



## MARKET COMMENTARY

March 2010

### FIRST QUARTER 2010 MARKET REVIEW

#### Bonds Post Positive Returns for the Quarter

The search for yield dominated fixed-income investing in the first quarter of 2010. With the Federal Reserve firmly on hold and money-market funds yielding close to zero, investors shifted funds to longer maturities. Riskier assets were a prime beneficiary in the search for higher yields. Fund flows into fixed income were strong, only starting to decline towards quarter-end.

While the demand for yield helped produce positive fixed-income returns for the quarter, the winning streak was broken in March for both taxable and tax-exempt bonds. After two months of range trading in which the bond market wavered between high deficit/inflation fears and low employment/deflation fears, yields began to rise in mid-March.

The catalyst appeared to be a combination of poorly received new-issue Treasury supply, the passage of the Health Care Reform bill with related fears of rising deficits and a worldwide focus on deteriorating sovereign credit quality. Particular attention was given to Greece's and Portugal's troubles; however, investors concluded that other countries such as the U.K. and the U.S. also have serious deficit concerns. At the same time, economic data showed signs of a stabilizing economy and the Federal Reserve began to discuss their exit strategy. A decline in fund flows into fixed income in late March reflected this shift to more negative sentiment.

### TAX-EXEMPT MARKET REVIEW

#### Spreads Narrow, BABs Support Long Maturities

Tax-exempt yields moved higher in the quarter. However, the shift in the tax-exempt yield curve differed from the shift in the Treasury yield curve. Yields rose in short and intermediate maturities, while yields on long maturities remained well contained. Short-maturity yields reached such extraordinarily low levels that investors resisted purchasing short-maturity bonds. In addition, short-maturity supply increased as investor selling expanded. Investors opted to sell expensive short maturities and extend out the yield curve for more yield. Yields on long maturities remained stable reflecting the lack of long-maturity, new-issue, tax-exempt supply as issuers switched from tax-exempt bonds to Build America Bonds.

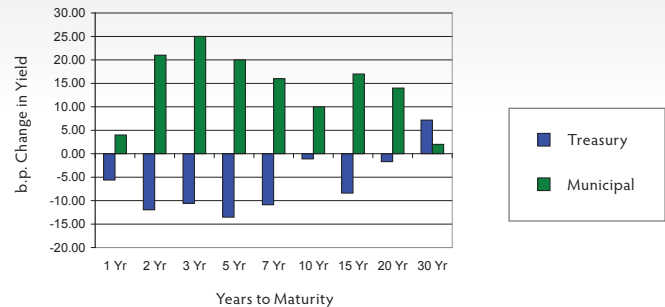
### TAXABLE MARKET REVIEW

#### Spreads Narrow, Yield Curve Steepens

During the quarter the Treasury yield curve steepened. Yields on maturities from one to 25 years declined while the yield on the 30-year maturity rose.

### Q1 2010 YIELD CHANGES FOR MUNICIPAL & TREASURY YIELDS

Source: Federal Reserve Board, Thomson Reuters Municipal Market Data



Investor sentiment was negative on long Treasuries due to increasing concern about rising U.S. budget deficits. As mentioned, the search for additional yield helped support intermediate Treasuries and all spread sectors.

Importantly, in March the Obama Administration submitted the 2011 budget proposal, which seeks to make the Build America Bond program permanent. Additionally, the House Ways and Means Committee submitted a bill that proposes to extend the program for three years with a reduced subsidy. Both proposals helped underpin a widely held view that the program is here to stay in some form. Amidst increased investor acceptance of Build America Bonds, taxable municipal yield spreads narrowed despite a dramatic increase in supply.

Corporate bond spreads continued to narrow to historically tight levels. At the same time, corporate bond "event risk" re-entered the sector with increased leveraged buy-out and merger and acquisition activity. This reinforces our sense of caution towards the sector at the current historically narrow yield spread levels.

### BRECKINRIDGE PORTFOLIO STRATEGY

#### Maintaining a Barbelled Structure

We are maintaining the barbelled structure in the portfolios with an overweight position in both short maturities and long maturities. In the tax-exempt portfolios, on a tactical basis we are taking advantage of the back up in yields to invest in select intermediate maturities where we see compelling relative value.

We continue to closely monitor the municipal credit situation and are focused more on core municipal sectors such as General Obligation and Water and Sewer bonds in order to limit risk. In the taxable portfolios, we continue to overweight taxable municipals due to the yield advantage over corporate spreads.

# RECENT DEVELOPMENTS IN THE MUNICIPAL MARKET

## MOODY'S GLOBAL RATING SCALE CHANGES

### No Change to Breckinridge Methodology

Moody's has announced that it will recalibrate its municipal ratings to its global rating scale, which has prompted questions and uncertainty over what the implications might entail. This conversion will result in positive rating changes to certain municipal sectors and credits. However, the rating changes do not reflect upgrades, only transfers to a different rating scale. Moreover, Moody's actions have not changed Breckinridge's approach to credit analysis.

A 2001 study conducted by Moody's revealed that municipal bonds defaulted at much lower rates than similarly rated corporate bonds. Subsequently, Moody's began offering limited global scale ratings to credits issuing taxable bonds. Later, Moody's proposed mapping municipal ratings to the global credit scale, but the effort was derailed in part by the credit crisis. Investors buying both tax-exempt and taxable bonds have been anxious for the rating agencies to produce a methodology that compares tax-exempt bonds with taxable bonds – primarily corporates – on an apples-to-apples basis. This change in methodology may accomplish that. The primary effects on ratings are as follows:

- » State ratings map to global ratings ranging from Aaa to A1, implying that the lowest-rated state, California, will move to A1 from Baa1;
- » Local General Obligation and Water and Sewer revenue bonds will likely receive a two-notch upgrade if rated in the A category, one notch if Aa-rated, and two to three notches in the Baa group;
- » Investment-grade public colleges and universities generally will gain one-notch upgrades;
- » Bonds backed by dedicated taxes (e.g., sales, excise, fuel taxes) on the whole will be given one-notch upgrades;
- » Revenue bonds secured by revenues from specific enterprises – including private universities, hospitals, municipal electric utilities, most transportation credits – are viewed by Moody's as already rated on the global scale and thus will see no rating action;
- » Issuers already rated Aa1 also will not have their ratings adjusted.

Although we agree with Moody's assessment regarding the safety of municipal bonds, we are not altering our research process to reflect the agency's rating recalibration. We continue to assign internal ratings based on our assessment of a number of fundamental financial, economic, security and management factors specific to individual sectors and credits.

## MUNICIPALITIES' TREATMENT OF SWAP CONTRACTS

### A Fluid Issue That Requires Monitoring

For many years municipal governments commonly entered into swap contracts with investment banks in order to hedge their floating-rate debt. In 2008 the hedges collapsed due to complicated relationships with LIBOR-based debt agreements. As a consequence, many municipalities are paying a higher cost of debt than otherwise available on the market. Swap agreements saved municipal issuers money in prior years, but are now costly.

A handful of municipal governments have renegotiated their swap contracts with investment banks. In March, the City of Los Angeles renegotiated two of its swap agreements with major investment banks. The effort was buoyed by the Service Employees International Union, which has begun a national "Stop the Swaps" campaign. If the renegotiation practice continues, it could potentially impact the municipal bond market.

Swap renegotiations can devalue an issuer's bonds. Swap renegotiations sometimes trigger technical defaults and bond-rating downgrades. However, full-fledged bond defaults precipitated by swap renegotiations are highly unlikely, as U.S. law insulates bond-investor interests from the interests of swap counterparties. Los Angeles' bond rating was unaffected by its recent renegotiations.

At present, the swap renegotiation issue is in its infancy. It may or may not develop into a larger worry in the coming months. Breckinridge is monitoring the situation. The overwhelming majority of Breckinridge's local government holdings contain little or no swap risk and states' swap exposure is very manageable.

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