

## A Month of Just a Few Bright Spots

October was yet another month of unprecedented global financial market disruption and declines; and equally unprecedented government and central bank policy response. In a global effort to improve market liquidity, the U.S., U.K., EU and Asian governments injected capital and guarantees into the banking systems; essentially offering unlimited liquidity. Monetary policy was also utilized with the U.S. Federal Reserve, ECB and Bank of China cutting rates. Despite these efforts, the process of worldwide deleveraging, compounded by simultaneously deteriorating economic conditions, couldn't prevent widespread market declines. It was a month in which almost all market sectors posted record breaking losses.

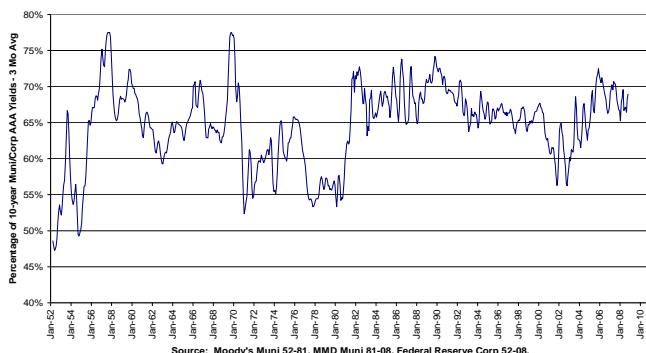
### *Flight to Quality Continued*

In the fixed income markets, Treasuries continued to benefit from the flight to quality trade, and the sector posted positive returns for the month. Almost all other sectors declined as the credit crisis and illiquidity gripped one market after another.

### *Intermediate Municipals Outperform*

A notable exception however, was the intermediate municipal bond sector, which posted slightly positive returns. After several months of underperformance, municipal bond yields had reached historically attractive levels. This did not go unnoticed, and in an effort to lock in these generous yields, retail demand for municipal bonds gained strength. There was particular interest in the short and intermediate part of the yield curve. As mutual funds and hedge funds that typically invested in longer maturities faced redemptions, the long end of the muni curve came under selling pressure, and posted negative returns. While intermediate maturity municipals performed well in October, yield spreads remain at historically attractive levels. Demand for short and intermediate municipal bonds continues to be strong, and we anticipate that this demand will only grow stronger.

**Municipal Bonds Cheap to Corporate Credits**

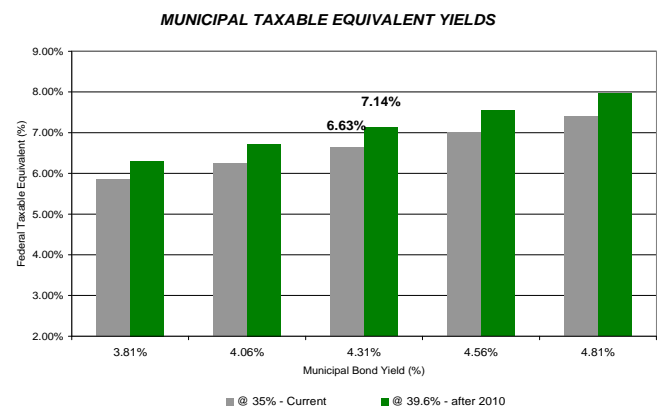


## Election Impact

We believe that the election of Barack Obama as President and a Democratic majority in Congress will have a direct impact on both the municipal and Treasury bond markets. The financial rescue package that has already been put in place by Congress will surely be expanded, and President-elect Obama has already promised additional fiscal stimulus.

This will result in increased Treasury note and bond issuance which will, in time, put upward pressure on interest rates. As the economy eventually responds to the fiscal and monetary stimulus, inflation expectations will increase, also putting upward pressure on interest rates. In the near term, however, it is expected that rates will remain relatively low due to deteriorating economic conditions. We believe it is not likely that that Fed will want to tighten credit further by raising interest rates any time soon.

It is almost certain that individual and some corporate tax rates will increase as promised by President-elect Obama. This would make municipal bonds even more attractive investments to an individual investor. The chart below illustrates the impact on various taxable equivalent yields at the top marginal tax rate, with a tax increase to 39.6% from the existing rate of 35%.



Another impact of a new administration on the municipal bond market relates to the possibility of fiscal stimulus through government infrastructure projects. Infrastructure projects that benefit states and municipalities yet are supported by the federal government serve a dual purpose. Infrastructure projects would generate local jobs while reducing state and local debt requirements for public construction programs.

## A Weakening Economy – Implications for Muni Credit

Recent articles in newspapers and magazines have highlighted the financial stress that states and municipalities are beginning to experience as tax receipts decline. We expect to see even more negative articles as states and cities struggle to balance upcoming budgets. As we discussed in September's newsletter, *we remain confident about the fundamental security of municipal bonds*. We do believe however, that understanding credit risk is even more indispensable in today's market. Although the municipal bond market largely is composed of relatively straightforward general obligation and essential service bonds, there are other sectors that bear uncertainties that extend far beyond those of the typical state or city.

Breckinridge continues to be diligent in reviewing the creditworthiness of municipal bond issuers. We are taking advantage of opportunities that emerge as the marketplace doesn't always differentiate amongst credits in a period of general stress.