

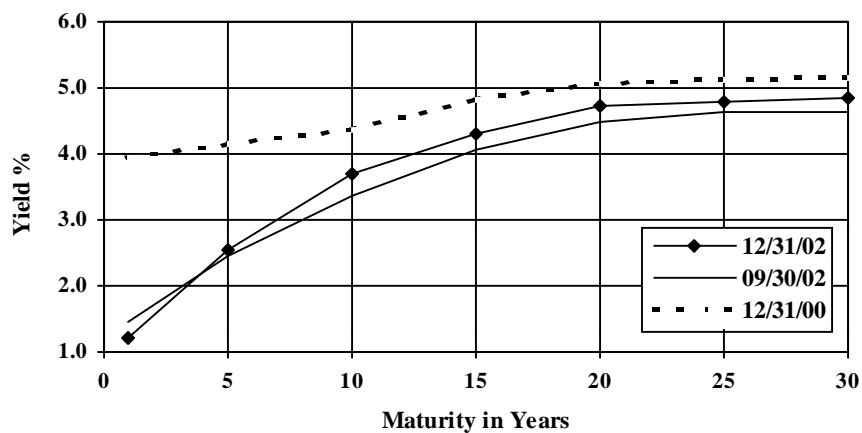
- **Background**

As indicated in the chart below, municipal rates backed up modestly in the fourth quarter in all but the shortest maturities. The Federal Reserve reduced the target Fed Funds rate by an additional fifty basis points to 1.25% in early November (to the lowest level since 1946) in response to their concern that the economy had encountered a “soft spot”.

Yields in the short end of the curve moved lower in response to the Fed’s action while rates on five year and longer municipals rose late in the quarter as some signs of economic firmness developed.

Investor uncertainty was prompted by conflicting economic statistics and was compounded by the resignation of Harvey Pitt as head of the SEC and by the departures of Treasury Secretary O’Neill and economic advisor Lawrence Lindsey as President Bush rearranged his economic team. The prospect of war in Iraq, nuclear saber rattling by North Korea and the continuing threat of terrorism created additional investor nervousness. Rising oil and gold prices, a weakening dollar and a third year of stock market declines reflected the threat of war and investor wariness.

AAA Municipal Yield Curve



- **Outlook**

It appears that the significant monetary ease that has been applied over the past two years will soon be supplemented with additional fiscal stimulus. Both the White House and the Democrats have put forward tax reduction proposals. We anticipate that a significant component of President Bush's proposed tax package will be enacted given that Republicans now control both congressional chambers. Tax cuts will enlarge, at least in the short term, already deepening federal deficits. Coupling tax reduction with increased defense spending and continued monetary accommodation should lead to a strengthening economy as the year progresses. A stronger economy, increased federal spending and expanding deficits are ingredients likely to foster higher interest rates. We therefore remain defensive and are maintaining conservative portfolio constructions.

We are also monitoring the dollar's weakness. Since last spring, the dollar has declined over 13% against the Euro, approximately 10% relative to the British Pound and 7.5% relative to the Yen. With foreigners currently owning over 40% of marketable U.S. Treasuries, any curtailment in their demand could have a significant negative impact on our fixed income markets.

We continue to feel that deflation/disinflation concerns will dissipate as economic momentum builds. Inflation is likely to remain controlled over the next few quarters, although we would not be surprised if the inflation indices move somewhat higher later in the year.

The Federal Reserve is likely to remain on hold for the foreseeable future. We do not anticipate additional ease to be warranted by economic conditions. On the flip side, they are likely to be hesitant to tighten until strong evidence of a turnaround is in place. Even if another soft spot is encountered, Fed officials are certain to be concerned about the impact of low rates on the money market fund industry. After-fee returns have declined to less than 1% on most money market funds and a further reduction in the Federal Funds rate could push net fund returns close to zero. Zero (or possibly negative) returns on this huge cash reserve pool could have unforeseen disruptive consequences.

A war in Iraq would probably cause investors to temporarily seek the safe harbor of fixed income investments, especially if the war is prolonged and casualty rates are high. However, our assumption is that the outcome, if there is a war, will be swiftly determined by the might of the U.S. led allied forces. A resolution to the Iraq question would remove a major uncertainty and would likely bolster investor enthusiasm. However, it seems probable that the resultant favorable investor sentiment would be focused more on the equity market than on the fixed income sector.

- **Rate Sensitivity**

We have commented in previous newsletters about the possibility of experiencing potentially severe declines in bond prices if rates rise. Falling yields over the past few years have extended durations on newly issued bonds. All bonds, except for very short maturity instruments, are vulnerable should rates rise. Shown below is the current AAA scale for five year and longer municipal bonds. The adjoining column indicates the rise in rates, over a one-year horizon, that would produce zero total returns for bonds in each maturity (i.e. the bond's price decline would offset its coupon return). We would not be surprised if rate increases of these magnitudes, or more, are witnessed in the coming year.

	Yield	Rate Increase That Zero Total Return
5 Years	2.56%	69 Basis Points
10 Years	3.70	50
15 Years	4.30	42
20 Years	4.73	39
25 Years	4.80	35
30 Years	4.84	32

- **Tax Exempt Corporate Dividends?**

Double taxation of dividends is considered by many to be inherently unfair, to foster corporate leverage and to inhibit corporate payouts to investors. Elimination of the tax on dividends is now part of the President's tax proposal. If the proposal is enacted, high yielding stocks (especially preferred stocks) will compete with the municipal market. How much money is siphoned from municipals into equities remains to be seen, but clearly there will be some marginal asset allocation shifts away from tax-exempt investments. This factor represents another reason to be cautious regarding the municipal market and further supports our defensive posture.

- **Budgetary Pressures**

Most states and many cities and counties are experiencing severe cash flow pressures. Reductions in income, capital gains and sales tax receipts have impacted revenues while social service requirements have increased with rising unemployment. Municipal officials are responding to their budgetary challenges by curtailing programs, tapping rainy day funds, imposing selective tax increases, appealing for increased support from the federal government, utilizing interim financing, etc. In addition, tobacco securitization bonds are being used extensively as short term funding solutions that, in some cases, forestall making difficult budget cuts. The period ahead will be challenging, but the vast majority of municipalities will weather the fiscal storms with minimal long-term consequences. Municipalities must continue to function and provide necessary social services regardless of the economic environment. They do not have the ability to

go out of business as do corporations. Police and fire protection, garbage collection, social services, water and sewer systems, etc. must be maintained. Further, to operate efficiently, municipalities must have ready access to the financial markets and the ability to raise capital. Municipal officials are acutely aware of this fact and strive to maintain sufficient financial credibility to insure that the rating agencies provide them with investment grade ratings. This discipline remains in place.

This is not to suggest that one can be lax regarding credit quality. There will continue to be pressure on ratings and investors need to be cognizant of credit developments and rating changes. Credit surprises are extremely rare in the high-grade municipal sector, but not unknown (e.g. Orange County in 1994). However, as illustrated in rating agencies analysis, default experience for single A and higher rated municipals (the only bonds we purchase) is extremely small.

- **Municipal Supply**

New issue volume reached a record level in 2002 with \$357.1 billion bonds marketed during the year. This represented a 24.6% increase from the \$286.6 billion sold the previous year and significantly exceeded the previous record of \$292.2 billion set in 1993. New Issue volume is expected to be smaller this year with initial estimates suggesting that perhaps \$275 billion new bonds will be issued this year. Municipal infrastructure development needs remain high, but some projects are likely to be postponed in the current challenging environment. Further, the volume of refunding issues, which increased 45% in 2002, is likely to be smaller in a rising rate environment.

- **Firm News**

At the close of 2002 assets under management at C.W. Henderson & Associates exceeded \$1.2 billion, an increase of close to 20% during the year. We appreciate the confidence of our clients and the support received from the brokerage community and from our many other friends. We anticipate challenges in 2003, but expect that our conservative management style will serve our clients well in the coming year.

Craig W. Henderson

Thomas L. Mallman

Jeanhee Hoffman

