

- **Background**

The past year was hardly uneventful considering the hard fought election, the continuing war in Iraq, gyrating oil prices, gaping federal and trade deficits and a declining dollar. However, interest rate comparisons at the start and end of the year suggest a benign environment in 2004. Despite periods of rate volatility, longer interest rates were essentially unchanged at year end compared to the levels experienced at both the close of the third quarter and at the end of 2003 - a surprise to most bond market forecasters (including us) who expected rates to move higher in 2004. Shorter rates rose in response to Federal Reserve tightening, but for most of the bond market it was a “clip the coupon” type of year. Year end prime municipal yield levels are shown in the accompanying table along with September 30, 2004 and December 31, 2003 levels. The yield curve that prevailed at the end of 2000 is also included for reference.

	<u>12/31/04</u>	<u>09/30/04</u>	<u>12/31/03</u>	<u>12/31/00</u>
1 Yr	1.92%	1.61%	1.02%	3.94%
3 Yrs	2.25	2.02	1.71	4.08
5 Yrs	2.65	2.65	2.37	4.14
7 Yrs	3.07	3.10	2.87	4.22
10 Yrs	3.50	3.49	3.41	4.38
15 Yrs	3.92	3.95	3.99	4.81
20 Yrs	4.24	4.38	4.40	5.03
30 Yrs	4.60	4.67	4.63	5.14

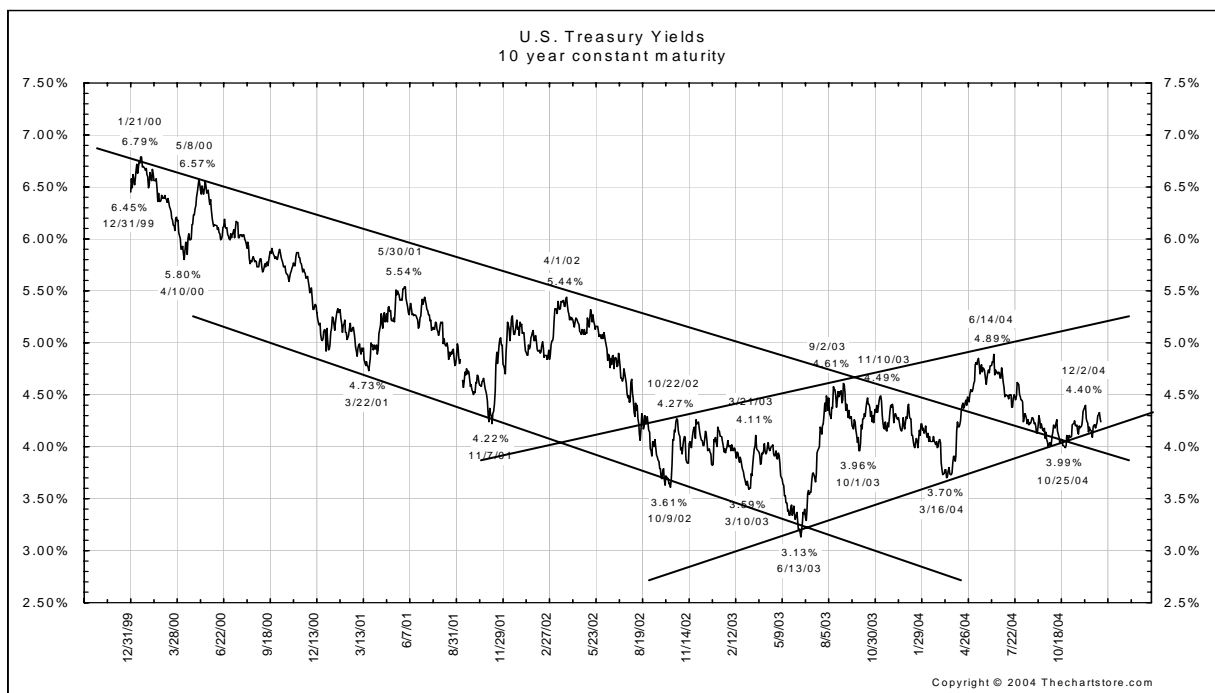
Municipal new issue volume declined approximately 6.5% to \$358.6 billion in 2004 from the record \$383.7 billion issuance the prior year. The decline largely reflected reduced refunding activity and improvements in state and local budgets in response to the strengthening economy and increased tax receipts. These same factors, and rising interest rates, are expected to cause new issue financings to decline further this year – perhaps by about 10% to about \$325 billion. This level will still provide plentiful supply.

- **Outlook**

Our base case outlook calls for continued 3+% RGDP growth this year with reasonable employment gains, sustained consumer spending and increased capital expenditures as the economic expansion continues. This point in the economic cycle is typically characterized by higher inflation levels and, in turn, rising interest rates. Rate movements in this cycle may be less pronounced, but the direction should be the same. We are therefore maintaining a defensive posture. In our view the question is not whether interest rates will rise, but how much.

We expect the Federal Open Market Committee to continue increasing the targeted Federal Funds rate at a “measured pace”. Their five quarter-of-one-percent moves in 2004 have brought the Fed Funds rate to 2.25% and we anticipate that they will continue this pattern at least through the first half of this year. There are four FOMC meetings scheduled through June, implying that the Federal Funds rate will rise to 3.25% at mid year. Whether that marks the end of their tightening will likely depend on inflation. We believe that the monetary authorities want to move to a neutral monetary posture (away from stimulation) with the Fed Funds rate above the prevailing inflation rate. Inflation has been creeping higher and they want to nip kindling price pressures. Whether a 3+% Fed Funds rate accomplishes this goal remains to be seen. The inflation indices over the next several months will likely hold the key to Fed policy later in the year.

In contrast to last year, we also expect that long rates will move higher. We again reference the chart of the ten year Treasury (courtesy of The Chart Store) shown below. We believe that rates bottomed in mid 2003 when deflation concerns prevailed. The June 13, 2003 low point in long rates coincided, within a couple weeks, with the Fed’s last easing move that lowered the Fed Funds rate to 1.0%. The secular trend now appears to have reversed. The relevant question seems to be whether the movement towards higher rates will be gradual or marked by periods of heightened volatility. A break in the dollar exchange rate, lessened buying of U.S. securities by foreign central banks (who currently own 43% of the outstanding U.S. Treasury debt) or unwinding of hedge fund fixed income holdings could precipitate a sharp reaction similar to those experienced in July of 2003 or in April of last year.



Municipals often experience less volatility than the taxable sector when rates rise as individual investors (the primary buyers of tax-exempt securities) are attracted by more generous yields. While the ratio of tax-exempt to taxable yields may decline somewhat in a rising rate environment, the municipal market will not be immune from rising rates and will follow the pattern established in the taxable arena. The accompanying table details the ratio of prime municipal and Treasury yields as of year end.

<u>Yield Comparisons</u>			
12/31/04			
	<u>Prime</u> <u>Municipal</u>	<u>Treasury</u>	<u>Ratio</u>
1 Yr	1.92%	2.76%	69.6%
3 Yrs	2.25	3.22	69.9
5 Yrs	2.65	3.61	73.4
10 Yrs	3.50	4.22	82.9
30 Yrs	4.60	4.83	95.2

- **Strategy**

We are maintaining barbell structures in our clients' portfolios with short effective duration securities on one end and intermediate and longer cushion bonds on the other. Longer portfolio components remain at lower than neutral allocation levels due to our defensive posture. Portfolio durations of about three years are being targeted in contrast to the Lehman Brothers Five Year GO Municipal Index (our reference benchmark) that has an effective duration of slightly over four years.

We continue to avoid intermediate par bonds (three to ten year maturities) where de minimus thresholds can easily be pierced if rates rise. The purchaser of a bond that is trading below the de minimus level (calculated as ¼ point times the number of years to maturity, e.g. 98.75 for a five year bond) must pay ordinary income taxes on the principal appreciation from the purchase price to par. At prevailing rate levels, five, seven and ten year par bonds would suffer respective declines of approximately 6 ½, 8 ½ and 10 ½ points if nominal rates experience a 1% rise. A move of this magnitude would not be surprising. The docile rate environment that we have experienced over the past few years has caused many investors to disregard volatility risk. Shorter bonds are not immune from potentially serious price declines in a rising rate environment!

- **Is Tax Reform Likely?**

President Bush has indicated that he is viewing his re-election and the Republican Congressional gains as a mandate to move forward with his tax agenda. Social Security reform is currently on the front burner, but a review of the tax code appears certain to soon follow. A consumption tax or a flat tax has been suggested. Both have serious negative implications for the municipal market since they would eliminate or diminish the advantages of tax-exempt bonds.

Our expectation is that any changes to the tax code will be modest. In an environment of substantial federal deficits for the foreseeable future, the continuing war in Iraq, homeland security, etc., there will be limited budgetary flexibility. It seems probable that any tax changes will have to be revenue neutral, at a minimum, since President Bush has stated that he intends to reduce the federal deficit by 50% during his second term. Further, there appears to be limited appetite in Congress for dramatic changes. Congressional support for tax code adjustments could diminish further if a bruising battle develops over Social Security reform. A non-partisan commission will probably study and make recommendations regarding tax reform (following a Social Security reform commission), congressional hearings may take place and a tax bill may be introduced. However, when all is said and done, we don't anticipate dramatic changes. Sunset provisions could be eliminated on the tax cuts enacted during the President's first term, but more substantial changes appear unlikely. However, we will closely monitor developments to judge whether any changes appear probable that could impact municipal security valuations.

- **Firm News**

C.W. Henderson & Associates had another successful year in 2004 with continued growth while we maintained conservative client account structures to protect principal valuations. We remain respectful of our clients' confidence and appreciate the support of many friends and business associates that have contributed to the success of our firm. We also appreciate our brokerage relationships that provide access to the securities we need to implement our investment strategies in our clients' portfolios. We wish all of our clients and friends a prosperous 2005.

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