



MARKET COMMENTARY July 2011

MARKET REVIEW

Debt Fears and Downgrades Abound

The spreading European sovereign debt crisis and the U.S. debt ceiling/deficit problem drove historic credit-rating downgrades in July and early August. Portugal and Ireland dropped to below investment grade and Greece to a very low Ca/CC level. For the first time in history, the U.S. lost its top credit rating. While Moody's and Fitch affirmed the AAA rating following the agreement to raise the U.S. debt ceiling, on Aug. 5th S&P downgraded U.S. debt to AA+ from AAA.

The U.S. downgrade could have implications for municipal ratings. Issuers directly linked to the federal government will move in lockstep with the U.S. rating. Other issuers that have indirect exposure to the U.S. government through federal transfer payments such as Medicaid, or significant federal employment could also face downgrades. Examples include local governments, universities and hospitals.

On the economic front, it became increasingly evident the recovery has stalled, as data continued to disappoint in July. Investors responded with a sharp flight to quality, buying Treasuries despite the then threat of a U.S. rating downgrade. Concerns over downgrade-driven, higher interest rates were overwhelmed by the disappointing economic data. Yields declined across the curve, with intermediate maturities declining more in a curve-flattening move.

TAX-EXEMPT MARKET

Strong Muni Demand Drives Positive Returns

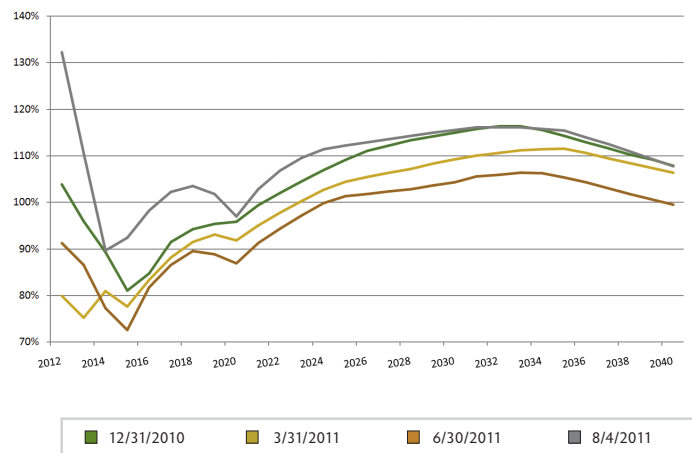
In July, the threat of credit-rating downgrades did not appear to negatively impact the tax-exempt market. Tax-exempt bonds benefitted from the flight to quality and were supported by strong investor demand during the month. Mutual fund inflows were high in intermediate maturities, although high-yield and long-maturity funds experienced outflows. Muni market

sentiment continued to improve in July as all states completed their budget processes, in many cases aided by increased tax receipts.

While muni yields declined, they did not keep pace with Treasuries, which brought muni/Treasury yield ratios to historically attractive levels, as seen in the following chart.

MUNICIPAL AAA - TREASURY YIELD RATIOS BY QUARTER 2011

Source: Treasury Yields from Bloomberg, Municipal Yields from Thomson Reuters - Municipal Market



TAXABLE MARKET

Spread Sectors Do Well in Search for Yield

Both corporates and taxable municipals performed well in July despite the flight to quality. Investors continue to search for excess yield over Treasuries and are especially attracted to corporations with strong balance sheets and high cash positions. These types of bonds are viewed as high quality substitutes for Treasuries in this period of uncertainty.

Taxable municipals benefitted from the improved sentiment surrounding the municipal market, as well as from the significant reduction in new supply. We expect this trend to continue as investors seek high quality bonds with attractive yields relative to Treasuries.

MUNICIPAL CREDIT UPDATE

Bankruptcies in the Headlines

Three ignominious municipal borrowers reared their heads again in July. Harrisburg, Pa., Jefferson County, Ala., and Central Falls, R.I. all made headlines. Each issuer inched closer to a lasting solution to its debt woes.

In Harrisburg, Mayor Linda Thompson and local officials appear willing to accept a variation of the state's Act 47 recovery plan. The plan would keep Harrisburg out of bankruptcy court and keep nearly all, if not all, retail investors whole. The city would sell its incinerator, lease its parking garage and impose tax hikes and spending cuts as part of the plan.

In Jefferson County, officials delayed a planned bankruptcy filing to assess a new offer by creditors, which include J.P. Morgan, bond insurers and bond mutual funds. The county now appears more likely to reach an out-of-court settlement with its creditors than it did earlier in July. The receiver has reiterated his intention to keep retail investors whole in any settlement or bankruptcy proceeding.

Central Falls officials filed for Chapter 9 on Aug. 1st. The one-square mile city has \$80 million in unfunded pension and retiree health-care debts against an annual budget of only \$16 million. The pension fund has run out of cash, and the general fund faces a 33 percent deficit in FY 2012. Notably, bond investors are likely to be made whole. Only weeks ago, Rhode Island's governor signed into law a bill giving municipal bond investors a statutory

lien on the property tax revenues that back GO bonds. The law is likely to be challenged, but most legal experts expect it will hold up in court. A bondholder-friendly ruling could create a template for other states seeking ways to protect their municipal debt.

BRECKINRIDGE STRATEGY

Conservatively Structured Amidst the Uncertainty

Given the many economic and political uncertainties that have the potential to affect the fixed-income market, we continue to target a relatively neutral duration with a barbelled portfolio structure.

The economy is weak, interest rates are already low and the Fed has few options left for monetary stimulus. The political stalemate in Washington does not bode well for meaningful spending and tax reform until after the 2012 elections. We expect future political debates will lead to continued market volatility and possible disappointment.

For this reason, we believe the prudent course is to maintain our emphasis on high quality bonds within a barbelled structure in our client's portfolios. We believe our emphasis on higher quality issuers will lessen the overall impact of a ratings downgrade. With an overweight position in long maturities the portfolios will benefit from a decline in yields and lock in a higher income stream. At the same time, the overweight position in short maturities provides protection against rising rates and flexibility for future purchases.

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