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Commentary

Market Opinions and Topics of Interest

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Municipal Bonds Remain Under Pressure

We concluded a January 2007 Commentary on municipal bonds:

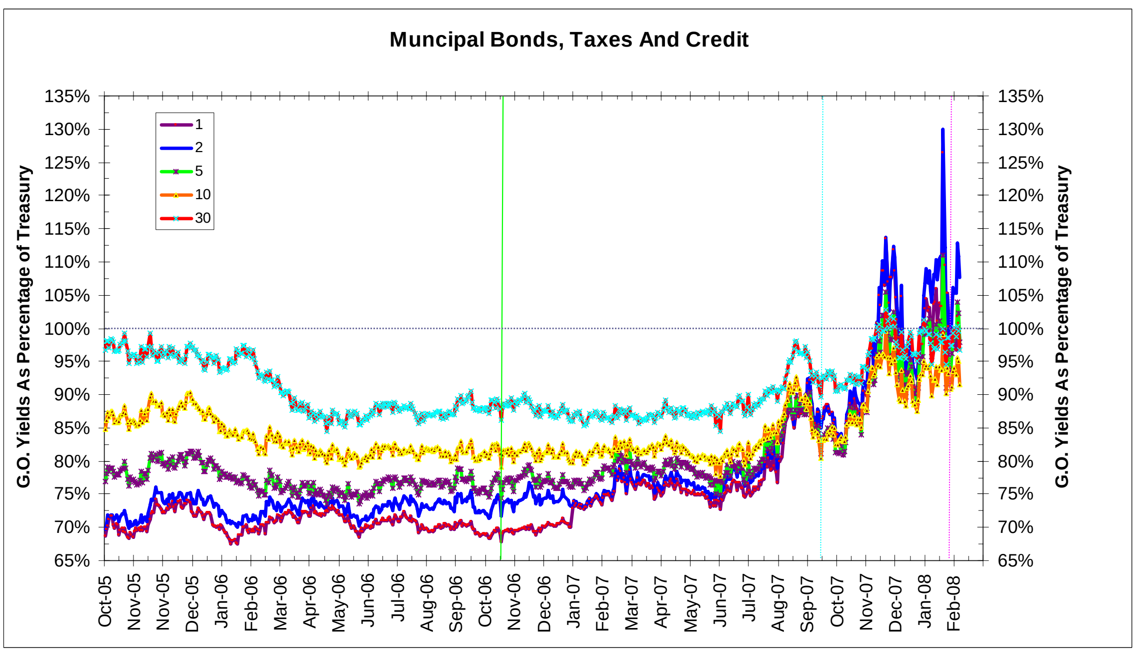
> *Municipalities benefited from the real estate boom; property taxes rose along with prices. If that boom is a thing of the past, property tax growth is at risk. In addition, municipalities will have to absorb the frictional costs of the changing local investment pictures. These adjustments put municipal finances at risk and likely account for the high tax-equivalent yields seen above.*
>
> *Along with higher federal taxes, this is the current message of the municipal bond market.*

This was a cautionary outlook for municipal bonds written seven weeks before the first global equity rout of 2007 and the various manifestations of the ongoing credit crunch, and without mention of monoline bond insurers. Those developments, once realized, made things manifestly worse.

Let's update that previous Commentary with the virtual certainty municipal finances will not improve over the next year and with the high likelihood federal marginal tax rates will increase sometime in 2009.

National indices of AAA-rated general obligation bonds have been yielding more than 85% of same-maturity Treasuries, with the two-year index yielding more than 100% of the two-year Treasury.

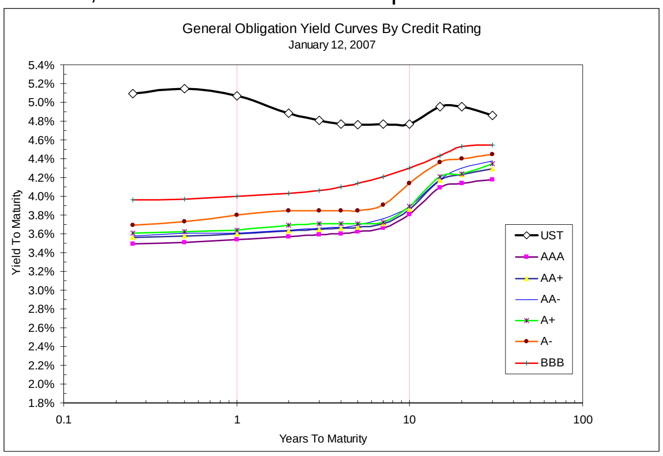
This rise began with the November 2006 election (green vertical line), which suggests the market began pricing in future tax increases at that time. The onset of the credit crunch and the magnitude of the housing problem accelerated relative municipal yields in the summer of 2007. This move reversed at the first 50 basis point cut in the target federal funds rate in September (turquoise vertical line) and at the January 30th FOMC meeting (magenta vertical line). **Hope springs eternal in the municipal market just as it does in the stock market.**

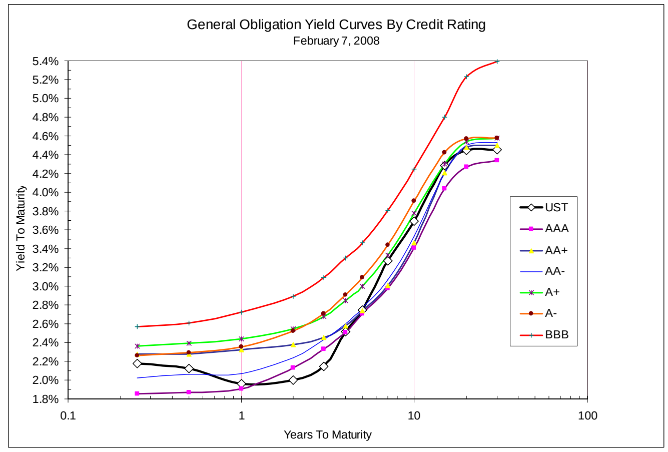


Municipal Yield Curves

These relative yield increases relative to Treasuries have been occurring mostly as a function of lower Treasury yields. If we compare the yield curves across rating classes from last January to today (left- and right-hand charts, respectively, commonly scaled) we can see the bullish steepening in Treasuries and only a modestly bearish steepening of municipals except at the BBB rating. As a parenthetic note; the chart last year used the BBB+ curve; that is not available at present. Investment-grade bond yields have climbed in the neighborhood of 20 basis points since January 2007.

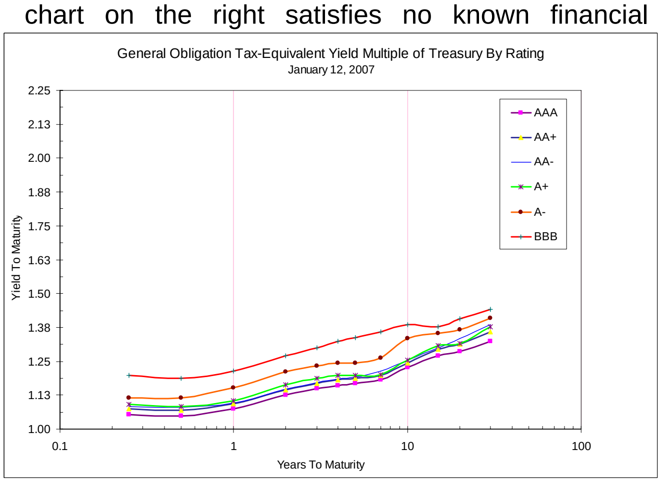
The plunge in short-term yields and the steepening of the investment-grade yield curves will place longer-term refinancing risk on those municipalities wishing to fund capital projects with long-term bonds. The issuance of short-term notes places, much like the issuance of a short-term adjustable mortgage, has a way of catching up to the borrower sooner or later.

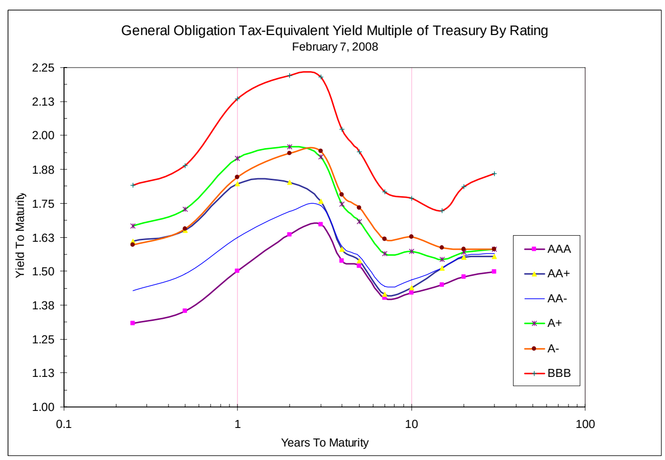




Taxable-Equivalent Yields

If we combine the information above into a map of taxable-equivalent yields at the 35% marginal federal tax rate in January 2007 and today (left- and right-hand charts, respectively, commonly scaled), we see a shift from an expected monotonic relationship to one with multiple inflections. The chart on the right satisfies no known financial theories and must be considered prima facie evidence of a broken market. It suggests either Treasury yields will have rise and the yield curve flatten, an unlikely combination in the immediate future, or that municipal yields will have to fall, an equally unlikely outcome in the near future.





Conclusion

An odd truth about investing is the greatest rewards often go to the person who takes the greatest risks; the population of former traders is drawn from the same pool, however.

The collapse of the monoline insurers, the prospect of rising federal tax rates, the likelihood of an economic downturn and the growing popular resistance to higher property taxes have combined to make longer-term municipals ugly at the moment.

While this creates opportunity, we suspect the opportunity will remain open and perhaps become significantly more attractive by mid-year.

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