

Market Summary

Calm Returns to the Markets

The financial markets' first quarter flight to quality reversed itself in April as the credit crisis appeared to ease. The extraordinary steps that the Fed had initiated in March in order to improve market liquidity seemed to have a calming effect on all markets. Fears of an impending financial crisis dissipated and investors shifted funds back to riskier assets. In a quick reversal, treasuries sharply underperformed all other fixed income sectors; treasury and municipal bond yield curves flattened, and risk was rewarded.

Economic Weakness Continues

From a macro-economic perspective all was not well with the U.S. economy. Signs of economic weakness persisted and further deterioration in housing, manufacturing and employment were evident. More economists changed their outlook or current view to one of recession. Inflation continued on its upward trend, and the impact on gasoline and food prices was the impetus for scores of media reports of global shortages and turmoil. At month end, the Federal Reserve Board lowered the Fed Funds rate 25 bps to 2.00%. They cited concerns about downside risks to growth, yet uncertainty about the inflation outlook as well. The statement has been interpreted as the Fed is in a "wait and see" mode at this time as the lagged effects of their past policy changes begin to impact financial markets and economic activity.

Risks Remain

We are concerned that the recent recovery in financial markets, and shift to riskier assets may prove to be fleeting. While we expect some near-term improvement in the economic data, and consequent rise in bond yields, we do not believe that it will be sustainable through the second half of the year. The ongoing deterioration in the housing market, rising mortgage rates, food and gas inflation pressures on consumer spending, inflation pressures on corporate profitability, and tight credit conditions leave little in the form of a catalyst for a strong pick-up in economic activity. Additionally, while credit market conditions have recently improved, many uncertainties remain. The restructuring of many failed Auction Rate Securities has begun, but is still unresolved, and many remain totally illiquid. The recently released earnings report from the monoline insurer, AMBAC was certainly worrisome as losses from their sub-prime exposure mounted. There is still a sizeable risk that some bond insurers could be downgraded by the rating agencies and lose their AAA status. Lastly, we have yet to hear from the Supreme Court about the Kentucky vs. Davis case.

Breckinridge Strategy

Caution Prevails

Near term, we are anticipating that yields will rise, especially in long maturities. We believe that this rise in rates will prove to be short lived as weakening economic fundamentals prevail. While currently the portfolios have a duration target that is neutral relative to their benchmark, we would take advantage of a rise in rates to slightly extend duration. Our strategy will be to reduce exposure in the intermediate part of the yield curve and reinvest in longer maturity securities. This will result in a more level maturity structure in contrast to the previous structure which was more bulleted in intermediate maturities.

Despite the recent "all-clear" signal in the markets, Breckinridge remains very selective about credit quality, and we are not deviating from our risk-averse stance. In these uncertain times we think it is more important than ever to remain true to our philosophy of structuring fixed income portfolios with a safe and reliable source of income and capital. Staying risk averse does not, however, keep us from taking advantage of opportunities we are seeing in the mispricing of high quality securities. In this way, we see some positive benefits to be derived from the market's uncertainty.

Perhaps the key lesson investors have learned over the last several turbulent quarters is that taking what even appears to be modest risk for granted can prove painful. Having the foresight to avoid severe market dislocation often simply requires acknowledging that the future is never absolutely certain. Fortunately, that has been our stance on a host of recent municipal market issues ranging from bond insurance to failed Auction Rate Notes.

Recently this theme was more eloquently stated by economic historian, advisor and author of the best selling book on risk, Against the Gods, Peter L. Bernstein.

Investors who admit to their ignorance of the future invest in an entirely different manner from those who cannot accept the reality of an unknowable future. These more cautious investors seldom float up with the bubbles or crash down with the busts. But recognizing our ignorance of the future does not mean you have no view of the future. Rather, it means you recognize your view of the future could be wrong. Then, if this is a situation that really matters, you manage your affairs so that you will survive the possibility of being wrong.

"Economics & Portfolio Strategy," Peter L. Bernstein, Inc.

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