



MARKET COMMENTARY

January 2011

MARKET REVIEW

Stimulus Generates Slow Economic Improvement

Last year's extraordinary fiscal and monetary stimulus is generating a slow improvement in economic activity. Data released in January revealed a solid increase in manufacturing spurred by increased consumer spending; yet continued low inflation and a weak labor market. These latter factors are likely to ensure the Fed will keep short rates at historically low levels for quite some time.

A tally of the stimulus spending led the Congressional Budget Office to revise upward the projected U.S. fiscal budget deficit to almost \$1.5 trillion for FY2012. In reaction, the Treasury yield curve steepened with long maturities rising and short maturities falling. While short rates remain anchored by the Fed, long rates are subject to investors' deficit-related fears.

MUNICIPAL BOND MARKET

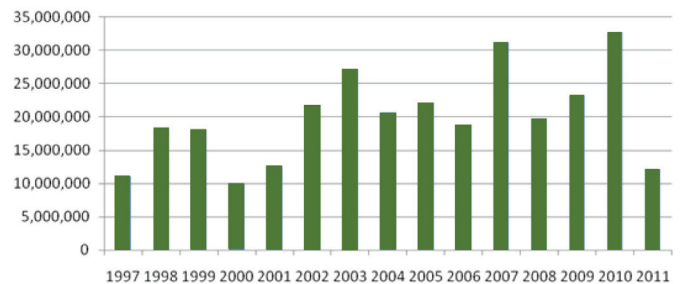
Outflows, End of BABs Drive Yields Higher

Two major factors impacted the tax exempt market during the month: substantial fund outflows as a result of ongoing negative municipal credit headlines and the aftermath of the termination of the Build America Bond program. Selling pressure brought municipal yield ratios to very attractive levels. The yield on 10-year high quality bonds approached 4 percent, a historically appealing yield level for retail investors.

New issue supply in January was a very low \$12.2 billion, the lowest monthly volume in 10 years. This was due to the heavy issuance that was brought forward last fall in anticipation of the end of the BAB program. Issuers also postponed new borrowing in January due to higher yield levels and that exacerbated the decrease in supply. Limited supply failed to support the market as fund outflows caused intense selling pressure. By month-end, outflows diminished and the market stabilized, as attractive yields caught the attention of investors.

JANUARY MUNICIPAL ISSUANCE

Source: Thompson Reuters



Municipal Credit Quality Update

Fiscal stress at the state and local level has garnered the attention of members of Congress, resulting in the scheduling of hearings regarding the feasibility of municipal bankruptcy for states. The primary intent is to improve states' negotiating position with public sector unions, not to encourage restructuring of long-term debt.

Meanwhile, state tax revenues are showing steady improvement and many states are reporting positive surprises in revenue collections. Newly elected administrations are demonstrating a strong resolve for fiscal improvement and recommending sharp cutbacks in spending to achieve balanced budgets. We believe increases in tax revenues will be directed to balancing budgets rather than new spending.

Pension reform is a major concern and an objective of most governors; and as we predicted, it is rapidly becoming a very contentious topic within certain states. Recent proposals for pension reform from the mayor of Atlanta and the newly elected governor of Florida are good examples of a resolve for fiscal improvement and are somewhat surprising in their severity. Most reform proposals suggest changing from defined benefit plans to defined contribution plans for future employees. The Atlanta reform proposal includes the elimination of the defined benefit plan for grandfathered employees. In addition, Florida Gov. Scott is recommending eliminating the cost-of-living adjustment on retirement benefits as well as some more typical reforms such as requiring employee contributions to a 401(K)-type plan. We expect to see more media headlines regarding pension reform as public sector unions voice their opposition to these proposals.

TAXABLE BOND MARKET

Taxable Munis Outperform With No Supply

The termination of the BABs program resulted in a dearth of taxable municipal issuance. Taxable municipal bond issuance totaled \$152 billion in 2010, while January 2011 issuance was a greatly diminished \$947 million. Yield spreads on taxable municipal bonds have narrowed in response to a lack of supply and overextended valuations. Taxable municipals outperformed corporate bonds during the month.

In January, corporations rushed to lock-in low borrowing rates. Issuance of investment-grade corporate bonds was \$114 billion, the 4th highest monthly volume on record. The issuance was heavily weighted in financials reflecting an improved market environment for the financial sector. Despite the high issuance, corporate-bond yield spreads also narrowed due to the rise in Treasury yields.

BRECKINRIDGE STRATEGY

Defensive yet Opportunistic

We continue to target a neutral duration relative to the benchmark given the current stress in the municipal bond market. The yield curve remains steep. We are targeting for purchase longer intermediate maturities due to the steepness of the yield curve in that range and attractive roll-down potential.

We remain defensive on credit and continue to diligently monitor our holdings. At the same time, we are poised to take advantage of opportunities to invest in what we believe are undervalued securities in this sometimes disorderly market.

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