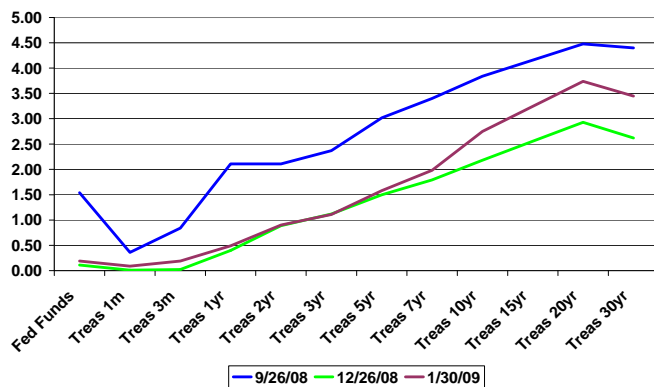


## Market Overview

*Weak Economy, Weak Treasury Market, Strong Municipal Market*

While economic data continued to show deterioration in January, fixed income market performance diverged and was quite varied depending on the sector. After a very strong 4<sup>th</sup> quarter 2008 performance, the Treasury market reversed course and yields rose despite very weak economic data and an accommodating Fed. Fears of the massive government spending and bond issuance overwhelmed near term fundamentals causing yields to rise. Long maturities in particular were sharply affected and posted significant declines in price.

**Treasury Yield Curve Comparison**  
Source: Federal Reserve



## Municipal Market

*Municipal Market Outperformance*

In contrast, the municipal bond market performed very well as inflows increased substantially. During the 4<sup>th</sup> quarter the relative attractiveness of municipal bonds had reached historic levels (see Year End 2008 Newsletter). This phenomenon was widely publicized and spurred outsized demand from both traditional municipal bond investors and crossover buyers. Yields, therefore, declined sharply in January producing positive total returns for the month. Overall yield levels are now very low in short and intermediate maturities. As this is being written, five year municipal yields dropped to an historically low level, 1.79% compared to 3.45% in October and 2.50% at year end. .

## California Credit Concerns

States continue to struggle with falling revenues and deficits while waiting for relief from the federal stimulus plan. In some cases, budget reports and negotiations have been deferred until states learn of their allocations from the recovery legislation. California, which now holds the lowest state credit rating, single-A by Standard & Poor's, will garner the largest share of stimulus funds due to its status as the country's most populous state. The state's cash crunch is serious due to deadlocked budget negotiations; California

state employees are beginning mandatory furloughs and tax refunds are being delayed. These actions help ensure, however, that the state can make its highest priority payments: education funding and debt service on general obligation bonds.

## Taxable Market

*Federal Home Loan Bank Headline Risk*

As Treasuries sold off in January, most other spread sectors outperformed. Within the Agency sector, Federal Home Loan Banks (FHLB) underperformed. Many of the regional FHLB's reported losses in their investment portfolios, thereby affecting their required capital ratios. The FHLB's still have the implicit guarantee of the U.S. Government, but unlike Fannie Mae and Freddie Mac, they have not required a more explicit guarantee. Their new regulatory agency, the Federal Housing Financing Authority (FHFA) announced a proposed change to the banks' capital requirements at the end of January; however, the new regulations are subject to a 90 day comment period and are not certain at this point. The resulting uncertainty surrounding the FHLB's has caused yield spreads to widen, and has impaired liquidity. We expect the weakness in the bonds to continue until the uncertainty over the new regulations and the government's future level of involvement are resolved. We continue to believe that the Federal government would support the FHLB system with a more explicit guarantee if necessary.

## Breckinridge Strategy

The extraordinary relative attractiveness of municipal bonds that occurred in the fourth quarter of 2008 has diminished as the yield spread with Treasuries has narrowed. In addition, we expect to see increased municipal issuance in the next few months which could cause upward pressure on municipal yields. For these reasons, we are currently focusing on shorter maturities for new investments, while at the same time taking advantage of select opportunities in longer maturities as they arise.

AAA GO 10 yr - Treasury 10 yr  
Source: Thomson-Reuters Municipal Market Data

