



MARKET COMMENTARY  
June 2011

MARKET REVIEW

**Bonds Rally Amid Flight to Quality**

Weaker economic data and resurgent European sovereign debt concerns pushed bond yields down during the second quarter. A flight to quality brought the 10-year Treasury note yield to a low of 2.86 percent near the end of June, down from a high of 3.58 percent in early April.

The probability of a Greek default rose during the quarter, raising concerns about ripple effects on the global banking sector. With the crisis unresolved, we expect continued volatility as investors flee "risky" markets for the safety of Treasuries.

Adding to uncertainty in the Treasury market is the ongoing Congressional haggling over a debt-ceiling compromise. The deadline for extending the U.S. debt ceiling is fast approaching and until resolved, this issue will also drive continued volatility.

TAX-EXEMPT MARKET

**Sentiment Improves, Supply Remains Low**

The rally in Treasuries drove a strong quarter for tax-exempt bonds. The tax-exempt market was also supported by improved sentiment with regard to municipal credit as well as increased demand and low supply.

Sentiment within the municipal market improved during the quarter. State tax receipts increased, which bolstered budgets during the critical budget-balancing season. Most states balanced their budgets on time. Even annual laggard California came to a timely resolution without having to issue IOUs. Budgets were balanced by various means – shrinking the workforce, raising taxes or fees, reforming pension and health care benefits, and by some accounting gimmickry. Importantly, no rash of defaults has emerged as some market watchers had predicted. In fact, there have been numerous examples where significant political resolve and public support has resulted in meaningful restructuring of state and local pension plans. Recent court

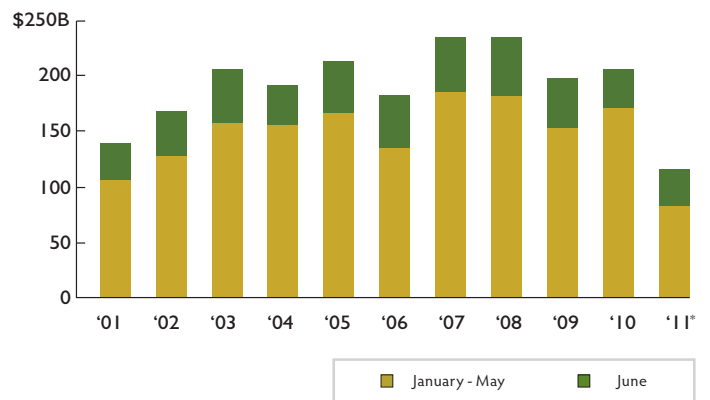
rulings in Colorado and Minnesota have validated these changes and may embolden politicians to undertake further reforms.

Demand for tax-exempts improved in second quarter. Mutual funds stabilized and recorded slight inflows. In addition, reinvestment demand increased from June and July maturities.

Lack of new-issue supply continued to support the tax-exempt market as it has throughout the year. Much of this year's issuance was brought forward into last fall in anticipation of the termination of the Build America Bond program. As shown in the following chart, issuance in 2011 has been running at half the typical rate.

JANUARY - JUNE BOND SALES

Source: The Bond Buyer



There was a noticeable increase in issuance in June, which coincided with improved sentiment in the market. We expect to see issuance increase somewhat in the second half of the year after the budget process is completed. However, there is little political appetite to take on additional debt. As a result, the magnitude of the increase is uncertain. Some analysts expect issuance to remain low for several years.

TAXABLE MARKET

**Taxable Municipals Continue to Outperform**

Taxable municipal bond spreads tightened significantly during the quarter. The outperformance reflected the continued lack of new-issue supply and

attractively valued yield spreads relative to corporate bonds. Corporate bond spreads widened in the flight to quality; however, corporates still managed to outperform Treasuries due to their yield advantage and the low absolute level of yields.

Taxable bond funds also recorded inflows during the quarter as riskier assets were shunned, which provided support for both taxable munis and corporates. In general, the quest for yield continues in this low rate environment.

### **BRECKINRIDGE STRATEGY**

#### **Closely Monitoring Credit Quality**

Breckinridge continues to maintain a conservatively structured portfolio positioning. A relatively neutral duration and barbell structure helps protect the portfolio amid volatility and the potential for either higher or lower rates. As states and municipalities struggle to resolve budget deficits, our paramount focus is on credit quality. Accordingly, Breckinridge remains committed to investing in high quality general obligation and essential service bonds.

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