*The Investor's Edge*

***C.W. HENDERSON & ASSOCIATES, INC.***

***Investment Managers Specializing***
***in Tax-Exempt Municipal Securities***

**January 2008**

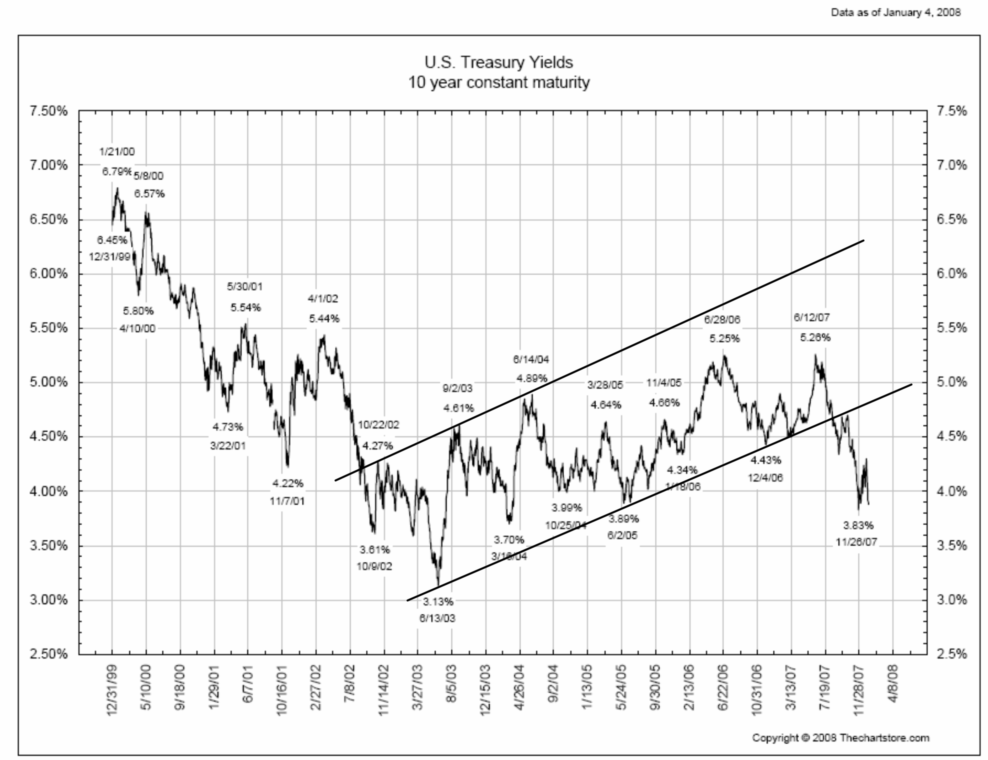
- **Background**

Economic conditions deteriorated in the fourth quarter with continued declines in housing values while oil prices tickled $100 per barrel. Moderate gains in consumer spending were recorded during the Christmas season, but that news was offset by an institute of Supply Management report indicating a sharp contraction in manufacturing activity. The bad news was capped early this month by a labor report that indicated a paltry 18,000 increase in non-farm employment in December and a surge in the unemployment rate from 4.7% to 5.0%.

Credit concerns related to mortgage backed vehicles intensified in the quarter as additional financial institutions announced losses related to sub-prime exposure. In addition, a variety of money fund pools, including municipal liquidity funds (e.g. State of Florida, King County Washington, Montana Board of Investments), encountered runs as their net asset values fell in response to mark-to-markets on mortgage backed commercial paper.

Lending by banks and other financial institutions was curtailed in the second half of the year in response to tightened loan qualification standards. The Federal Reserve responded with two quarter point reductions in the Federal Funds rate during the quarter in an attempt to add liquidity to the system, bringing the target fed funds level to 4.25%, a hundred basis point decline since mid-September. The discount rate has been reduced by 150 basis points since late summer.

Credit concerns prompted investors to seek refuge in the safe harbor of the government market. As noted in the attached chart, the ten year Treasury yield fell by close to 140 basis points from 5.26% in late June to 3.85% currently and decisively broke through the lower end of the upward sloping band that has been in place since mid 2003.




- **Outlook**

We anticipate additional economic challenges in the coming months. Further declines in housing prices are all but certain as valuations are adjusted to more realistic levels. Whether consumer spending continues to advance in the face of home equity erosion, high energy costs and, if it continues, feeble employment gains, remains to be seen. We expect growth to slow in the coming months, only the degree of the slowdown seems to be in question. The possibility of a recession cannot be dismissed.

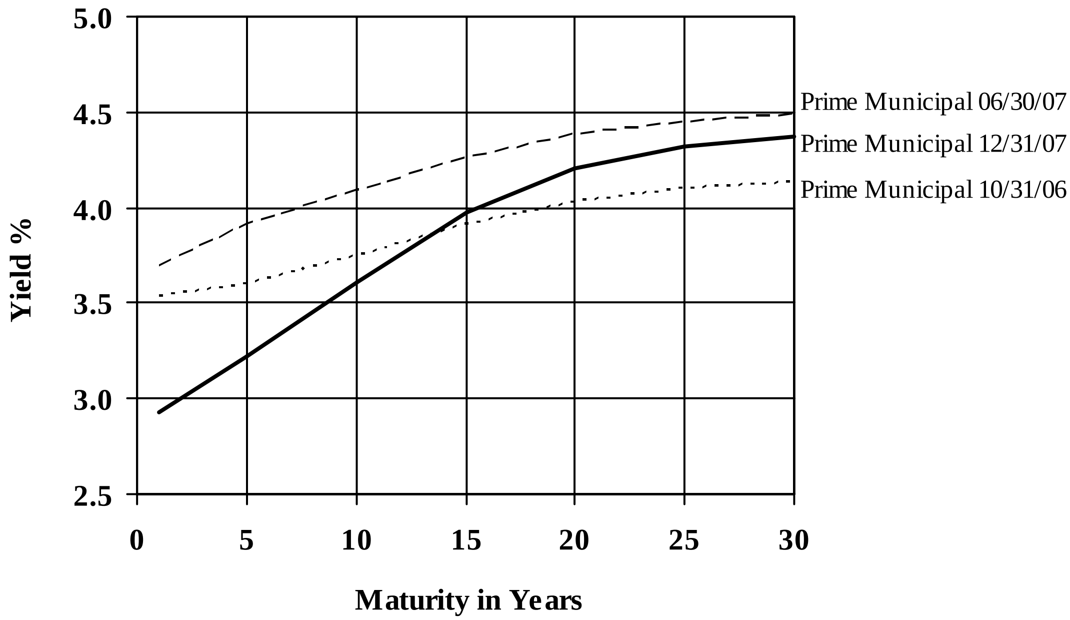
The Federal Reserve will continue to be responsive in the face of deteriorating economic strength. Another ease at the January 29/30 FOMC meeting appears all but certain. Whether the cut is 25 or 50 basis points seems to be the issue. Forward rates are now suggesting a 3.50% Federal Funds rate by the end of March. Recent unsettling inflation reports (e.g. the CPI in November was up 4.3% year-over-year) could give the Fed pause, but we expect that their primary focus will be on maintaining economic growth. Fiscal stimulus is also being discussed in Washington. Whether these efforts will be sufficient to keep economic growth from slumping into negative territory remains to be seen.

Volatility is expected to remain high in the coming months as economic, international and political developments unfold, but we expect that investors will continue to favor the safe harbor Treasury market which will, in turn, be positive for municipal security prices. We are maintaining portfolio durations at about 4.2 years.

- **Municipal Market Is Cheap on a Relative Basis**

Compared to the Treasury market, municipals are a steal! As noted previously, the ten year Treasury yield dropped 140 basis points since late June when it reached an interim peak of 5.26%. During this same period ten year prime municipal yields have declined by about 50 basis points as is indicated in the accompanying chart that shows the prime municipal curves as of the end of last year, on June 30 and at the end of 2006. The upward drift in rates during the first half and sharp reversal in the second half is quite obvious. The steepening of the curve in response to Fed ease is also apparent.

**Municipal Yield Curve Shifts**




Why did Treasury rates drop so much faster in the second half than in the tax-exempt sector? First, Treasuries are typically favored in a flight to quality due to the U.S. government backing and the liquidity of the market. Second, concerns over bond insurers caused some investors to step back from the tax-exempt sector while new issue volume continued to surge. A record $428 billion of new municipal debt was marketed in 2007, up 10% from the previous year. Third, the shift between the municipal and taxable markets caused several hedge funds that had been employing municipal arbitrage strategies to suffer double digit losses as basis spreads (i.e. municipal to Libor spreads) moved against them. Many funds and dealers employing these strategies moved from aggressive acquirers of longer tax-exempts to net liquidators during the past several months. Fourth, if the economy does contract, there will be pressure on municipal revenues and some entities will experience budgetary deficits as they did in 2002 and 2003 when the economy slumped.

The relative cheapness of the municipal sector is evident from the ratios of prime tax-exempt to Treasury yields as is reflected in the following table:

| | **12-31-07** | | | **6-30-07** | | | **12-31-06** | | |
|---|---|---|---|---|---|---|---|---|---|
| | Treas | Muni | Ratio | Treas | Muni | Ratio | Treas | Muni | Ratio |
| 5 yrs | 3.58% | 3.23% | 90.2 | 5.00% | 3.91% | 78.2 | 4.69% | 3.60% | 76.8 |
| 10 yrs | 4.03 | 3.64 | 90.3 | 5.12 | 4.09 | 79.9 | 4.69 | 3.74 | 79.7 |
| 30 yrs | 4.45 | 4.30 | 96.7 | 5.21 | 4.49 | 86.2 | 4.80 | 4.13 | 86.0 |

- **Quality Spreads Widen**

As might be expected, investor risk tolerances have declined in response to the sub prime losses. This carried into the municipal market and is reflected in widening quality spreads. The table below indicates tax-exempt AAA/BBB spreads over the year:

| | 12-31-07 | | | 6-30-07 | | | 12-31-06 | | |
|---|---|---|---|---|---|---|---|---|---|
| | BBB | AAA | Spread | BBB | AAA | Spread | BBB | AAA | Spread |
| 1 yr | 3.67% | 2.93% | 74 BP | 3.99% | 3.69% | 30 BP | 3.85% | 3.54% | 31 BP |
| 10 yrs | 4.42 | 3.61 | 81 | 4.48 | 4.09 | 39 | 4.18 | 3.74 | 44 |
| 20 yrs | 5.08 | 4.21 | 87 | 4.69 | 4.38 | 31 | 4.44 | 4.03 | 41 |
| 30 yrs | 5.30 | 4.37 | 93 | 4.79 | 4.49 | 30 | 4.54 | 4.13 | 43 |

The widening has taken place from the extremely narrow levels that prevailed early in the year. We expect that heightened investor risk aversion will be part of the landscape for the foreseeable future and we would not be surprised to witness additional widening of credit spreads (possibly dramatic) if the economy contracts and credit concerns intensify. The widening thus far has been modest on an historic basis. It is not appropriate to lower quality standards.

- **Update on Bond Insurers**

Our initial analysis was provided in our November 15 memo that discussed the sub-prime exposure of the larger insurers and their potential risk mitigation strategies. Rating agency reviews have been ongoing. FSA's AAA rating has been affirmed but several other insurers have been put on credit watch. Those with negative outlooks are taking steps to bolster their capital positions. For example, it has been reported that Ambac purchased $29 billion of reinsurance while MBIA has received capital support through stock sale to a private equity firm. We anticipate that additional steps will be taken by the insurers to enhance their capital positions as they work to maintain their AAA ratings.

We want to reiterate that a downgrade of an insurer would signify a weakening of the coverage, but does not eliminate the insurance. More importantly, a weaker insurer does not imply a weaker underlying credit. If the issuer of the securities is sound, there should not be any question of that entity honoring it's debt service requirements. As we have stated, our security selection process requires that underlying credits be evaluated. We do not rely solely on bond insurance when making purchases.

Warren Buffett added a new dimension to the situation by announcing that Berkshire Hathaway Assurance Corp. will enter the municipal bond insurance arena. What is unknown is how quickly his company will ramp up and how broad their imprint will be. State registrations can take several months as can rating agency reviews. Also, it is unclear how big a player Mr. Buffett wants to be in the municipal insurance industry. We will continue to comment on bond insurer developments as they unfold.

- **Firm News**

As we begin a new year we want to again thank our clients for their support and confidence. Our only product continues to be municipal bond portfolio management and it remains our goal to provide conservative, but opportunistic management that produces strong total returns in prudently managed portfolios. Our staff is experienced and eager to assist you with any needs and inquiries. We look forward to another excellent year in 2008.

Craig W. Henderson                Thomas L. Mallman