

- **Background**

The U.S. is struggling with recession and the after effects of September 11, but the country is cautiously optimistic. Despite continued corporate retrenchment, the Enron debacle, rising unemployment, tepid holiday sales, etc., there are some favorable signs. Consumer sentiment has improved, the leading indicators are pointing upward, commodity prices have firmed and the stock market continues to advance from the post-terrorist attack lows. The country remains on guard and braced for possible additional terrorist attacks, but swift military success in Afghanistan coupled with the detainment of suspects and freezing of bank accounts, both in the U.S. and abroad, have eased the nation's fears somewhat.

Barring a setback in the war on terrorism, we continue to expect that positive growth will return in 2002 in response to the substantial monetary and fiscal stimulus that have been introduced during the past year. In addition, dramatically pared inventory levels should allow production rates to increase as demand redevelops. Although the unemployment rate has risen from a low of 3.9% to 5.8%, and is certain to move still higher as the downturn persists, the peak level in this cycle appears likely to be lower than the highs reached in the last four recessions (9.0% in 1975, 7.8% in 1980, 10.8% in 1982 and 7.7% in 1992). The ranks of the employed should gain confidence as threats of layoffs diminish. The timing and pace of the upturn remain uncertain. Our assumption is that the recovery will be in place before the middle of the year, but that the rebound will be muted. The housing and auto sectors have been firm throughout the downturn which provides little room for significant upside in these key economic groups. In addition, corporate and personal debt burdens are high and there is nothing currently on the horizon suggesting a near term rebound in technology. Real GDP growth of perhaps 2% in 2002 remains our working assumption.

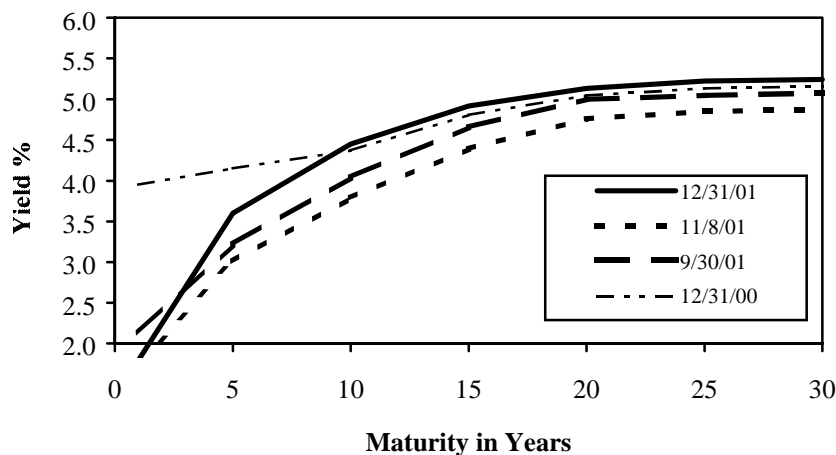
Inflationary pressures are all but non-existent and are likely to remain dormant in the environment currently envisioned. However, monetary aggregate growth has been extremely rapid in response to the Fed's aggressive easing. Excess liquidity could rekindle inflation down the road and must be monitored. Also, smaller inflation offsetting productivity gains appear likely in an environment where governmental units and corporations are forced to divert resources to increase security.

- **Interest Rate Outlook**

The Federal Reserve remains poised to cut rates further if the economy does not respond. However, we feel that little additional monetary stimulus will be required, and the current 1.75% Federal Funds rate (a 475 basis point drop since the start of last year and a 50% reduction from the 3.50% level that prevailed prior to September 11) is at, or very close to, the low for this cycle. This does not imply that a reversal in policy is likely any time soon despite the fact that the forward market is forecasting a rise in short rates in the latter part of next year. We would not be surprised to see the Fed remain on hold throughout all of next year just as they did from late 1992 to February 1994 after the early 90s recession. While the Fed may adopt a bias towards higher rates later this year, we doubt that they will tighten significantly.

As shown in the following chart, municipal rates experienced significant volatility during the past quarter. Recession concerns and a flight to safety after September 11 pushed yields sharply lower early in the period. The reemergence of post-attack national confidence along with a few encouraging economic signals and the realization that the federal budget surplus had rapidly eroded, caused the market to retreat dramatically. In the space of only a week in mid-November rates on intermediate municipals ratcheted higher by about sixty basis points. They continued to drift still higher in the remaining weeks of the quarter. Yields on ten year and longer municipals are now higher than they were at the start of 2001.

AAA Municipal Yield Curve



We anticipate continued volatility in the months ahead as the market grapples with conflicting economic signals. However, as the consensus builds that a recovery is on the way there is likely to be some additional upward pressure on longer rates. With the Federal Reserve holding short rates steady the yield curve is expected to steepen further. In this environment we anticipate making purchases of longer securities selectively in reaction to market weakness. Our primary tactic will be to trade to take advantage of fluctuating intra-market yield spreads while maintaining below neutral portfolio durations.

- **Municipal Supply**

Heavy new issue volume is also likely to keep pressure on municipal rates. Supply in 2001 totaled \$286.3 billion, up about 43% from just over \$200 billion in 2000. Issuance is expected to remain strong this year and initial estimates suggest that \$300 billion new bonds could be sold. Infrastructure development needs are high and there is limited ability for municipalities to finance projects from cash flow in the current environment of reduced tax and revenue receipts. Massive California Department of Water Resources and New York MTA issues, that have been pending for months while legislators struggle through political details, remain in the wings.

- **Budgetary Pressures**

Recessions create budgetary challenges. Like the federal government, many municipalities enjoyed surpluses during much of the 90s that have subsequently evaporated. Mayors and governors throughout the country are now looking for ways to pare expenditures to match reduced receipts. This situation is likely to persist for some time. A recent Moody's Investors Service report noted that it typically takes six months to a year after the end of a recession for states to regain budgetary stability. Moody's has assigned negative outlooks to thirteen states although they feel that all states have the ability to manage their budgetary challenges. Similar pressures are being felt by many counties and cities throughout the country and some rating downgrades will probably be experienced in the coming months. Our focus on using only liquid, high quality securities serves our clients well in times like these.

- **Value of Active Management**

A fundamental component of the service provided by C.W. Henderson & Associates is active management of municipal bond portfolios. In contrast to our process, the vast majority of municipal portfolios are structured using a laddered, buy-and-hold approach. The focus in developing these passive accounts is on ratings, maturity, yield and, typically, on purchasing bonds close to par. The use of par bonds avoids concerns of principal erosion with premium bonds, de minimus taxation with discount bonds, and allays fears that income taker and remainder interests in dual interest accounts will not be equally represented. The buy-and-hold approach typically provides required income flows and the portfolios require little maintenance other than the reinvestment of proceeds from maturing bonds. However, a passive approach ignores the potential to capitalize on return enhancements of perhaps one percent or higher annually that can be garnered through active management.

A complete treatise on active management is beyond the scope of this newsletter, but we have written an in-depth white paper that details the logic and strategies that we employ in our process. We would be pleased to provide a copy to anyone interested in seeing it. Suffice it to say that our approach focuses on 1) bonds with structures that provide enhanced returns, 2) combinations of premium and discount securities that cushion price declines during periods of rising rates and accelerate price increases when rates fall, 3) active trading to take advantage of the frequent shifts in supply/demand patterns within the extremely diverse municipal market, 4) duration management to control portfolio volatility and 5) continuous focus on gains and losses to maximize after-tax returns. Our well defined strategies are implemented in diversified portfolios holding only high quality, liquid securities.

- **Firm News**

C.W. Henderson & Associates witnessed significant growth during the past year. Our new office, that we moved into in January, has proven to be extremely conducive to enhanced productivity and interchange between members of the firm. New additions to the staff, Clare Nickels and Kim Kluender, have added depth and professionalism. Our client base continues to expand and we are proud to report that assets under management moved above \$1 billion this past November.

We appreciate the confidence of our clients and the strong working relationships that have been established with the brokerage community. We are optimistic about our prospects in 2002 and enthusiastically look forward to the new year. We thank you for your continued support.

Craig W. Henderson

Thomas L. Mallman

Jeanhee Hoffman

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