

Positive Returns, But Continued Market Turmoil

With the exception of High Yield and long maturity Municipals, most fixed income sectors posted positive returns during the month of November. Once again, Treasuries were the top performers with yields dropping sharply in reaction to increasingly negative economic data. While the positive returns were a welcome respite from the negative returns of the past several months, underlying conditions within the fixed income markets remained difficult. The post-election announcements of new government initiatives and changes to some of the newly created programs helped provide a positive undertone to the markets. On the surface, it appeared that the credit markets were functioning a bit more smoothly with new issues in both the taxable and tax exempt markets quickly being absorbed. The caveat however, is that the new issues were sold at unprecedented spreads reflecting the ongoing, and in some cases accelerating, dislocation and illiquidity in the markets.

Municipal Market Update

Intermediate maturity municipals performed well, with the five to seven year part of the yield curve posting the highest returns. The municipal yield curve steepened with long maturity yields rising and short and intermediate yields declining. This movement in the shape of the yield curve is directly related to specific factors that are currently affecting different facets of the municipal market. Portions of the muni market continue to struggle with liquidity.

Long End Supply Pressures

Municipal bonds are typically issued for long term capital projects, so issuance is heavily weighted toward long maturities. In the past, most long term bonds were wrapped with credit enhancement (bond insurance) and liquidity facilities from banks, and then remarketed as floating rate securities (VRDNS) to money market funds. Now, the lack of bond insurance, and high cost or unavailability of liquidity facilities, has virtually shut down this option. Therefore, as new issues are brought to market, a large amount of long-term fixed rate bonds must be absorbed at much higher yields.

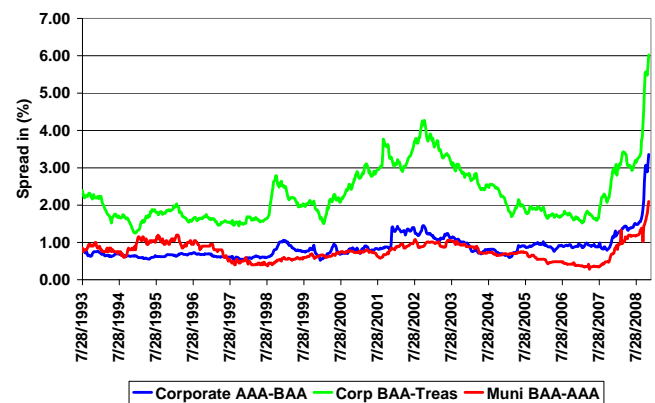
Additional demand for long maturities has typically come from institutional investors; i.e. mutual funds, hedge funds and insurance companies. Demand from these institutions is currently very weak. Mutual funds are experiencing net redemptions as individual investors concerned about volatility shift their preference to direct ownership of bonds. Hedge fund buyers of municipals that used leverage and attempted to hedge with Treasuries or Libor swaps experienced weak performance and were forced to sell their municipal holdings. Lastly, insurance companies are currently experiencing losses so there is no need for tax-free income. Consequently, a large pool of buyers is absent from the long end of the muni market, thus forcing long maturity yields up.

Individual Investors – Discriminating Buyers

In contrast, demand from individual investors is very strong as they shift their preference to direct ownership of bonds rather than a fund. Concerned about fund volatility, they are focusing on intermediate, high quality, “familiar” issues. This increased demand has caused short and intermediate yields to decline.

Liquidity has also been constrained in weaker credits. Bond insurance is no longer viewed as reliable. At the same time, a severe economic downturn has produced negative headlines and heightened concern about municipal credit quality. There are over 75,000 different muni issuers and many trade infrequently, if at all, leaving a market of countless unfamiliar issuers. Generally, traders and investors will be comfortable bidding for a straightforward AA or AAA General Obligation or Revenue bond. However, for issues rated below a AA credit, liquidity begins to suffer and a concession is demanded. The following chart illustrates the impact this illiquidity has had on credit spreads.

Credit Spread Comparison



Taxable Market Update

A similar situation is occurring in the taxable bond market. While new issues are being sold, the yields are at historic high levels due to the lack of liquidity in the market. Buyers have become more discriminating in terms of quality and specific issue liquidity. Taxable municipal bond supply is low, yet yield spreads are at historically attractive levels. Corporate bonds continue to be pressured by declining earnings expectations in a weak economy, and are trading at levels last seen in the Great Depression. The newly created FDIC Treasury Loan Guarantee Program (TLGP) began in November and issuance is picking up strongly. Three year bank debt (guaranteed by the government) is attractively priced relative to Agencies and Treasuries.

Breckinridge Strategy

As we have previously stated, we continue to position portfolios for wider spreads by emphasizing higher quality, intermediate maturity bonds. We remain poised to take advantage of opportunities in smaller, very high quality issues that are unfamiliar to the average investor.