

MUNICIPAL MARKET UPDATE THE COST OF WAITING

In recent months, we have often heard the refrain from investors, “I’m just going to wait until interest rates rise.” and, in fact, many investors are waiting for Federal Reserve policy makers to raise interest rates before committing money to the bond market. This attitude is understandable given the Federal Funds rate has been held in the 0% to 0.25% range for many months. Rates MUST go up, right? The answer, of course, is yes (but when and what interest rate are we talking about?). A portion of the hike in interest rates that investors are waiting for may have already happened. In just the past 15 months, the yield on the Benchmark, 10 year Treasury note has climbed from 2.65% to 3.55%, where it stands as of this writing. That's a 90 basis point increase in yield at the same time the Fed Funds rate has remained unchanged.

Shown below is an analysis of four past Fed credit tightening cycles along with the resultant yield on the 3 year and 10 year Treasury notes during the same period. You will notice that the Fed Funds rate actually ended up higher than the yield on the 10 year T-Note in three of the four cycles!

July 1st, 2004 through September 2007:

Fed Funds increased from 1.00% to 5.25%, plus 425 basis points
10 year Treasury note yield increased from 4.27% to 4.63%, plus 36 basis points
3 year Treasury note yield increased from 3.03% to 4.02%, plus 99 basis points

February 30, 1999 through May 16th, 2000:

Fed Funds rate increased from 4.75% to 6.50%, plus 175 basis points:
10 year Treasury note yield increased from 5.79 to 6.44%, plus 65 basis points
3 year Treasury note yield increased from 5.24% to 6.84%, plus 160 basis points

February 4, 1993 through February 1, 1995:

Fed Funds rate increased from 3% to 6%, plus 300 basis points:
10 year Treasury note yield increased from 6.26 to 7.65%, plus 139 basis points
3 year Treasury note yield increased from 4.57% to 7.47%, plus 290 basis points

January 1988 through February 1989*:

Fed Funds rate increased from 6.50% to 9.75%, plus 325 basis points:
10 year Treasury note yield increased from 8.67% to 9.36%, plus 69 basis points
3 year Treasury note yield increased from 7.97% to 9.41%, plus 144 basis points

*Fed Funds rate figures for this period are approximated as Federal Reserve decisions were not officially announced at the time.

It's important to remember that historically, the Federal Reserve has not been an active trader of longer maturity bonds. Traders, investors and other market participants dictate the yields on long bonds based, in large part, on future inflation expectations. As the economy expands, these “participants” typically drive the yields of long bonds upward to compensate for the expected erosion of net return resulting from inflation.

Many expect the Federal Reserve to start raising rates later this year or in early 2011. We, too, have this expectation, but our view is tempered somewhat by the continued weakness in the housing market. The root cause of the 2008-2009 financial crisis was the collapse of the significantly over-inflated housing market. A modern day economy from which we can draw a parallel is Japan's in the late 1980's. Japan experienced a similar real estate meltdown and its economy is still dealing with deflationary pressures 25 years later. So we wonder, what is different for us today? Additionally, we believe the persistent, near double-digit, national unemployment rate and weak bank balance sheets will make it politically difficult for the Federal Reserve to raise short term interest rates too high or too quickly. Clearly, the Federal Reserve will have to walk a fine line as it attempts to spur the economy without stoking inflation.

We believe the reason many bond investors are maintaining high balances in low yielding money markets right now is because they've been scared into thinking the value of their investment will decline sharply if interest rates rise. They may well be right. They may be wrong. We do not know with certainty. However, we do know with certainty that approach has been dead wrong over the last 12 - 18 months and it may continue to be the wrong strategy for another 12 - 18 months.

In our view, it is the dreaded “total return” argument that is a questionable strategy for many bond investors. Annual total return measures the net coupon rate plus or minus the change in a bond's value over a 12-month period. For those who hold the bond to maturity, the fluctuating value of their bond is meaningless; their net coupon rate IS their annual return. Investors looking for INCOME from their portfolio should not leave investment funds in near zero paying money markets waiting, hoping for rates to rise. Get the funds invested out along the interest rate curve and get your funds earning a higher return. Let's be clear: this is not a blanket recommendation advocating 20 year bond investments today for everyone. We are advocating committing your funds beyond a money market time frame.

Here's an illustration to bring this all home: Assume one has \$100,000 available to invest in the municipal bond market. Let's say you can invest the funds either in a 7 year, non-taxable municipal bond with a 3.00 % coupon, priced at par, or park the money in a money market fund yielding 0.30 %. An investment in the money market for 12 months gives you \$300 while the bond returns \$3000 annually. The money market investor retains liquidity, but at a steep cost.

Over the next three years, the bond investor will earn a total of \$9000.00. Let's assume money market rates increase 100 basis points over a 3 year period (we assume in equal installments on January 1st of each year), which mirrors the yield increase experienced by the taxable 3 year Treasury note from July 1, 2004 through September 2007.

Under these circumstances, the money market investment will earn approximately \$1890.00 over the three-year period or \$7110.00 less income than what is produced by the seven-year bond investment.

Of course, because interest rates have risen over this three-year period, the bond investment will have a market value that is less than its original cost, while the money market will presumably have retained its \$100,000.00 value. If we assume nontaxable, municipal bond rates increase by the same magnitude (100 basis points) as the yield increase experienced by the taxable, 3 year Treasury note, the now 4 year, \$100,000.00 par value, municipal bond will have an approximate market value of \$96, 337.00. If the investor sells the bond after 3 years, he will realize an approximate principal loss of \$3663.00. Subtract this principal loss from the \$7110.00 gain in income cited above and the bond investment option nets \$3447.00 more than the money market investment strategy. That is approximately 3.44 % more total return over the 3 year period produced by the bond investment versus leaving the funds in a low paying money market. That difference, in our view, is significant.

If you're a buy and hold investor, the preceding analysis is moot. If you generally don't sell prior to maturity, you know the score of the game at the outset, which is the yield you'll earn and the amount you get back at maturity. What happens to the market price in the interim should ultimately be of little concern.

We are not advocating abandoning your current investment parameters by investing in long-term bonds and disregarding the potential of higher interest rates in the future. Rather, we suggest you adhere to your existing ladder strategy without focusing too greatly on trying to time the market. There's a hefty price to pay for thinking you can predict the unpredictable.

Thank you for your continued confidence. Please call us with any questions or comments.

Bernardi Securities, Inc.

May 2010

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Municipal bonds not FDIC insured * May lose principal * Not appropriate for all investors