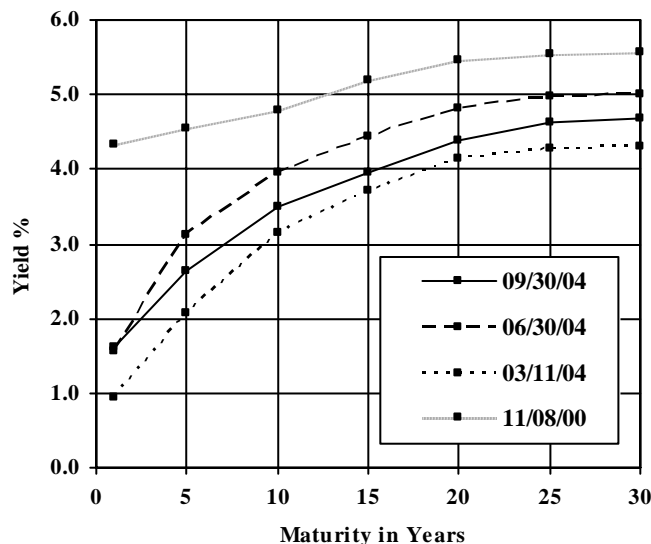


• **Background**

Interest rates moved lower during the third quarter as concerns developed that economic growth might be waning in response to the drag of higher petroleum prices, tightening by the Federal Reserve and a fading tax cut impact. Declines in the leading indicators and sluggish retail sales reinforced this view. Investor apprehension was further heightened by the uncertain impact of hurricanes in the southeast, growing acrimony in the presidential race and apparent lack of progress in Iraq. The country breathed a collective sigh of relief after the Olympic Games and the national conventions were held without terrorist attacks.

As shown in the chart below, rates moved lower throughout the municipal yield curve during the quarter except in the very short sector that is being impacted by Federal Reserve tightening. Following their widely advertised policy, the monetary authorities nudged the targeted Federal Funds rate another twenty-five basis points higher to the 1.75% level at their September FOMC meeting. Also shown in the chart is the yield curve that prevailed in March when interest rates reached this year's lows and, for reference, the late 2000 municipal yield curve that existed when the Fed Funds rate was at 6 1/2% before the Federal Reserve began its easing campaign in response to the recession, the stock market bubble burst and the September 11, 2001 attack.

AAA Municipal Yield Curves



• **Outlook**

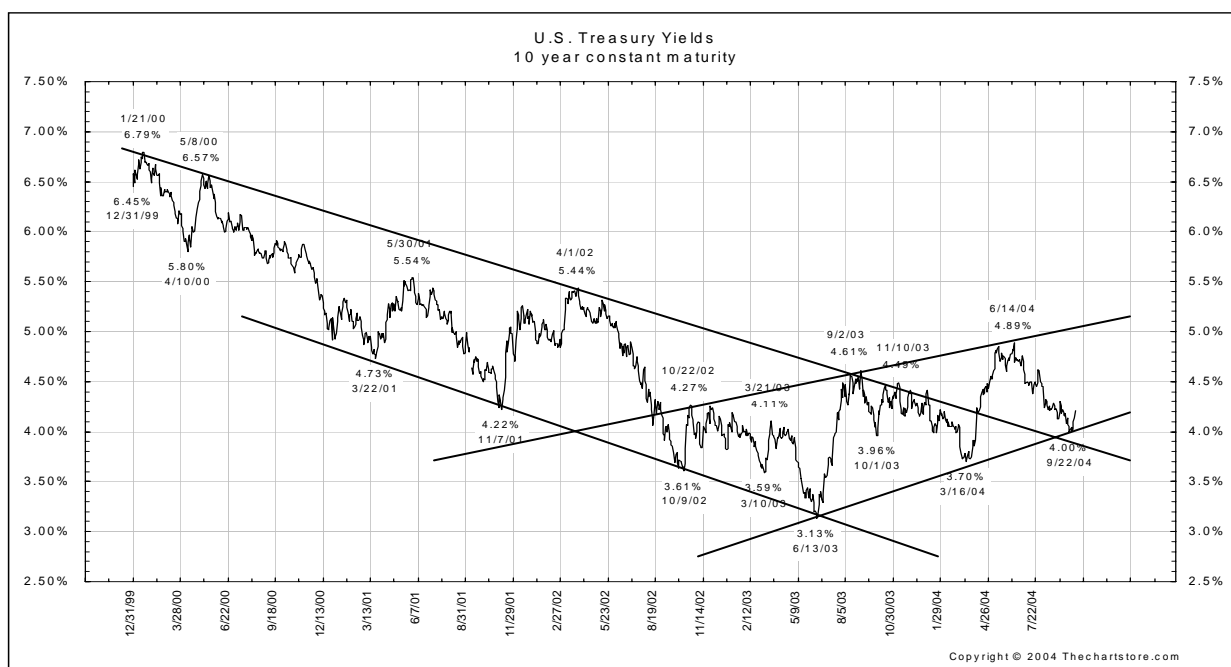
One uncertainty will be removed in the next few weeks as the electorate determines the occupant of the White House for the next four years. Despite the outcome, there is likely to be little impact on the near term economic outlook. The Iraq struggle will continue, large budget deficits will persist for the foreseeable future, high oil prices are likely to remain a drag on consumer spending, we will remain dependent on foreign central banks to recycle trade deficit dollars into U.S. Treasuries and debt as a percent of GDP is expected to continue to climb. The federal government will have limited budgetary flexibility.

The trend in interest rates over the coming quarters will be primarily dependent, as always, on economic growth and inflation. Unfortunately, economic data is likely to be clouded over the next few months by the impact of the Florida hurricanes. However, assuming no disruption such as another terrorist attack or a sharp decline in the dollar, we continue to believe that the fiscal and monetary stimulus that has been put in place over the past few years will sustain economic momentum for the next several quarters. Real GDP growth of 3% or higher remains our basic assumption. It appears that continuing productivity enhancements and global competition will retard inflationary pressures. However, with commodity prices continuing to rise, gold trading well above \$400 an ounce and oil at \$50+ per barrel, it seems likely that underlying price pressures will be building.

We expect that the Federal Reserve will continue to move short rates higher at a “measured pace” until a positive real Federal Funds rate is established. A targeted Federal Funds rate in the 3 ½% to 4% range would not be surprising. Long rates are also expected to move higher, although the path is likely to be erratic as investors react to conflicting economic reports and developing world events.

The chart below, courtesy of TheChartStore, indicates ten year Treasury yields since the end of 1999. The downtrend in rates during the first three and one-half years of this period is clearly evident as is the 3.13% low that occurred in June of last year. It appears that the trend in rates has subsequently reversed and is now moving higher. We anticipate that this pattern will continue with interest rates remaining volatile in reaction to world events and sometimes conflicting economic statistics, but trending higher as economic growth continues.

The market continues to be supported to some degree by the “carry trade” (financing long bond positions with low short rates). A flattening curve would cause these positions to become less profitable and some would be unwound. The resultant increase in secondary market supply could accentuate market retrenchments and heightened market volatility.



We continue to feel that fixed income portfolios should be constructed conservatively and defensively biased. Trading opportunities are likely to periodically appear but, as witnessed in July of last year and in April of this year, rate spikes can be sharp and violent. Investors must remain nimble to avoid bear traps.

- **De Minimus Risk**

With rates having trended lower over the past several months it is appropriate to again remind investors that rate increases can seriously impact the prices of bonds purchased near par. Any purchaser of a bond in the secondary market that is trading below par must pay a tax on the price appreciation back to par. If the price of a discount bond is above the de minimus threshold, the principal gain is taxed at the capital gains rate. However, if the price of the bond is below the de minimus level, the gain is taxed at ordinary income rates. The de minimus threshold is determined by multiplying the number of years to the bond's maturity by one quarter point per year. As an example, the threshold for a ten year bond would 97.5 (i.e. $100 - (10 \times 0.25)$).

This table below details the current AAA yield curve. The de minimus threshold for each of the maturities is also shown. Assuming that par bonds were purchased in each maturity and then a sharp one percent upward adjustment in market yields was experienced along the curve, all of these bonds would be trading below de minimus levels. The resultant yields to maturity and dollar prices of each of the bonds after the 1% market yield adjustment are detailed. As is obvious, all of these bonds would suffer significant price declines. Short and intermediate bonds do not provide protection from market volatility!

<u>Maturity</u>	<u>Coupon</u>	<u>De Minimus Threshold</u>	<u>One Percent Market Adjustment Yield to Maturity</u>	<u>Dollar Price</u>
3 Year	2.14%	99.25	3.54%	96.05
5 Years	2.73	98.75	4.17	93.56
7 Years	3.15	98.25	4.55	91.69
10 Years	3.54	97.50	4.87	89.57
15 Years	3.99	96.25	5.58	86.13
30 Years	4.72	92.50	5.80	84.72

- **Municipal Supply Remains Moderate**

Monthly new issue supply has fallen relative to 2003 levels in all but two months of this year. Municipal volume totaled \$262.5 billion through September, down 9.9% from the \$291.1 billion issued during the first nine months of 2003. Some improvement in state and local budgets this year has eased fiscal pressures, but not sufficiently to prompt municipal officials to initiate capital projects unless they are critically necessary. The decline in rates last year, and the need to reduce expenditures wherever possible, caused many municipalities to issue refunding bonds where feasible to reduce debt service expenses. Fewer refunding opportunities now exist and the volume of refunding issues this year is off over 18% from the level seen in 2003.

Reduced new issue volume in the tax-exempt market coupled with reasonable retail demand and continued purchases by yield curve arbitrage players has caused the municipal sector to outperform the Treasury market in recent months. The ratio of ten year prime municipal yields to ten year Treasury rates was 85.9% at the end of June and has subsequently fallen to 83.7%. Additional declines in tax-exempt/taxable yield ratios are possible if municipal new issuance remains modest as is currently expected. Rate increases in the tax-exempt sector may therefore be less pronounced than in the taxable area, but municipals will not be immune from rising nominal rates. The relative strength of the municipal sector could be impacted negatively if casualty insurers are forced to liquidate municipals in response to losses sustained from the Florida hurricanes. No evidence of such activity is yet apparent.

- **Tobacco Suit**

The United States suit brought under the Racketeer Influenced and Corrupt Organizations Act (RICO) against the tobacco industry got underway late last month. The government is alleging that the tobacco industry perpetrated a massive scheme to defraud the public by systematically withholding evidence for decades about the dangers of smoking. The Justice Department is seeking \$279 billion in damages.

The suit could have a significant impact on the municipal market in that a large judgment against the tobacco companies could impact the tobacco companies' ability to make payments to the Master Settlement Agreement (MSA). The MSA is an agreement that was reached in November 1988 between forty-six states (Florida, Minnesota, Mississippi and Texas settled independently) and six other municipalities with the four largest tobacco companies; Philip Morris, RJ Reynolds, Brown & Williamson and Lorillard. Thirty-four smaller tobacco companies subsequently signed on to the agreement. The MSA mandates annual payments by the manufacturers on or before April 15 each year in perpetuity in exchange for releasing all claims against the tobacco companies.

According to a recent article in "The Bond Buyer", as of the end of last year \$26.7 billion tax-exempt tobacco revenue bonds backed by future MSA payments had been sold in seventy-four separate issues. The Justice Department suit creates obvious uncertainty in regard to these credits. We believe that tobacco settlement bonds are inappropriate investments in conservatively managed, high quality portfolios.

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