

**October 2007**

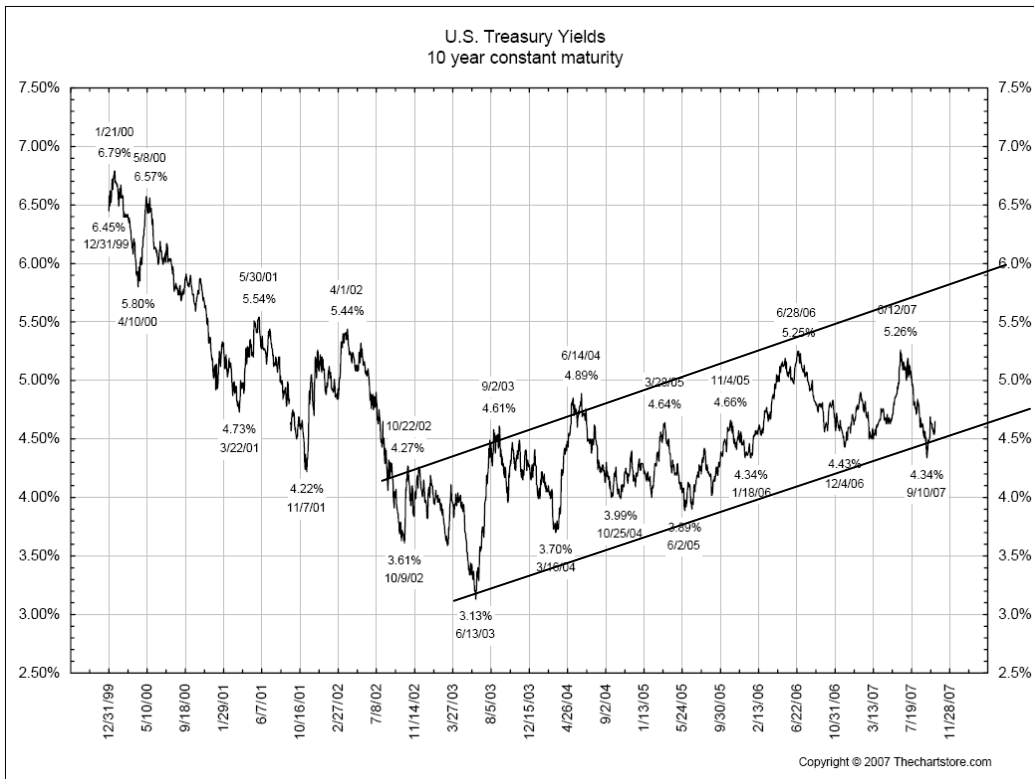
- **Background**

If anyone was hoping for a quiet summer in the financial markets, they were disappointed. Accelerating sub-prime mortgage problems caused dramatic price declines in collateralized debt and collateralized loan obligations. Liquidity for many of these products evaporated and credit spreads widened dramatically. Problems spread from the U. S. mortgage banks (e.g. Countrywide Financial) to various bond funds, hedge funds and other investment portfolios both in the U.S. and overseas. Concern over asset backed commercial paper forced Libor rates higher as banks that provide liquidity and credit support for these programs came under pressure. Northern Rock in Britain is experiencing severe pressure and several other financial institutions (Bear Stearns, UBS, Citicorp, Merrill Lynch, Deutsch Bank) have all reported significant losses related to mortgage backed products. Additional problems, yet to be disclosed, could come to light in the coming months. Turmoil in the credit markets spread to equities causing the Dow to drop from slightly over 14,000 in mid July to 12,845 on August 16.

As the financial markets reeled, concern about the economy also increased. Higher resets in adjustable mortgage rates coupled with rising energy prices heightened fears that the consumer would retrench. These concerns intensified in early September when it was reported that non-farm labor declined by 4,000 in August and that the employment gains in the earlier two months were revised sharply lower. Estimates of economic growth were lowered and the possibility of a recession was included in numerous forecasts.

The Federal Reserve took action to improve liquidity and confidence by lowering the discount rate (the cost of banks borrowing directly from the Fed) from 6.25% to 5.75% on August 17 and encouraging bank borrowing. Sagging sentiment after the labor report prompted the Fed to take another step by lowering the Federal Funds rate by a larger than expected 50 basis points to 4.75% at the September 18 FOMC meeting. They also lowered the discount rate by another 50 basis points at that time. Investor sentiment improved in response to the Fed moves and the markets began to stabilize.

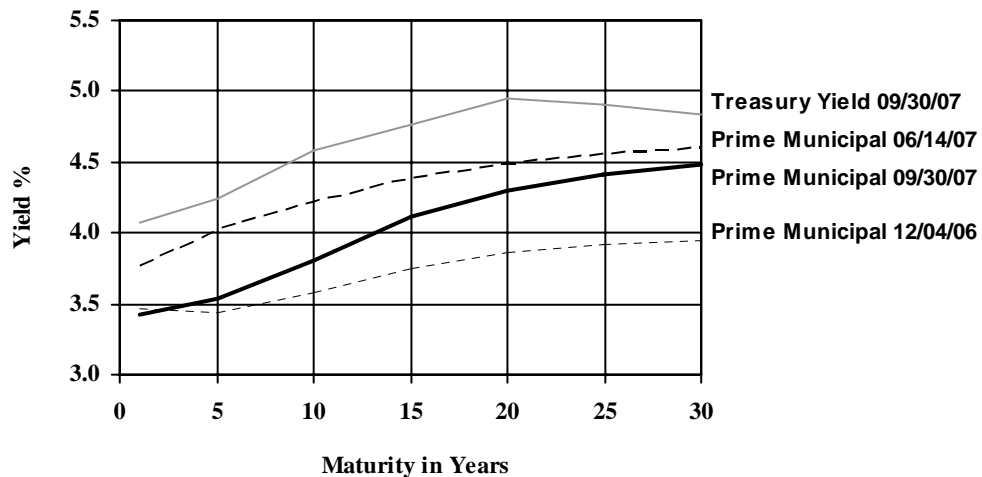
As is typical during periods of market disruption, investors flocked to the safe harbor of the government market during the quarter. As is shown in the accompanying chart, courtesy of The Chart Store, the yield on the ten year Treasury fell from 5.26% in mid June to 4.34% in early September before moving back towards the bottom of the channel that has been in place for the past four years.



Prime municipal yields also declined, but not to the extent recorded in the Treasury market. Ten year prime municipal yields fell by about sixty basis points from mid June to the end of September. The tax-exempt market functioned well during the quarter despite the turmoil in the mortgage backed and corporate sectors. Municipal new issues were easily marketed with \$87.8 billion of new supply, a slightly larger volume than in the third quarter of 2006. Year to date supply of \$318.7 billion is 19.4% ahead of the 2006 nine month level.

The accompanying yield curve graph depicts the quarter end prime municipal yields along with the curves that existed in mid June and last December when the interim high and low were reached. The curve steepened in response to the Fed action. The quarter end spread between one and thirty year yields was 105 basis points compared to an 84 basis point spread in June and only 48 basis points last December.

**Third Quarter Yield Curve Shifts**



- **Outlook**

We anticipate that economic growth will be slower than normal in the coming quarters as consumers grapple with high energy costs and a housing market that is unlikely to bottom for some time. However, we do not feel that a recession is in the immediate future. The latest labor report indicated a reasonably solid 110,000 increase in September's non-farm employment. Perhaps more importantly, the August number was drastically revised from a 4,000 loss to an increase of 89,000. Although the unemployment rate notched up by a tenth of one percent to 4.7%, the U.S. work force remains largely employed and workers' resultant spending power should provide support for the economy. In addition, the continuing decline in the dollar is spurring export growth that provides an additional economic prop. Our base assumption calls for modest, but positive growth.

Core inflation remains subdued, but we have a nagging fear that it could begin to drift higher. Global growth is expected to keep pressure on commodity and energy prices. Productivity growth in the U.S. has diminished and the 11% decline in the dollar relative to the Euro over the past year, with more expected, is pushing up import prices. In addition, average weekly earnings in the U.S. are up over 4% from a year ago. It seems possible that these pressures could lead to increases in the core price indices that exceed Chairman Bernanke's stated tolerance range. Looking at the inflation picture, and the improved labor environment, the monetary authorities may be wondering if the extent of their easing moves last month was necessary.

The investment landscape is likely to remain volatile in the months ahead with additional credit issues coming to light and conflicting economic data. Slower growth could cause the short end of the curve to stabilize or perhaps move somewhat lower while longer rates remain steady or move higher in response to credit and price concerns. Until a discernable trend develops we plan to maintain current barbell portfolio weightings and keep durations at about four years, in line with our benchmark, the Lehman Brothers Five Year Municipal GO Index.

- **Treasury/Municipal Spreads**

The sharp decline in Treasury yields in July and August caused the municipal sector to temporarily become very cheap relative to governments. For a period of time ten year prime municipals yielded close to 90% of like maturity Treasuries. Such aberrations do not persist for extended periods of time and cross over buyers moved from taxable to tax-exempt investments which caused municipal rates to decline. As of quarter end the prime municipal/Treasury yield ratio had reverted to a more normal 83%.

- **Kentucky Case**

The U.S. Supreme Court is back in session and the Kentucky Department of Revenue v. Davis case is scheduled for oral arguments on November 5<sup>th</sup>. The municipal market is anxiously awaiting the decision that could impact the forty-two states that tax income from out-of-state bonds but exempt in-state municipal income. We will provide our assessment of the decision, and its likely impact, as soon as it becomes available.

- **Barbell Portfolio Structures**

A fundamental aspect of our active portfolio management process is the use of barbell structures rather than ladder constructions as we seek to achieve our dual objectives of not having negative total returns in any year and maximizing tax-exempt income for our clients. The barbell approach lessens volatility risk and provides the potential to garner enhanced returns. The duration of a one to ten year ladder at current rate levels is about 4.5 years compared to four years in our current portfolio constructions. The short component of the barbell has very limited volatility exposure and is typically composed of investments with six to twelve month durations. However the strategies employed have the potential to provide returns that are comparable to much longer securities. In the long portfolio component we purchase ten to twenty year premium bonds that are generally priced to ten year calls. When the yield curve is steep we venture further along the curve, but maintain the volatility characteristic of a ten year bond due to the call features. Barbells have a further advantage by providing the flexibility to quickly adjust portfolio durations in response to changing market conditions by adding to or selling longer duration securities. Enhancements of forty to fifty basis points over static, ladder portfolios are typically attainable through our process and strategy application.

- **Firm News**

We are pleased to announce that Rob Richards has joined C.W. Henderson & Associates. Rob is from Grand Rapids, Michigan and is a recent graduate of the University of Michigan where he majored in Economics. He joins Clare Retrum and Matt Andrews on our client service team and will be working on trade settlement, custodian interaction and servicing client requests as our business continues to grow. We are delighted to have him on board.

Craig W. Henderson

Thomas L. Mallman

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