Perspectives

SAMSON CAPITAL ADVISORS

KATRINA: Long and Short Term Impact on the Bond Markets

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Hurricane Katrina's full impact on the communities it devastated, the economy, and the bond market is yet to be fully known. But indications strongly suggest that there will be some upward pressure on interest rates, an increase in the federal budget deficit, and a major, but manageable, challenge to municipal bond insurers.

Interest Rates and the Economy

The next Fed meeting is on September 20th. We believe the Federal Reserve may pause to assess the impact of Katrina on the economic data before continuing its campaign to raise interest rates. The bond market has already discounted this prospect as short U.S. Treasury rates have fallen over the past several days.

If the Fed does pause, we believe that both the Treasury and Municipal yield curves will steepen, with longer maturity rates rising, and shorter maturity rates remaining near current levels. This would be a departure from the flatter yield curve environment of the past two years and might indicate expectations for increased inflation. Such concerns will be sustained by a sharp increase in government spending to deal with the aftermath of the storm, consumer concerns about the high cost of energy, and evidence of an increasingly assertive workforce struggling to maintain their incomes in the face of rising prices. The strike by Boeing machinists began September 1st and has received very little press.

A more restrained Fed will also have an impact on the currency markets. Interest rate differentials between the US and overseas markets are swiftly contracting at the short end of the yield curve due to the recent fall in short U.S. rates. This is a negative for the dollar as U.S. rates become less attractive to foreign investors. Capital flows away from the dollar could be exacerbated by a rising trade deficit, as Katrina-related damage slows agricultural exports at a time when we also need to import more oil. This combination of falling farm exports and rising energy imports could contribute to a wider trade deficit, another negative for the dollar.

We are still at the beginning of what will be a long-term test of our Federal, State, and Local government capacities to deal with this crisis. Federal government spending plans for the region's clean-up and reconstruction are rising sharply, and the additional spending will hinder efforts to reduce the budget deficit and thus create more pressure on longer interest rates.

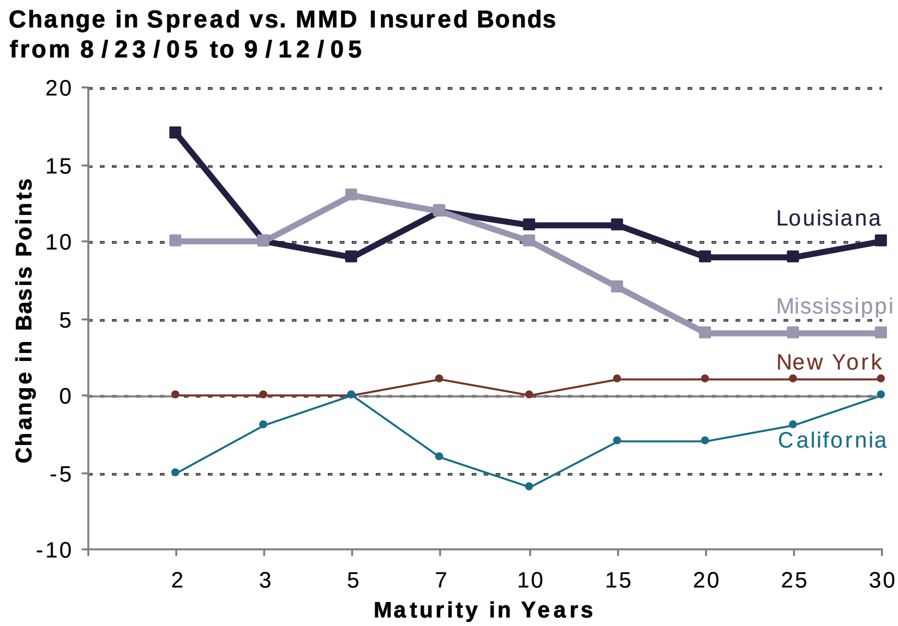
With regard to our bond strategy, we will focus our portfolios in the 3-7 year part of the curve – avoiding the 7-12 year sector and beyond that we think is vulnerable to further curve steepening.

Credit Perspectives

Our account exposure to the affected area is minimal for several reasons: our client base is concentrated in other parts of the United States, and the credits of some of the larger entities such as Louisiana had been below average and not viewed as improving until very recently.

A major issue going forward is Katrina's impact on bond insurance, both for outstanding bond issues and for new issues. The most recent data as of September 12th, show insured bond exposure to FEMA-designated counties in Louisiana, Mississippi and Alabama at approximately $15 billion, which is less than 1% of the total municipal bond market. Moody's recently conducted several stress tests on the bond insurers' capital. The worst-case scenario saw all bond insurers with enough hard capital (defined as qualified statutory capital, unearned premium reserves and installment premiums) to cover losses at a 99.9% confidence level. However, the worst-case scenario might reduce capital below the Aaa threshold, in which case insurers would be expected to take the necessary steps to maintain the Aaa level.

We recently analyzed the change in spreads of insured bonds both pre- and post-hurricane. Specifically, we looked at insured curves on August 23 (pre-hurricane) and then again on September 12 (post-hurricane) for Louisiana and Mississippi. *We then looked at California and New York, the two states where the Moody's GO ratings are the same or lower than that of Louisiana, and presumably where bond insurance adds extra security.*



Yield spreads on Louisiana and Mississippi insured bonds weakened more than other states after the hurricane.

We can infer from this graph that:

- At present, the market does not anticipate insurers to suffer meaningful damage. This is reflected by the stability of *insured* New York and California spreads. (The improvement in California's spreads is due to a temporary lack of supply of California bonds).
- The modest spread weakness for *insured* Louisiana and Mississippi paper during this period indicates that the market looks through insurance to the underlying credits.

Conclusion

There is no doubt that Katrina is a historical inflection point in the development of the Gulf Region. If the Federal government's response to this tragedy is implemented with vision and effectiveness, it has the capacity to transform the region.

As more information and data become available we will keep you informed of our findings and how it relates to any changes in our portfolio strategy.

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