

Monthly Review

Fed Rate Cut Unlocks Frozen Markets

On September 18 the Federal Reserve moved aggressively to stem the credit crisis with a 50 basis point cut in both the federal funds and discount rates. This decision proved pivotal, boosting the short end of the bond market as well as equities. Long treasury rates rose on fears of rising inflation and a weak dollar. As a result, the yield curve steepened sharply. In general, most spread sectors performed well and the credit markets seemed to stabilize in anticipation of continued accommodation by the Fed.

Municipal bonds were one of the best performing investment grade sectors (returning over 1%) as investors opportunistically bought bonds that had become historically cheap to treasuries. Municipals also benefited from the perception that they're safer investments in stressed markets. Municipal credit spreads widened throughout the quarter.

July and August's credit sector freeze eased, as evidenced by a record amount of corporate new issuance and narrowing of yield spreads. The dislocation in short rates (in particular, short t-bills vs. LIBOR) eased with the Fed rate cut. However, the dislocation is far from over. Commercial paper remains under some pressure.

Breckinridge Strategy

Continued Positioning for Steeper Curve and Lower Rates

We anticipated a Fed rate cut and a steeper yield curve, so we have been opportunistically adjusting our portfolios. We still believe the yield curve will steepen due to a rate decline in short and intermediate maturities. In our opinion, the housing sector will not improve for some time. Its negative impact may spread throughout the economy. We expect more Fed easing over the next 12 months.

Tax Exempt Strategy

During the month we took advantage of historically cheap spreads in the tax-exempt market, adding to positions in the intermediate part of the yield curve. We continue to focus on 5% or higher coupons with limited extension risk.

Taxable Strategy

As in the tax-exempt portfolios, we opportunistically purchased intermediate taxable municipals and agencies. Yield spreads had widened to historically attractive levels in August and early September. Agency spreads tightened sharply after the Fed rate cut. As usual, taxable municipals did not move as quickly, so yield spreads to treasuries remain at historically cheap levels.

A Short Term Fund Alternative

This summer's dislocation in the credit and commercial paper markets has made all investors more concerned about short term and money market funds, including municipal cash equivalents and money market funds. Short-term municipal investments fall into two categories: money market eligible vs. non-eligible. Given how liquidity dried up over the summer, we think it's worth understanding the difference.

Money market eligible securities:

- Short-term notes and bonds with maturities shorter than 13 months
- VRDOs (Variable Rate Demand Obligations), which are bonds with long maturities, floating rates, and puttable that are secured by a credit facility that ensures liquidity

Non-eligible:

- Auction Rate Notes – Floating rate notes issued by a municipality where liquidity is dependent on the successful remarketing of the security.
- Auction Rate Preferred Stock – Floating rate preferred stock issued by closed end leveraged funds.

During the heightened credit crunch, lack of liquidity seemed to drive a spike in yields of floating rate municipals (particularly for auction rate securities). Breckinridge has always considered liquidity an important component of our investing. Accordingly, we offer a strategy that primarily invests in short-term notes and bonds. This represents a good alternative for investors concerned about liquidity because:

- We limit exposure to VRDOs, thus avoiding a concentrated exposure to liquidity providers (typically foreign banks and brokerage firms). Money market funds are often 70% invested in VRDOs.
- We avoid auction rate notes and preferreds, which eliminates dependence on the market for liquidity.
- Our focus on short-term notes and bonds produces a slightly longer duration vs. floating rate securities. Thus it provides a more stable and predictable income stream. This is especially beneficial as the Fed eases and short-term interest rates decline.