

Tax Efficient Fixed Income

1st Quarter 2006 Review and Outlook

The first quarter of 2006 ended with an exclamation point as rates rose sharply on longer maturity bonds and the yield curve inversion that began in January abruptly ended.

The Lehman Municipal benchmark data for the quarter shows masks the significant turbulence that occurred in March.

Lehman Municipal Benchmark	1st Qtr 2006	Mar-06
3-Yr	0.12%	-0.18%
5-Yr	0.02%	-0.39%
10-Yr	-0.12%	-1.03%

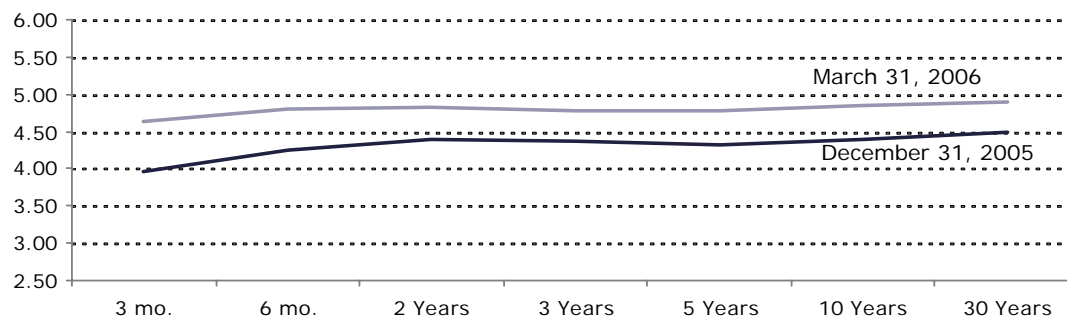
While Municipal benchmark returns were disappointing, Treasury bonds performed considerably worse:

Lehman Treasury Benchmark	1st Qtr 2006	Mar-06
3-Yr	-0.09%	-0.03%
5-Yr	-1.19%	-0.63%
10-Yr	-2.83%	-2.01%

Since the Fed began to tighten in 2004, the yield curve flattened as short rates increased far more than longer-dated rates – a very typical response. The public press and market journals made much of Greenspan’s “conundrum”, whereby longer rates fell as short rates were being pushed upward. Indeed, the yield curve inverted, however slightly and briefly, in the quarter that just passed. But that no longer is the case as the curve then flattened and now slopes modestly upward.

As we entered the quarter, we maintained the bulleted yield curve strategy we had adopted in late 2005. Although the yield curve has returned to a positive slope, we intend to maintain our bullet strategy as we believe inflation expectations and the slope of the curve will continue to rise. Interestingly, the Fed’s March policy statement, highlighting their concern about commodities, heightened the markets inflation concerns despite the accompanying raise in the Fed Funds target (Please see our commentary When Markets Disagree for a further discussion of the relationship between commodities and CPI).

U.S. Treasury Yield Curves



The municipal market performed better than the taxable market, as is usually the case when rates rise. New issuance dropped off as the cost of borrowing increased, refundings declined, and the growing economy produced stronger tax revenue thus reducing the need to borrow. Unfunded pension and other post-employment benefits for state and municipal employees are a greater concern, as new government accounting standards are being implemented this year.

The indicators of domestic and global economic growth are many. Liquidity remains buoyant across the globe as evidenced by continued (albeit slowing) growth in property prices and new construction, corporate borrowing at slim margins above Treasury rates, and a marked increase in domestic and international mergers and acquisitions activity. Domestic job creation seems to have meaningfully accelerated, with average monthly job growth now exceeding 200,000 per month. This is in contrast to the 100,000 to 150,000 range that had prevailed over the past few years. However, it remains below the 300,000 levels set in the late 1990s.

The upward slope in the yield curve seems to confirm that the bond market is now more certain that the global economy is strong enough to drive interest rates higher and to support them there longer than originally expected. There is also the prospect that foreign central banks – notably the Japanese- are likely to join ours in pushing global rates higher. With the disappearance of ultra-low short rates, the rapidly diminishing allure of the “carry trade” is also disappearing, and with it a major prop under intermediate and longer dated bond prices.

Our argument for higher rates is not one-sided. Energy costs are rising, housing sales are moderating and the consumer is showing some signs of fatigue. Broader inflation measures have remained under control, and bond yields have increased to the point where they finally offer some value on an historic basis and when adjusted for inflation. Nevertheless, increasing demand for capital driven by a growing global economy should support a higher level of real interest rates, and the possibility of rising inflation leads to upward pressure on nominal rates.

We remain constructively defensive in terms of keeping the duration short and maintaining high credit quality. Within these constraints, we have been able to identify some good opportunities with pre-refunded bonds and bonds with short-dated put features, where spreads are reasonably attractive. Municipal issuers have experienced improving fundamentals and many credits, especially in New York, have been upgraded. Likewise, California credits continue to perform strongly and remain on the upswing.

This year, security and sector selection, along with the changing shape of the yield curve, will be the main driving factors behind portfolio performance. In addition to maintaining our bullet yield curve strategy for the foreseeable future, we intend to increase the quality of our portfolios – purchasing prerefunded bonds when possible and utilizing high quality agency bonds when they make sense on an after-tax basis. Though the Fed may be near to the end of its tightening cycle, other major central banks – particular the ECB and the Bank of Japan are just at the start of their own tightening cycles. Despite improving municipal credit fundamentals, an environment of global central bank tightening is unkind to lower quality bonds and given our emphasis on capital preservation we will be particularly careful in the months ahead.

April 21, 2006

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