

Market Review

Fed Cuts Rates in Emergency Meeting

Economic data in January was mixed, although investor sentiment was skewed to the downside. Continued deterioration in the housing sector, as well as unexpected weakness in the retail sector, offset relatively benign news from the manufacturing sector. Inflation fears were put aside as stress in global financial markets moved to the forefront. The Fed initiated a 75 bp cut in rates at an emergency meeting on January 22nd and followed with another 50 bp cut at their regularly scheduled meeting on January 30th. A tightening in credit conditions due to global financial market stress was cited as the catalyst for the sharp drop in rates. The Fed reiterated that downside risks to growth remain – a view echoed in early February by Fed President Lacker. Further eases are expected, and at this writing the Fed Funds Futures are pricing in another 50 bp cut at the March 18th meeting.

Flight to Quality Continues – Curves Steepen

Investor response was a continuation of a flight to quality. The treasury and municipal yield curves steepened sharply with short and intermediate rates declining more than long rates. U.S. Treasuries again were the top performers with the intermediate sector posting strong returns. Municipal bond returns were also higher in the intermediate sector, and long maturities actually posted negative returns. The long end of the municipal bond market was sharply impacted by a lack of liquidity as leveraged bond portfolios lowered both their insured bond risk and short-term financings. Additionally, institutional municipal money market funds sold short-term securities that were viewed to be vulnerable to ratings downgrades.

Breckinridge Strategy

Expecting More Yield Curve Steepening

We are maintaining our emphasis on intermediate securities, both in tax-exempt and taxable portfolios. However, we have changed our overall portfolio duration targets closer to neutral to their respective benchmarks. Given the already substantial decline in rates, and our cautious outlook on long term rates in both the treasury and municipal markets, we believe this is the prudent thing to do. We believe fiscal stimulus, inflation fears and the unwinding of leveraged hedge funds will prevent long rates from declining as much as intermediate and short rates. Accordingly, we expect to see yield curves continue to steepen as the Fed lowers short rates.

Moving Beyond Bond Insurance

Problems within the insurance guarantor (monoline) industry worsened as their exposure to losses within the structured product area mounted. These losses primarily stem from sub

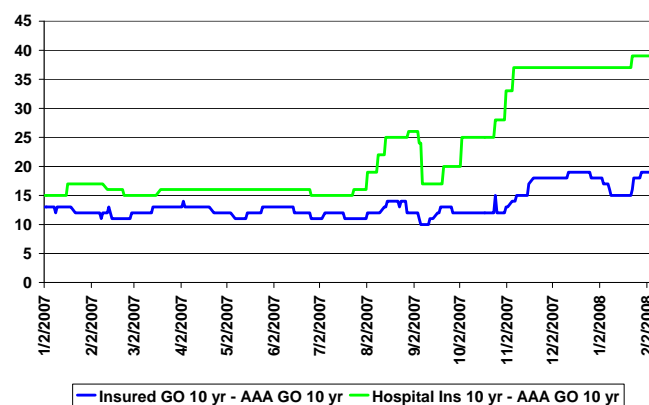
prime mortgages held within complex financial instruments that the companies wrapped with insurance (CDO's, CLO's, ABS CDO's, etc.). Following the earlier actions of Fitch and S&P, several of the major insurers are at additional risk of downgrades by one or more of the rating agencies. This is due to the lack of reserves set aside for losses of this magnitude, and the subsequent impact on their capital structure. If companies wish to retain their AAA status it has become necessary for them to raise capital. This is not an easy task in the current market environment of risk aversion and tight credit. The implications of rating downgrades are far-reaching and may profoundly impact some financial institutions. These heightened fears have weighed heavily on all financial markets recently.

There continues to be a great deal of uncertainty about the resolution, yet many analysts expect to see some rating agency downgrades within the next 4 to 6 weeks. Due to the evolving nature of the situation, we hesitate to make predictions of how it will ultimately be resolved. However, we would like to share our thoughts on what we believe the impact will be on the municipal bond market.

Crisis of Confidence – Business Model Impairment

In mid-January the municipal bond market began the process of differentiating the pricing of bonds based on their underlying credit quality. This is in contrast to the past convention of focusing on insured versus non-insured bonds. (See chart below of Insured GO spreads and Insured Hospital spreads). We believe that this is a permanent change in the municipal bond market. The problems within the major monolines have created a lack of confidence among the investor base, and impairment to their business model that we believe is irreparable.

Insured Spreads Wider on Underlying Quality



Breckinridge is well positioned to benefit in this evolving marketplace. We have had a cautious view regarding the insurers branching off from the public finance business since 2002 (please view www.bondinvestor.com market commentary archive). For this reason we have concentrated our purchases on bonds with strong underlying credit quality. At the same time we have continued to put a premium on our in-house research efforts. We believe the municipal bond market revaluation process is in the beginning stages, and Breckinridge is poised to take advantage of opportunities that will arise.