

▪ **Background**

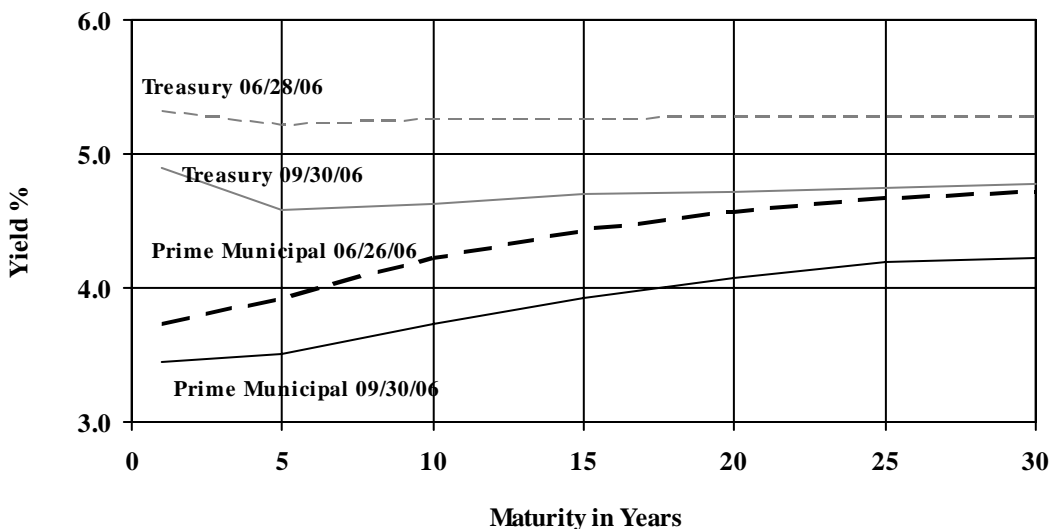
September 2006

Fixed income markets rallied strongly during the past quarter with the yield on the ten year Treasury having dropped by over sixty basis points since late June. A growing belief that the economy will slow in the coming months provided the catalyst for the rally. The consensus view now looks for subdued consumer spending in reaction to the sluggish housing market where slow sales of existing homes are being experienced and new housing starts are falling. Homeowners are seeing potential profits from the sales of their homes decline and also finding the cost of home equity loans to be significantly more expensive. Add high energy costs, and the consumer's ability to continue spending is considered to be in jeopardy. Furthering the argument for a slowing economy is the assumption that if the consumer falters, corporate profitability will also be under pressure.

The revised market view was supported by the Federal Open Market Committee's decision to leave the targeted Fed Funds rate unchanged at 5.25% at the August and September meetings. While core inflation is trending at a higher rate than Chairman Bernanke's stated 2% tolerance level, the Fed has indicated that they believe inflation will moderate in the coming months as economic activity slows.

The yield curves shown below vividly illustrate the decline in both Treasury and prime municipal yields since late June. The Treasury curve's inversion is more pronounced than it was in June due to short yields being anchored, to some extent, by the Fed Funds rate. The one to thirty year spread in the municipal sector dropped from 96 basis points in late June to 78 basis points currently.

Third Quarter Yield Curve Shifts



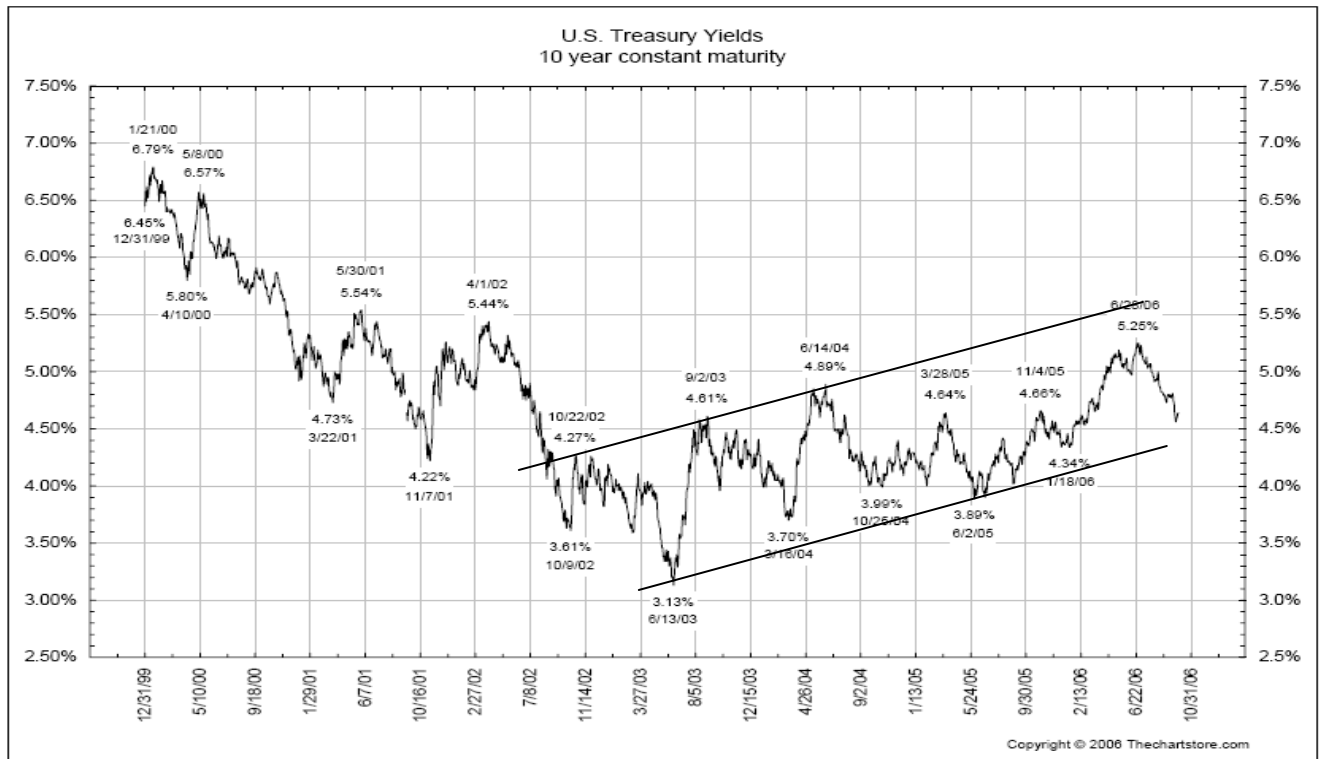
- **Outlook**

Is the consumer about to falter under the pressure of high energy prices and eroding housing values? Will the Fed be forced to ease in an attempt to prop economic activity? The bond market appears to have concluded that the Fed will blink and lower short rates sometime next year in response to moderating economic growth.

We feel that this conclusion may be overly pessimistic and that the economic footings may not be as precarious as bond investors appear to be assuming. The 4.7% unemployment rate provides a firm underpinning for the economy. We anticipate that the labor force will continue to expand and that the corporate sector will remain on a solid footing with continuing profitability spurred by domestic demand and growing exports as the global economy expands. Certain segments of the labor market will be under pressure (e.g. domestic auto workers) but overall, we expect that employment and wages will continue to grow. Consumer confidence should remain resilient in this environment and be further supported by the recent fall in gasoline prices. In addition, rising equity prices are offsetting, to some extent, the impact of the decline in housing valuations.

Core consumer price inflation is advancing at about a 2.8% year-over-year rate. Inflation is unlikely to moderate unless the economy softens more than we expect. On the flip side, we don't expect a surge in core prices, but additional pressures could develop as wages expand while productivity slows. The Fed's press release after the September meeting indicated that additional firming would be dependent on the outlook for the economy and inflation in the months ahead. The assumption that the Fed's next move will be to ease may be overly optimistic.

The attached chart, courtesy of The Chart Store, indicates the extent of the decline in Treasury yields since the interim peak in late June. We extended portfolio durations in client accounts to near benchmark levels as rates rose during the first half of the year. The recent rally prompted us to move to the sidelines and we have not made additional tactical allocations to longer duration securities in the past months. Should the rally continue, we will consider selling some longer securities and locking in profits. It is our working assumption that rates will remain within the upward sloping band shown on the chart.



- **Specialty State Bond Developments**

Tax statutes in many states allow residents to deduct the income received from municipal bonds issued by in-state municipalities while income from bonds issued by municipal entities from other states is taxed as ordinary income. In states with high marginal tax rates (e.g. California 9.3%, New Jersey 8.97%, Montana 11.0%, etc.) there is a strong incentive for residents to purchase in-state bonds to avoid state taxes.

A lawsuit brought in Kentucky challenged this arrangement and argued that the taxation of their municipal income received from out-of-state bonds, while exempting in-state municipal bond income, violated the U.S. Constitution's Commerce Clause that cedes to Congress the power to regulate commerce among states and with other nations. The commerce law prohibits states from favoring the economic interests of their citizens in a manner that impedes interstate commerce. Lower Kentucky courts and the Kentucky Court of Appeals ruled in favor of the plaintiffs and the Kentucky State Supreme Court refused to review the Appeals Court's decision. State officials have subsequently indicated that they will ask the U.S. Supreme Court to review the case.

Final resolution of the issue is likely to take a good deal of time, possibly years. If the U.S. Supreme Court does not overturn the Kentucky decision, then all states would be impacted and would have to either tax income from both in-state and out-of-state bonds or not tax any municipal income. The former is certainly more likely given states' hunger for revenue. Demand from residents for in-state municipals would decline and cause borrowing costs in high tax states to rise. Also, the many state specific municipal bond funds, that have been formed to provide state tax exempt income, would no longer have a purpose and most would likely be merged with general market funds.

- **Public Pension Funds and OPEBs**

Many public pension funds are significantly under funded. It has been estimated that unfunded state and municipal pension liabilities (that cover about 12% of the total U.S. work force) could approach \$700 billion over the next several years. Also significant are other post employment benefits (OPEBs), consisting largely of health care obligations, that have been promised to public employees. The under funding of these liabilities will push the total funding shortfall in post-retirement obligations significantly higher. A spot light is being put on the OPEB issue as governmental accounting rules now require that these obligations be included on balance sheets. Having them included as long term liabilities will increase pressure on governments to find ways to fund both pension and OPEB shortfalls.

The challenges are significant in that it is politically difficult or, in some cases, impossible for states and municipalities to change plans such as switching from defined benefit to defined contribution plans where costs can be funded on an ongoing basis and be better controlled. In certain instances, state courts have ruled that promises made to workers cannot be altered or amended and that benefit plans cannot be changed. The issue of funding pension obligations and OPEBs is therefore certain to grow in prominence in the coming years.

One tool that could be used to address this problem is the use of private public partnership transactions as discussed in our last quarterly newsletter. As was mentioned, the City of Chicago leased the Chicago Skyway for ninety-nine years for \$1.89 billion and the State of Indiana entered into a seventy-five year lease arrangement for the operation of their east-west toll road and received \$3.8 billion. Many like transactions are being considered around the country. Should the proceeds garnered from these deals be used to cover pension and OPEB shortfalls, the under funding issue could be ameliorated. These factors will have a growing impact on municipal credit quality going forward and will be monitored to assure that we only purchase high quality securities in client portfolios.

- **Firm News**

We are sorry, but at the same time pleased, to announce that Scott Atkinson has left C.W. Henderson & Associates. We are sorry in that Scott was a dedicated trader who added a great deal of professionalism and market acumen to our investment operation. But we are also very pleased for him in that he made the decision to follow his passion for food and wine and is now an owner/partner in a new restaurant venture in Nashville. The enterprise, called Flyte, is up and operating and, from all reports, off to a good start with upscale, healthy American cuisine. We wish him great success and hope to sample Flyte's menu and ambiance in the near future. We are in the process of identifying individuals that can fill Scott's role and add additional depth to our operation.

Craig Henderson

Tom Mallman

Jeanhee Hoffman