

In August, municipal yields were lower and the curve was flatter as the market anticipated an economic slowdown from high oil prices and lower oil and gas output caused by Hurricane Katrina. The rally reflected the risks we have discussed over the last year, that a supply shock or housing market weakening could lead to low intermediate and long term interest rates over an extended period of time. Looking back over the period from 1954 to 1966, ten-year municipal yields remained in a very tight trading range. This was a period marked by average growth, the Vietnam War and price stability. Currently, growth is estimated to be slightly above average by most economists, there are ongoing struggles in Iraq and Afghanistan and inflation has remained in a range of 1% to 3%.

Our portfolios are positioned in a neutral stance over the yield curve. We are slightly favoring three to eight year maturity bonds because the yield curve is very flat on an historical basis. Our average quality is up with 77% of holdings rated AAA and heavily weighted in the General Obligation and essential service sectors. The durations of individual accounts are targeted between 4.05 to 4.25 years to match benchmarks' durations of ~4.15.

### Hurricane Katrina

With the damage to the Gulf Coast, we have reviewed our holdings in Louisiana, Alabama and Mississippi. We continue to monitor these credits as the situation develops and aid and recovery efforts become known. At this point, we do not expect any credit problems to develop in any of our portfolios due to the storm. We have no uninsured exposure to the hardest hit areas of the states. Moreover, all of our exposure to the region is in essential service revenue and G.O. bonds which have proven to be very resilient in difficult times. This fact was noted by Standard and Poor's Rating Service report on the \$13.8 billion in insured debt in the region. S&P states, "General obligation defaults may tap a bond insurer's liquidity, but recoveries have historically been at or close to 100%. At the other extreme, bonds backed by revenues from a specific enterprise—such as airports and ports, hospitals, or convention centers—might be more susceptible to impairment..."<sup>1</sup> Insurers will cover the debt service on bonds that default due to the storm. The total impact on the insurers may not be clear for some time. Moody's and S&P are reviewing the insurer ratings.

### Housing

The housing prices in the US are rising due to the low interest rates and increased demand from investors

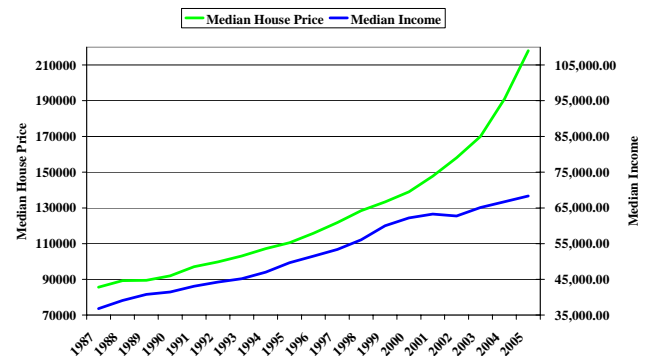
<sup>1</sup> "Some Bond Insurers Are Facing Uncertainty In The Aftermath Of Hurricane Katrina", 07-Sep-2005, Standard and Poor's Ratings Direct.

diversifying out of equities. The potential "bursting" of the price bubble in housing could impact municipal bond yields and credit quality as local tax revenues are dependent on property valuations.

Over the last five years, rents have not kept pace with the cost of houses due to the availability of low interest mortgages. According to US Census data, home ownership has risen from 63.7% at its low in Q2-1993 to 69.2% in Q4-04. The trend to home ownership has slipped to 68.6% in Q2-05. Anecdotally, the New York Times real estate section mentions that rents nationally have started to increase, an indication of the higher demand as housing prices have risen.

In particular, house prices have risen dramatically versus income. The chart below shows the median house price and median income. The scales are set so the housing scale is exactly double the income scale to show the relative movement with housing rising 155% and income rising 86% over the period.

Median House Price versus Median Income  
1987 to 2005



Affordability is based as much on mortgage interest rates as the price of houses. The cost of a median mortgage as a percent of the median income has risen in the last year. With interest rates historically low on long-term mortgages, housing was more affordable through the end of 2003. In the last two years, the rapid increase in house values has overcome the low interest rate and affordability has dropped.

A decrease in affordability of houses would lead to a downward spiral as opportunistic investors move out of the housing market and homeowners lose the ability to tap home equity for consumption. The economic growth generated by the housing sector and refinancing is estimated to be 1-1.5% of GDP. Should the bubble burst and growth slow, interest rates should continue to be fairly stable. Together with the oil price drag on growth, intermediate interest rates could remain in the current trading range for an extended period of time.