

## June 2004

After two months of rising rates, peaking in mid-May, the municipal market settled into a tight range of yields in June. This allowed most accounts to collect coupons and offset some price volatility. As expected the Fed Funds rate was increased on June 30 to 1.25% and the statement maintained “measured” increases going forward. We anticipate the Fed Funds rate to edge up to at least 2% by year-end.

We are maintaining our strategy of barbelled maturities and short-neutral duration in portfolios. This strategy is designed to take advantage of rising short-term rates with higher reinvestment through 2006 and high 10-year maturity yields. Over the next two years, the portfolios will be reinvested for a more balanced approach as the longer bonds roll down the yield curve.

During June, California bonds, and particularly the California Economic Recovery Bonds and direct state obligations, improved significantly as the market grew more comfortable with the fiscal situation in the state. As noted in the April Newsletter, we saw an opportunity to take advantage of particularly wide yield spreads on high grade California issues. The Breckinridge California holdings appreciated about 0.20% more than comparable national bonds.

### Mid-Year Portfolio Topics

#### *Alternative Minimum Tax*

This is a good time of year to review accounts which may be close to paying the AMT. Breckinridge does not invest in any municipal bonds that are subject to the AMT. We believe that as the AMT becomes more prevalent, these issues will become much cheaper compared to other issues.

With six months left this year, we can change portfolio holdings to offset expected AMT exposure. For accounts that are close to paying the AMT, we can reevaluate out-of-state holdings. AMT excludes deductions for state and local taxes paid on out-of-state bonds. This increases the value of in-state bonds for investors who are close to paying the AMT. In addition, if an investor needs to generate more taxable income to avoid falling into AMT, Breckinridge can rebalance with taxable municipal bonds, US Government bonds or agency bonds. Please review our article “Considering taxable municipal bonds” on our website.

#### *Expected Total Return*

With interest rates much higher, there is more reason to consider additional exposure to fixed income investments. In January, 2004, we simulated several market scenarios to gain a better perspective on the risk of the municipal market. We anticipated a market move similar to the move in 2003. Over a twelve month period, the total return for our model portfolio would have been -0.253%. After the change in rates from January to June, if yields were to rise like last summer, the 12 month simulated return would be +0.574%. The higher income level from the portfolio would offset more of the price change.

#### *Inflation Concerns – Municipal Yields*

The most important risk factor for a municipal bond portfolio is the purchasing power of the income stream. The risk of increased inflation will decrease the value of the income from bonds. The chart below shows the relationship of interest rates and the Consumer Price Index (CPI) and the CPI without food and energy (Core CPI). The significant increase in oil prices caused the divergence between CPI and Core CPI.

Although CPI has increased to 3.05% for the period from May, 2003, to May, 2004, the less volatile core CPI remained at 1.7% year-over-year. As the chart shows, the Core CPI rate will move with longer term trend. Interest rates will tend to move based on the market perception of the longer term inflation. So the less volatile Core CPI will give a better indicator of the implied inflation in the yield curve. Since the Fed has begun to tighten monetary policy, economic growth and inflation risk should decrease. We are maintaining short-neutral durations in accounts and believe much of the inflation risk has been discounted in the municipal market.

Municipal 10-Year Yield vs. Consumer Price Index

