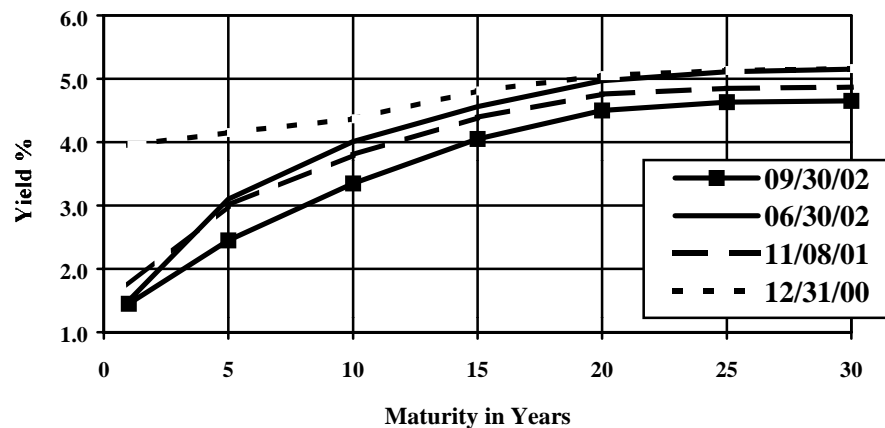


- **Background**

Interest rates continued to move lower during the third quarter as investors moved into the “perceived” safe harbor of the fixed income markets. Lackluster economic statistics, deteriorating earnings projections, continuing corporate governance issues, the threat of war, etc. caused investors to maintain their pace of asset allocation shifts from equities to bonds during the quarter. Most municipals experienced yield to maturity declines of forty to fifty basis points. The graph below details the shift in the AAA municipal yield curve during the quarter and also indicates the prevailing rate levels at the end of 2000 just before the Federal Reserve began easing (the Fed Funds rate was then at 6.50% vs 1.75% currently). Also shown are November 2001 yields when municipal rates reached their previous lows. As is evident, new lows have been established.

**AAA Municipal Yield Curve**



- **Background (contd.)**

The landscape is unsettled. Excess manufacturing capacity and minimal pricing power suggest that corporate earnings will remain under pressure and that capital spending will environment and that could limit consumer spending, the primary resilient component of the economy. A falloff in mortgage refinancings and a slowdown in the housing market could further impact consumer demand. Add to the picture weak global demand, rising oil prices and possible additional disclosures of corporate malfeasance. On top of all this, Iraq remains a significant wild card. Warfare can lead to unintended consequences, especially in an environment where support from our allies and members of Congress is less than total.

The Federal Reserve left the Federal Funds rate unchanged at the September FOMC meeting although two governors dissented, feeling that there should be immediate additional ease. Speculation is high that the monetary authorities will ease at the November 6<sup>th</sup> meeting unless clear signs emerge that economic momentum is recovering.

- **Interest Rate Outlook**

Are we on a path towards even lower rates? Demand for municipals has been extremely strong due to asset allocation shifts from equities to fixed income, maturity extensions to maintain portfolio cash flow in retail portfolios and large flows into municipal bond funds (\$17.6 billion during the first eight months of the year). These trends may well persist over the near term, but we feel that the market is now extended. We continue to expect the economy to slowly recover over the next several quarters in response to monetary and fiscal stimulus. We do not anticipate a double dip recession and also do not expect deflation concerns to materialize. Economic growth is the natural result of an expanding population and growing productivity. We expect these trends to reassert in the quarters ahead. Capital commitments to intermediate and longer bonds at current levels appear to have more potential risk than reward.

The market is now pricing in an expected inflation rate of about 1.5% over the next ten years. Near term inflation should remain docile given the degree of slack that exists throughout the world, but we question whether over capacity and sluggishness will persist for ten years. The Congressional Budget Office's latest projections forecast federal government deficits through 2006. Municipal governments are also encountering significant deficits. Heavy government borrowing needs do not tend to foster declining rates.

We are maintaining conservative portfolio constructions and are willing to sacrifice some near term upside potential to protect our clients from the principal risk associated with sharp rate increases.

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- **Bond Math Review**

Duration provides a measure of potential principal volatility. For example, a bond with a duration of ten years will experience a 1% price change for each 0.10% move in rates. Shown below is the current AAA municipal yield curve and the curve that existed at the beginning of 2001 before the Federal Reserve began easing. In essence, the fall in yields over the past twenty-one months has increased potential volatility by about 5%.

	Current		12-31-00	
	Yield	Duration	Yield	Duration
1 Yr	1.45%	0.99 yrs	3.95%	0.99 yrs
5 Yrs	2.45	4.74	4.15	4.57
10 Yrs	3.35	8.58	4.37	8.21
15 Yrs	4.05	11.38	4.81	10.85
20 Yrs	4.50	13.39	5.05	12.81
25 Yrs	4.63	15.05	5.13	14.35
30 Yrs	4.65	16.27	5.16	15.56

More to the point, bonds have significant principal risk should rates rise. The table below indicates the prices that bonds, purchased today at par, would likely trade at if municipal rates moved back to year-end 2000 levels over a one year time horizon. Note that the greatest risk under this scenario is in the intermediate sector (five to fifteen years), the area that has performed the best during the rally due to the sharp steepening of the yield curve.

	Coupon	Price	Principal Decline (%)	Total Return
1 Yr	1.45%	\$100.00	0.00	1.45%
5 Yrs	2.45	91.81	8.19	-5.74
10 Yrs	3.35	90.48	9.52	-6.17
15 Yrs	4.05	91.53	8.47	-4.42
20 Yrs	4.50	92.60	7.40	-2.90
25 Yrs	4.63	92.82	7.18	-2.55
30 Yrs	4.65	92.23	7.77	-3.12

- **New Issue Value**

Financings by state and local government entities continued at a brisk pace in the third quarter as \$84.9 billion bonds were issued, up 43% from the same quarter a year ago. Year to date new issue volume is \$251.2 billion, a 28.3% increase from last year. Our forecast of \$300+ billion new bonds this year should be easily surpassed. Low rates prompted a flurry of refunding issues that represented close to 27% of the nine-month volume. Insured issues continued their prevalence with approximately half of the new bonds having insurance. Although supply has been heavy, it has been easily absorbed in the declining rate environment.

- **Relative Value**

As shown below, municipals are very cheap compared to Treasuries. Treasury yields have fallen sharply due to demand for U.S. Government securities by investors seeking to avoid credit risk, by mortgage lenders wanting to offset duration contraction, etc. It now makes sense for taxable investors to consider swapping from Treasuries to municipals given the modest spreads, especially in longer maturities.

	AAA Municipal	Treasury	Treas/Muni Ratio	12 Month Average
1 Yr	1.45%	1.52%	95.4%	79.6%
5 Yrs	2.45	2.67	91.8	83.6
10 Yrs	3.35	3.66	91.5	87.8
30 Yrs	4.65	4.68	99.4	96.1

Quality spreads in the municipal market remain tight in reaction to strong demand. The yield pickup between ten year AAA and single A bonds is about 25 basis points. Moving to BBB bonds provides another 45 basis points. These spreads do not justify lowering quality standards, especially in an environment where budgetary pressures are likely to intensify as municipalities work through the challenges of reduced revenue flows.

- **Concluding Thought**

The current environment is in many ways unique and seemingly unprecedented. The search for positive returns among the uncertain and turbulent markets is certainly challenging. We remain focused on the long term and feel that a stronger growth trend in the U.S. economy will resume. Our objective, as always, is to create attractive after-tax returns in our client portfolios and minimize principal risk.

- **Firm News**

A recent issue of “Bloomberg Wealth Manager” ranked the top municipal separate account managers by assets under management. C.W. Henderson & Associates ranked 6<sup>th</sup> in a listing of 21 managers. Reprints are available. As always, we welcome your thoughts and comments.

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