

Market Review

Treasury and Municipal Bond Yield Curves Diverge

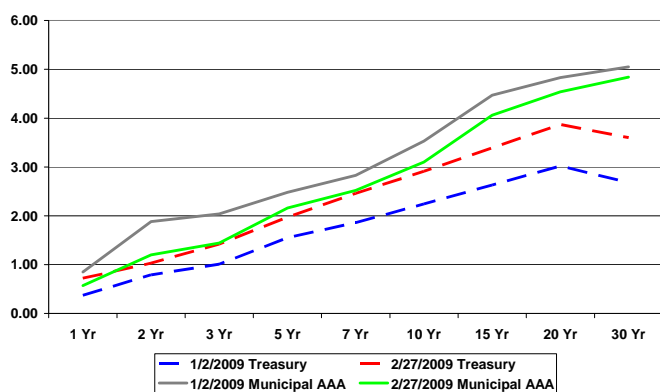
The trend of rising long term treasury yields that began at year end spilled over to municipals in February, resulting in negative returns for most fixed income sectors. The treasury yield curve steepened as long rates rose more than short rates. The rise in yields occurred despite ongoing economic weakness and speculation of outright government purchases of long treasuries. The specter of ever-rising budget deficits, coupled with the addition of significant new issuance overwhelmed the consensus view that the Fed would try to keep rates low for an extended period of time.

Municipal Market

Some Give-Back of Recent Gains

In February, the municipal yield curve flattened with intermediate maturities rising more than both short and long maturities. As mentioned in January's newsletter, yields on intermediate munis had declined to very low levels, resulting in significantly reduced demand for that part of the muni yield curve. Maturities less than three years, and longer than ten years, posted positive returns while the "belly" of the curve (3-10 yrs.) posted negative returns. In this low yield environment investors focused on longer maturities with higher yields. In general, inflows by individual investors into the municipal market remain strong despite the low absolute yield levels. Future trends continue to support demand for municipal bonds.

Comparison of Lower Municipal Yields to Higher Treasury Yields



Source: Treasury from Federal Reserve; Municipal from Thomson-Reuters Municipal Market Data

Federal Stimulus Package/Budget Proposals

The stimulus package (titled the American Recovery and Reinvestment Act of 2009) was unveiled at the end of February. As proposed, it is very generous to the states, with approximately \$225 billion directed to states and municipalities through direct grants and changes in tax provisions or rules.

The largest piece of the stimulus will be directed to bolster the States' Medicaid programs. The second largest portion is directed to Fiscal Stabilization Funds which will provide immediate relief to help balance governmental budgets. The third largest portion is directed to Highway Infrastructure projects. These three programs will provide a near term infusion of funds which will help resolve the imminent budget pressures; as well as create jobs for the much publicized "shovel-ready" infrastructure projects. Additional programs are targeted for health insurance (COBRA), schools, education, law enforcement, and other infrastructure projects.

All of the implications of the stimulus package on the municipal bond market are still unknown; however, over the near term it should provide some stabilization of budgets, and credit ratings. Increased federal funding of infrastructure projects could result in decreased overall bond issuance. In general, while temporary, the Federal funding provides a solid backstop for states and municipalities, and should help ease investor concerns.

Build America Bonds

An interesting piece of the proposed stimulus package is the option for municipalities to issue taxable bonds to finance school and capital projects. The bonds may either be issued with a federal subsidy that the issuer would receive, or a tax credit that the bondholder would receive. The issues would be structured more like corporates with large (over \$250mm) bulleted maturities. We expect to see an increase in taxable municipal issuance under this program, and it may shift supply away from the tax-exempt market. Breckinridge has been actively involved in the taxable municipal market for many years, and we look forward to the potential of more supply.

Demand for Munis Should Remain Strong

An increase in future demand for tax-exempt bonds by individual investors became more of a certainty when the Obama administration proposed to raise higher marginal tax rates from 36% to 39.6% beginning in 2011. In addition, reduced tax deduction benefits, and a 20% capital gains tax could make tax-exempt bonds a more attractive tax shelter for individual investors. These longer term proposals will have a more permanent impact on the municipal bond market in terms of demand/supply relationships and after-tax returns.

Breckinridge Strategy

Within the tax-exempt portfolios we continue to find value in both short maturities and long maturities. We remain vigilant in monitoring the credit quality of all of our holdings. In the taxable portfolios we are focusing on taxable municipal bonds in longer maturities, and in shorter maturities, the FDIC-backed bank and Agency debt.