

June 2005

In June, 10-year municipal bonds tested the upper and lower ends of the latest trading range before ending 4 b.p. lower at 3.45%. The yield curve was a bit steeper because one-year municipal yields fell 15 b.p. as the market began to discount the possibility of future Fed Funds rate increases. The current target for Fed Funds in the market is 3.75% by year-end according to a consensus of economists. After the June 30 announcement that Fed Funds was raised to 3.25%, the yield curve is priced for 25 b.p. increases in August and September.

Through the first six months of 2005, municipal market new issue activity is at record levels with \$206 billion of bonds issued. In addition, municipal issuers took advantage of low interest rates through most of the first six months and refunding issues grew by 60% compared to last year. After a bumpy first quarter, the market has remained very strong throughout the second quarter. Issuance should remain strong if yields continue to offer attractive refinancing rates.

Our portfolio strategy remains neutral to interest rates because the economic data is mixed and as the FOMC statement indicates is suggesting balanced growth /inflation risk. The yield curve has flattened and we are moving to a more neutral exposure to yield curve shifts. We are purchasing bonds to fill the barbell strategy and achieve a more level distribution of maturities.

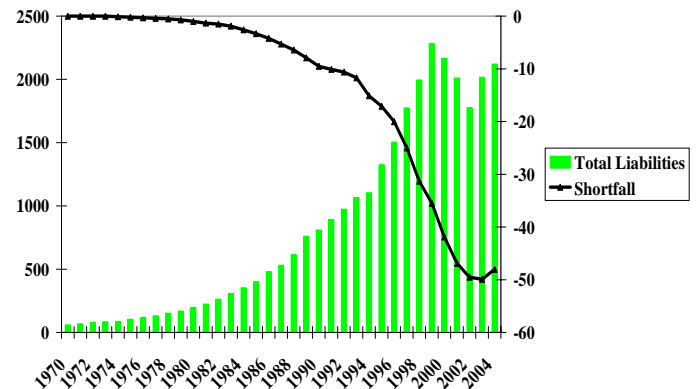
### Municipal Pension Obligations

As pension funding becomes more of an issue for corporations like GM, Ford and United Airlines, municipal pension funding has begun to get more press as a future risk. In a recent special report from Fitch Ratings, the new accounting statement number 45 from the Government Accounting Standards Board (GASB) requires governments to report their pension fund obligations to current employees. The adjacent chart shows the Federal Reserve Flow of Funds reports for the total pension liability and funding shortfall.

The shortfall has occurred as governments have chosen to spend funds for current expenditures rather than making contributions to cover future pension liabilities. Some municipalities have issued debt to cover the shortfall. It is a growing area of the taxable municipal market. This route is popular since the assumed investment rate of return is about 8% yet the municipality can borrow in the taxable municipal market at around 5%. For example Riverside, CA, issued a pension funding taxable issue for an average interest rate of 4.63%.

### State and Local Pension Funds and Shortfall 1970 - 2004

\$(Billions) - Source: Federal Reserve Flow of Funds



Below are short credit summaries of some of the states with large pension shortfalls.

Illinois sponsors 5 defined benefit retirement plans. Pensions are under funded by \$35 billion. The funding shortfall will grow by over \$2.6 billion this year and by an additional \$4 billion within 5 years. Unions want taxes raised but the governor is looking to cut costs and limit benefits to new employees. Illinois had outstanding GO debt of \$19.95 billion by end of 2005 including \$10 billion of pension funding bonds issued in May 2003.

New Jersey's pension benefits and unfunded pensions have left funds \$25 billion short. The proposed 2006 \$27 billion budget will put \$100 million into its pension funds but will have to contribute over \$1 billion next year. In 1997, New Jersey borrowed \$2.7 billion to fill the gap in funding. Currently the interest payments on debt obligations are \$170 million a year. The bill will hit \$500 million by the end of the issue's 30 year life. (Business Week, July 13<sup>th</sup>, 2005 edition)

California has two large pension funds: one for state and one for local employees. The state tried to move new state employees into defined contribution plans to cut an annual retirement bill of \$2 billion. Workers are fighting the changes to the benefits. The governor has taken the unusual step of adding ballot measures in November 2005 to pass the pension reform plans. This change makes funding futures pensions much more predictable and less subject to market changes.

Municipal pension funding is a developing story that is beginning to be more widely analyzed. Breckinridge, as always, is reviewing all of our investments for issues related to pension funding shortfall and debt burdens.