

April 2004

Municipal yields rose steadily through the month of April with evidence of an improving economy in very strong employment growth. 10-year high grade municipal yields rose to 3.96% from 3.43% at the end of March. We are consistently seeing reinvestment rates above 4% on the longer half of our maturity barbell trade. U.S. Treasury Notes fared slightly worse with yields rising from 3.83% to 4.49% during the month. According to Lehman Brothers Indexes, the Municipal Bond 5-7 year maturity index outperformed the US Government index 5-7 year maturity by 1.08%.

For most of this year, we have been discussing our use of a maturity barbell. This involves selling bonds that have our targeted maturity of four to six years and buying risk weighted holdings of two year bonds with ten-year bonds. This trade increases total return when rates rise from a very steep yield curve. A subset of the bonds we own in this trade outperformed the index by 18 basis points in April. We continue to look to place new money in this trade to take advantage of further yield curve flattening.

The current bear market in bonds measured from 3/9/04 to 4/30/04 has seen 10-year yields go up 82 basis points from 3.14% to 3.96%. Looking back to the 6/13/03 low for yields, rates are up 111 basis points from 2.85%. The most discussed reason for rising rates is the fear of the Federal Reserve Open Market Committee raising the rate at which banks can borrow. Historically, municipal yields rose when the Federal Funds rate was rising. This year we are seeing a significant rise in rates prior to the FOMC changing policy. The worst market corrections over the last 20 years accompanied large increases in the Fed Funds rate. So far it appears municipal bond yields are pricing Fed Funds increases of 100 bp to 220 bp.

Bear Bond Markets over 20 Years

	Federal Funds	Municipal Bond 10 Yr	Municipal Bond 5 Yr.
Avg.	+255 bp	+166 bp	+165 bp
1983-1984	+325 bp	+160 bp	+170 bp
1987	+175 bp	+210 bp	+175 bp
1993-1994	+300 bp	+175 bp	+185 bp
1998-2000	+220 bp	+120 bp	+130 bp
2003-2004	N/C	+111 bp	+110 bp

Golden Opportunity in Golden State?

In early May, California will issue the first tranche of the California Economic Recovery Bonds. In a state-wide election in March, the voters approved a \$15 billion borrowing to bond out the rolling short-term deficit notes of the state. The first tranche of the issue will be \$7.97 billion fixed rate serial bonds, followed in June by \$4+ billion floating rate notes. The combined size of the issues will be the largest municipal bond offering ever. The bonds are particularly interesting because the large volume of bonds will have to be placed and slowly digested by the market. After the bonds have been placed, the only new issuance for the credit will be refunding the outstanding bonds.

Moody's Investors Service rates these bonds Aa3, Standard & Poor's assigned an AA-minus rating to the deal and Fitch Ratings rates them A-plus. These ratings compare favorably with Baa1 and triple-B ratings assigned to the state's general obligation bonds by the three rating agencies because these bonds carry an additional state sales tax pledge.

This issue may offer an attractive opportunity for both California and out-of-state investors. The large size will force the yield to be very attractive to other market offerings. For most municipal bond investors, the yield will be more than enough to cover their additional in-state taxes and yield more than other in-state names. More importantly, since it is a one-time offering and in a high-tax state, the issue should perform better than other bonds. As the bonds are placed with buy-and-hold investors, the volume of bonds available in the market will decrease. The continued demand for diversity in new portfolios will drive up the price of the bonds. For out-of-state holders, the bonds will be available to swap at very attractive spreads to their in-state names.

California Economic Recovery Bonds
Retail Offering

