

Market Overview

Yields Rebound

In a reversal from the previous two months, long-maturity U.S. Treasury yields rose in October. The sell-off was triggered by a combination of stronger economic data, a weaker dollar, recurring fears of fewer Treasury buyers in the face of increasing supply, and general resistance to low rates. Short-maturity bond funds, both taxable and tax-exempt, continued to benefit from flows out of low-yielding money-market funds. Reflecting this strong demand, Treasuries with maturities under five years produced positive returns for the month, as did tax-exempt bonds with maturities less than two years.

With the release of positive third-quarter GDP data, many declared an end to the recession; yet the debate continues over the strength and sustainability of the recovery. The ongoing debate is likely to drive continued market volatility.

Tax-Exempt Market and Strategy

Yield Curve Steepens and Spreads Widen

In October, the municipal market gave back some of its strong gains and yields rose across the curve. Intermediate maturities were particularly hard hit, with yields increasing the most in the ten-year part of the yield curve. Short maturities were supported by the movement out of low-yielding money-market funds. Additionally, longer maturities received some support from the reduced new-issue tax-exempt supply. During October, most longer maturity issuance came in the form of taxable Build America Bonds, keeping tax-exempt issuance low. As a result, yields did not rise as much in longer maturities as they did in the intermediate sector.

Another important factor pressuring municipals relates to a seasonal effect. After nine months of strong outperformance, some investors are taking profits. At the same time, as typically happens towards year-end, many dealers are attempting to maintain low inventories. These factors tend to put upward pressure on yields as the market in general becomes less liquid.

We view the increase in yields as an opportunity to buy bonds that are more attractive both on an absolute basis and as a percentage of Treasuries. We have not changed our strategy and continue to target a barbelled portfolio.

Taxable Market and Strategy

Yield Curve Steepens and Spreads Tighten

The search for higher yielding assets continued in the taxable market in October with corporates, agencies and mortgages outperforming Treasuries. Like their tax-exempt

counterparts, taxable municipals experienced some underperformance in the month of October.

Agencies and mortgages continue to be supported by the ongoing government-buying program, which is scheduled to end in March 2010. Corporate-bond yield spreads have narrowed in response to positive earnings reports and the search for yield.

We believe this year's dramatic yield-spread narrowing in the corporate-bond sector has gotten ahead of itself, particularly in light of increasing event risk. Over the past year, corporate balance sheets have undergone extensive repair. Companies have reduced debt and have cash to invest. Several mergers and acquisitions have recently occurred and we expect more in the months ahead. We continue to favor taxable municipal bonds given the yield-spread advantage and lack of event risk.

Municipal Bond Credit Update

All is Not Bleak

As has been extensively reported by the media, economic conditions continue to generate revenue and budget challenges for some municipalities. However, there are many strong municipalities that are effectively managing through the cycle by maintaining conservative strategies.

The number of cities and towns earning Standard and Poor's top AAA rating has increased to 169, more than doubling since early 2008. While the list contains wealthy communities that may readily come to mind (Greenwich, CT and Malibu, CA, for example), the group is not limited by size, geographic location or affluence. The ranks include Troy, MI (population: 81,118); Phoenix, AZ (1,513,850); Coral Springs, FL (127,312); and Sherborn, MA (4,217). The communities tend to be affluent (the median household effective buying income is 163 percent of the national average) but wealth is not a requisite: Charlottesville, VA (79 percent) and Oklahoma City (84 percent) are included.

All of the AAA credits, however, share sound financial measures. The group's median unreserved general-fund balance represents an ample 30.4 percent of expenditures, while the median debt burden amounts to only 1.9 percent of full real-estate values. Approximately two-thirds of debt issued by the municipalities matures within 10 years.

Municipalities with good reserve levels and modest debt loads are well positioned to weather difficult times. These are the credit characteristics we seek in mid-to-high investment-grade general-obligation bonds for Breckinridge portfolios.