Market Commentary

April 2007

In April, the municipal yield curve was flatter from one to twelve year maturities. This is a seasonal event as short municipals are liquidated to pay taxes during the month. In addition, municipal new issue supply slowed from the first quarter. New municipal issuance was up over 50% in the first quarter of 2007 versus the first quarter of 2006. April issuance was up only 11% year-over-year. Over the last ten years, April issuance averages the third lowest month of the year, only January and August average less issuance. The relative lack of demand and supply has constrained trading volumes during the month and kept spreads very tight. Seasonally, May through July should see more new issue volume and more secondary market trading.

The tax-exempt portfolios are targeted for a slightly longer duration than their indexes. The maturity structure is targeted to be modestly bulleted by the end of 2007 in anticipation of a steeper yield curve next year. The mixed economic reports in the last few months, with inflation still higher than "targets" and growth weaker than expected, should keep the FOMC on hold through the summer. This could delay the start of a steeper yield curve into 2008. We remain committed to the highest quality bonds, as mentioned in our comments on asset valuation. During April, we focused on secondary market activity for individual accounts and avoided the primary market where yields tended to be lower.

U.S. treasury yields were volatile during the month of April as investors reacted to mixed economic data. Despite trading in a 10 basis point range over the course of the month, the yield on the ten year U.S. Treasury note ended the month barely lower than where it started. The data from the manufacturing and housing sectors continued to weaken, further supporting the view of many that the next move from the Fed would be an ease. However, at the same time, the inflation data (wages and commodities) remained above the Fed's "comfort zone" of 2%, thus reinforcing the fact that the Fed would be on hold for the foreseeable future, and the ease in rates would not occur in the near future.

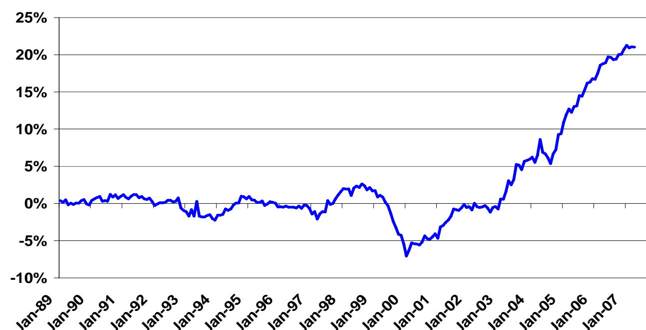
Taxable and Hybrid portfolios are also pursuing a more bulleted structure from 2012 to 2015 for an eventual steepening of the yield curve. We are more focused on Agencies and callable Agencies to take advantage of the additional yield in these bonds. Municipals make up the longer maturities in both taxable and hybrid portfolios, although supply has been very tight in the last month as new issuance dropped. In contrast with tax-exempt municipals, taxable municipals were cheaper in the primary market than the secondary market. With very low credit spreads, we continue to focus on the highest grade issues.

Market Valuations: Low Quality Spreads

The dominant theme in the markets was not interest rates or the yield curve, but a revival of risk appetite. In a reversal of the risk aversion that occurred in March, high risk assets performed strongly as higher than expected corporate earnings reports and an apparent stabilization in the housing market (particularly the subprime market) brought investors back to the sectors that had performed poorly in March. With the equity market taking the lead (S&P 500 returning almost 4.5% in April), higher risk asset returns rebounded as fears subsided and complacency returned. With the Fed on hold, the yield curve flat to slightly inverted, the economy still growing (albeit at a slower pace), and plenty of cash to invest, the risks and fears that dominated the global markets just a month ago are largely being ignored. Despite this complacency, the problems in the subprime mortgage market have yet to be resolved, and the spillover effects from a weak housing market on the rest of the economy are still unknown. Geopolitical risks seem to be rising, not falling, and the increasing use of derivatives and leverage bring another element of uncertainty into the equation.

Applying these same themes to municipal bonds, lower rated sectors have produced outsized returns. The chart below shows the accumulated total return comparison of the Merrill Lynch Hospital Index and the Merrill Lynch General Obligation Index. Typically, hospitals will have better performance when the economy is strong and yields are steady. Then the trend will reverse when the economy slows. The previous low cycles were in 1993-4 and 2000-1 where the cumulative return on hospitals fell below the cumulative return for GOs. In the current cycle, hospitals have moved to "bubble" levels of over 20% in excess performance. If the markets trade as they have in previous cycles, as the economy slows hospitals will reverse and under perform GOs on a cumulative level.

Breckinridge continues to believe that higher income and capital stability come from the long-run stability of high grade intermediate bonds. We continue to avoid "hot" sectors where the reversal of returns can be sudden and dramatic.



Source: Merrill Lynch Index Data, Breckinridge Research.

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