BRECKINRIDGE CAPITAL ADVISORS

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In March, ten-year municipal yields hit a floor of 3.14% on March 9. By the end of the month, municipal bond yields were 3.43%, higher than the 3.40% at year-end. Municipal issuance soared to a $37.5 billion, a record for the month of March. The heavy supply caused municipal bonds to trade at yields as high as 91% of Treasury bond yields. On April 2, the Department of Labor announced job growth of 308,000 new jobs in March with upward revisions of January and February. Given the Federal Reserve focus on job growth, the market took the high job growth as a sign Federal Funds Rate may increase before year-end. Since the end of March, municipal ten-year yields have risen to 3.73%.

The new economic data focus will be on inflation reports going forward. The Consumer Price Index (CPI) Year-Over-Year was last reported at 1.69% through February, the lowest inflation rate since September 2002. Many analysts have discussed the prices of commodities as being inflationary with oil and gold prices rising through most of the year. However, the most important factor in US CPI is labor costs. With the job market looking stronger, we will be watching for an increase in labor costs. So far, wage inflation has not appeared in any reports.

Our strategy remains a slightly short duration, barbelled portfolio. We are trying to take advantage of the higher yields available in longer maturity bonds while increasing holdings of shorter maturity bonds that we can reinvest at higher yields over the next two years. This trade is a long-term strategy that will see more return performance as the short-term yields begin to rise as the economy accelerates and inflation increases.

Treasury Inflation Protection Securities (TIPS)

Since 1997, the US Treasury has issued TIPS as an inflation hedge for fixed income investors. The par value of TIPS remains at 100, but the holding value is increased semi-annually based on the change in CPI. Although the nominal interest payment and maturity values remain constant, the increased par value held increases the cash flow of the securities with inflation. For example, purchasing TIPS 2% due 1/15/14 at the current market price of 102-20 has a nominal (or real) yield of 1.70%. If CPI remains at February's level of 1.69%, the investment would have a realized yield of 3.44%. If CPI increases to average 3% to maturity, the investment would have a realized yield of 4.74%. This compares to a current ten-year Treasury Note yield of 4.17% or an implied inflation rate of 2.50% for the TIPS.

The stated yield of TIPS is called a "real" yield because there is an adjustment for inflation. Since TIPS have only been available since 1997, looking back at longer-term "real" rates for bonds helps identify if TIPS are fairly priced. Currently, ten-year TIPS have a real yield of 1.70%. In the table below, the average real rate for ten-year Treasury notes has averaged 2.83%. The yield of the ten-year Treasury is made up of the real yield and inflation estimate.

Real Interest Rate Averages

	Real Federal Funds	Real Municipal Bond	Real 10-yr Treasury
Avg.	1.81	1.77	2.83
1960s	1.95	1.26	2.26
1970s	0.03	(1.05)	0.42
1980s	4.13	3.32	4.85
1990s	2.06	3.14	3.72
2000s	0.66	2.64	2.39
Last	(0.91)	2.78	2.24

Source: Board of Governors of the Federal Reserve System, Economic Research and Data Web Site as of March 1, 2004.

The pricing of TIPS is based solely on the value of real yields. From 1997, TIPS prices have tended to change at about half the rate of comparable ten-year notes.[1] Over the last four months, TIPS price volatility has actually been 86% of notes.

Price Volatility

	10-Year Note (%)	10-Year TIPS (%)	TIPS/Note (%)
2001	8.126	4.011	49.4
2002	8.545	4.966	58.1
2003	9.185	7.107	77.4
2004-Q1	8.464	7.307	86.3

Source: Bloomberg

Currently, we would recommend remaining in fixed rate bonds. The higher relative price volatility and lower real yield make TIPS a much less attractive investment given current market and economic conditions.

[1] "Empirical TIPS", Financial Analysts Journal, January/February 2004, Volume 60 Number 1, pages 31-53.