury yield curve where the one to thirty year spread remains slightly inverted.

AAA Municipal Yield Curves



- **Outlook**

Will inflation rekindle at a faster pace while economic activity moderates? That appears to be the primary question that the markets are grappling with. The Fed is attempting to stem the recent pickup in inflation pressures while still allowing economic growth to move forward at an acceptable pace. This requires a delicate balancing act, especially with a flat to slightly inverted yield curve that has historically often forecast a slowdown. The markets are skeptical as to whether the new Fed Chairman can successfully walk this tightrope while also moderating pressure on the dollar in the face of continuing massive trade deficits that require increasing levels of foreign financing. The Federal Reserve's job is further complicated by the uncertain message conveyed by the highest gold prices seen in a quarter of a century, softening housing values and a challenging international backdrop with North Korean missile launches, Iran's nuclear threat and bubbling turmoil throughout the middle east.

Our outlook continues to call for real growth of 3+% this year with the pace of economic activity moderating as the year progresses. Consumer spending is expected to decline, but not drop dramatically. Higher energy prices and a slowing housing sector are having an impact, but consumer sentiment remains buoyed by the low unemployment rate. Other than a few notable exceptions such as airlines and domestic auto companies, the corporate sector remains on a solid footing and employment gains are expected to continue to be recorded at a steady, although possibly moderate, pace.

We continue to feel that the Fed is at or near the end of their tightening cycle. The monetary authorities want to maintain their hard won credentials as inflation fighters which could cause them to tighten a bit further. They have stated that additional moves will be data dependent and we expect that the data will provide evidence of moderating growth as the year progresses. Another increase in August cannot be ruled out, but we expect that the FOMC will conclude in the not too distant future that they should move to the sidelines and assess the impact of the seventeen tightening moves that they have made over the past two years.

How will long rates be impacted by a Fed pause? It would not be surprising if we initially witness a relief rally. However, additional pressure on longer yields could subsequently develop if signs of easing inflation don't quickly emerge. Volatility should be expected until a stronger market consensus develops.

Despite the cloudy outlook, it is important to focus on the backup in rates that has taken place over the past six months and note that the market is now offering the highest rates seen in several years. As shown in the accompanying chart, taxable rates have experienced a considerable back up and appear to represent attractive value.

As pointed out earlier, the lack of supply in the municipal market this year has limited the increase in tax-exempt yields. The following table indicates the quarter end ratio of prime municipal to Treasury yields and those that existed a year ago. The out performance of the tax-exempt sector is clearly illustrated.

Ratio of Prime Municipal to Treasury Yields

	6-30-06			**6-30-05**		
	Muni	Treasury	Ratio	Muni	Treasury	Ratio
1 yr	3.71%	5.23%	70.9	2.58%	3.54%	72.9
3 yrs	3.81	5.11	74.6	2.78	3.66	76.0
5 yrs	3.87	5.10	75.9	3.00	3.72	80.6
10 yrs	4.16	5.14	80.9	3.47	3.94	88.1
30 yrs	4.67	5.18	90.2	4.24	4.22	100.5

We continue to target portfolio durations at slightly below benchmark levels. An improvement in the tax-exempt/taxable ratio and/or further increases in nominal rates would likely prompt us to extend durations further. We are cognizant that the markets will continue to be volatile in reaction to the many cross currents and conflicting signals that are affecting the outlook. Purchases of longer bonds must be made on a disciplined basis.

- **Enterprise Privatization**

In January 2005 the City of Chicago closed on a transaction that leased the Chicago Skyway to an Australian and Spanish consortium for ninety-nine years. The City received a $1.83 billion cash payment from the group that assumed responsibility for the operation and maintenance of the 7.8 mile toll road that connects the Dan Ryan Expressway with the Indiana Toll Road. This was the first privatization of a toll road in the United States. The same consortium is now close to closing a deal that will pay the State of Indiana $3.8 billion for a seventy-five year lease of the toll road that runs east and west near the state's northern border.

This type of arrangement is not uncommon in Europe and Australia where municipal markets are small or non existent. Foreign local governments in need of infrastructure development have often turned to the private sector to build and operate public facilities. Legal blueprints are well developed and funding sources from foreign pension funds and insurance companies are readily available. These institutions seek long duration assets with predictable and steady cash flows that match their liability obligations.

These transactions have been coined in the industry as 3P – private public partnerships. We expect that more will be forthcoming given the lure of large up front payments that municipalities can generate by extracting equity value from transportation assets. Tollroad enterprises in Virginia and Texas are reported to be studying potential transactions and additional deals seem sure to emerge. This activity has captured the attention of the U.S. investment banks and private equity funds that are amassing large funding pools to facilitate additional transactions.

Other infrastructure enterprises besides tollroads such as airports, telecommunication, water systems, power generation, etc. have been used in structuring 3P transactions in various countries. It would not be surprising if the types of enterprises used in 3P transactions expand in the U.S. in the coming years. The question then facing municipal investors is what happens to the supply of revenue bonds? If a strong 3P trend develops, it could reduce new issuance and cause existing bonds to increase in value. We will be watching developments in this area to assess the impact on municipal security valuations.

- **Firm News**

We are pleased to report that C.W. Henderson & Associates has signed a new lease and will continue to reside at 20 W. Kinzie St. for several more years. The design of our office continues to serve us well and provides for fluid communications in a comfortable setting. Our location in the River North section of Chicago provides ready access to transportation in a rapidly developing section of the city. We are happy with our home.

The Firm experienced continued strong growth in assets under management during the first half of this year. We are very appreciative and respectful of the confidence of our clients and friends and remain dedicated to providing conservatively managed high quality municipal bond portfolios.

Craig W. Henderson Thomas L. Mallman Jeanhee Hoffman