

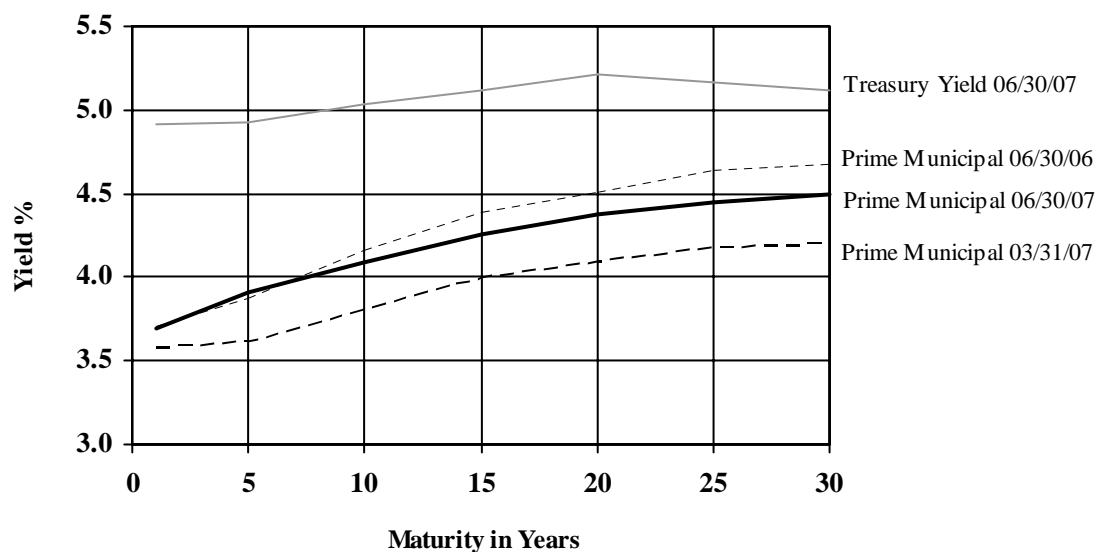
July 2007

▪ **Background**

In contrast to the first quarter when interest rates moved sideways, yields moved higher across the maturity spectrum in the second quarter in response to a rebound in economic growth and kindling inflation concerns. Inventory rebuilding, continued consumer spending and export growth moved real GDP from the anemic 0.6% first quarter level to an expected 2.5+% in the second. Continued employment gains supported consumer sentiment despite concerns about high energy prices. Core inflation measures remained under control, but rising wage rates suggest that inflationary pressures could move somewhat higher. The Federal Reserve remained on hold during the quarter and the targeted Federal Funds rate was kept at 5.25% where it has been maintained since June of last year.

As indicated in the chart below, prime municipal yields moved twenty-five to thirty basis points higher in most maturities during the quarter. However, yields are still below the levels seen in June of last year when rates reached an interim high. The municipal curve also steepened with the one to thirty year spread rising from 57 to 80 basis points. In addition, rising long taxable rates caused the Treasury curve to regain a slightly positive posture after being inverted since early last year.

Second Quarter Yield Curve Shifts



New issue volume remained strong with \$86.7 billion of new debt marketed during the quarter. The total for the first half was \$193.7 billion, an 8% increase from last year. Strong appetites for bonds from retail investors and casualty insurance companies, along with the use of municipal arbitrage strategies in hedge funds, easily absorbed the supply.

- **Outlook**

Will the economy continue to grow at a reasonable pace or will the burden of high energy prices and the sluggish housing market sap consumer sentiment and cause growth to falter? Will slower domestic growth ease inflation concerns or will strong global growth foster higher prices? These are key issues as investors ponder the outlook for interest rates.

Our base assumption is that the economy will expand at a reasonable two to three percent pace. Housing will act as a retardant as will high gasoline prices. However global growth remains on a strong upward path which should continue to bolster U.S. exports, especially given the weakness in the dollar. Serious slackening in the labor market does not appear to be in the cards which should keep the unemployment rate low. Resultant wage gains are expected to support consumer confidence.

We are somewhat concerned that inflation rates may creep higher. Wages appear to be bottoming in India and China, possibly causing the deflationary effect of moving facilities offshore to diminish. Rising global wage rates may be on the horizon and whether they can be totally offset with other productivity gains is uncertain. A surge in inflation is not anticipated in a still highly competitive world, but a shift to somewhat higher core levels would not be surprising. Yields on Treasury Inflation Protected Securities (TIPS) have moved modestly higher in recent months suggesting that investors are sensing that price pressures may advance.

The technical picture also suggests caution. The following chart, courtesy of The Chart Store, provides a long term view of ten year Treasury yields since the late 70s. The downward trend in rates since the 1981 peak is clearly evident as is the counter trend over the past few years after the Treasury yield bottomed at 3.12% in mid 2003. The break through the long term down trend line should be noted and may indicate a shift to higher interest rate levels.

We are currently maintaining portfolio durations near benchmark levels as we monitor market developments. Indications of higher inflation or increased economic activity would likely prompt us to reduce exposure to the longer component of our clients' barbell portfolio structures.



- **Supreme Court to Hear Kentucky Case**

As we anticipated, the Supreme Court announced that they will hear the case appealed by the Kentucky Department of Revenue dealing with the question of whether states can tax income from municipal bonds issued by out-of-state municipalities while exempting income from in-state bonds. Kentuckians George and Catherine Davis brought the case and argued that exempting in-state municipal income while taxing out-of-state income violated the dormant commerce clause of the U.S. Constitution that prohibits states from competing against one another in a manner that burdens interstate commerce. A Kentucky appellate court ruled in favor of the plaintiffs and rejected the state’s argument that, as an issuer bonds, the state is a market participant and precedent allowed the permissibility of the in-state tax exemption. The court opined that the state was acting as a regulator in regard to taxation and not as a market participant. The Kentucky Supreme Court declined to review the appellate decision.

The U.S. Supreme Court has indicated that they will hear the case in their fall session. Their decision could be forthcoming late this year or early next year. If the Kentucky appellate decision is not overturned, there will be significant ramifications for the municipal bond market. Most states tax income from out-of-state bonds while exempting in-state municipal income. Residents of high tax states like California and New York currently have a strong incentive to purchase in-state bonds to avoid both federal and state income taxes. That incentive would no longer exist if states are forced to either exempt or tax all municipal income. (Our presumption is that most states would opt to tax all

municipal income.) Borrowing costs of states with high income tax rates would increase due to lessened in-state demand. A more homogeneous market would likely develop with trading levels based primarily on each bond's credit and liquidity characteristics. There are close to five hundred single state municipal bond funds structured to provide income that is exempt from specific state income taxes. These investment vehicles would no longer have a purpose and would likely be merged into national funds.

How the Supreme Court will decide remains to be seen. We have not as yet evidenced any yield shifts that would indicate that the market is betting heavily one way or the other.

We have always felt that portfolios should not be invested totally in bonds from only one state. Geographic risk should be diversified. Also, given our active management process, it is often possible to find securities that provide enhanced returns on an after state tax basis. Exploring the entire municipal market provides broader opportunities for attractive purchases. Therefore, regardless of the Supreme Court's decision, our clients will be insulated to some extent should negative price movements be experienced on specific bonds.

- **Market Risk Increases**

High foreign savings rates and global liquidity created the low interest rate environment experienced over the past several years. Easy money tends to foster riskier investments as has been evidenced in the housing arena where creative financings and sub-prime mortgages have flourished and, more broadly, in the use of collateralized debt obligations. Rising interest rates have created stresses and uncovered flaws in some of the structures. Bear Stearns' need to prop two of their funds with a \$3.2 billion cash infusion provides a vivid example. Dramatic problems have not been evidenced in the municipal market, but we would not be surprised to see credit spreads widen in all sectors as investors seek refuge should additional problems develop. If that becomes the case, our focus on using only high quality, liquid securities will serve our clients well as uncertainty and volatility increase.

- **Firm News**

We are pleased to introduce Charlie Yorke as the newest member of the C.W. Henderson & Associates team. Charlie has twenty five years of experience as a fixed income salesman with Salomon Brothers, Credit Suisse First Boston and, most recently, Hong Kong Shanghai Bank. He is assuming the role of Managing Director for business development and will market the Firm's services to individual, institutional and advisory clients. His experience and expertise add depth and insight to our product development and product distribution efforts. We are very pleased and excited to have Charlie on board.

Craig W. Henderson

Thomas L. Mallman

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