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## Economic Indicators Improve Amidst Sluggish Recovery

The Federal Open Market Committee reaffirmed on November 4th its commitment to maintaining a near-zero target rate for the foreseeable future, citing a slowly improving economic landscape and growing confidence in financial markets. Although recovery remains sluggish, activity in several key sectors seems to be improving relative to the stresses of earlier this year. Housing market data indicate positive momentum among homebuyers, and consumer spending appears to be growing slightly as we enter the holiday season. However, many of the positive trends have been attributed to the assistance of stimulus initiatives (i.e. first-time homebuyers housing credit, "Cash for Clunkers" program) and therefore some of the improvement may be transitory. Clearly, our economy requires sustainable consumer and business activities to repair confidence and build for the future. For its part, the Federal Reserve is committed to an "extended period" of low interest rates to encourage job growth and remains unconcerned about near-term risks to inflation. A broader revolution of sorts, though, is likely required to restore those economic fundamentals necessary for a full recovery.

The Federal Reserve's strategy to unwind the debt positions accumulated on its balance sheet largely remains an unknown at this point. *Figure 1* shows the central bank's extraordinary credit market purchases which were successful in propping up the struggling credit markets. The Fed's method and timing of unwinding these accumulated debt positions must ultimately be strategic to avoid destabilization of capital and foreign exchange markets.

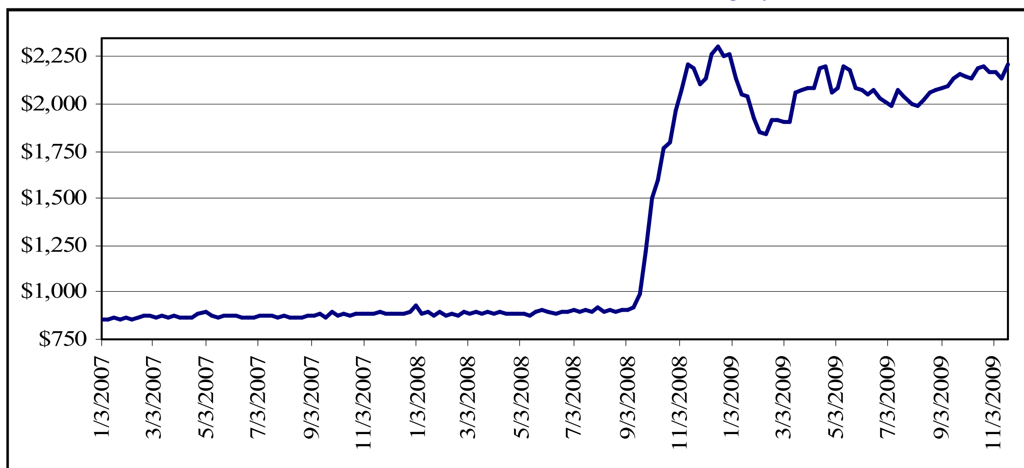


***Figure 1. Federal Reserve Balance Sheet (in $millions) from 2007-present*** *Source: Bloomberg*

During the last week of October, the Federal Reserve halted its active debt purchase program. We had anticipated a weakening of bond prices and resulting higher yields, especially given the earlier than expected improvement in our gross domestic product. Headwinds persist, though, and substantial financial resolve

### Highlights:

- Fed reiterates previous statements, maintains near-zero fed funds rate
- Higher muni yields in November provided buying opportunity, value
- Caprin using short maturities to add yield to muni portfolios
- Caprin managing to a neutral target duration of 5.0 years

*"In this environment, financial markets will continue to be volatile as monetary and fiscal policies evolve."*

is required to wean consumers, businesses, and our governments from their collective borrowing habits. In this environment, financial markets will continue to be volatile as monetary and fiscal policies evolve along with the consumer and business behaviors necessary for prolonged economic optimism.

## Caprin Strategy

After a strong price rally from the beginning of September to early October, the municipal market momentum reversed, and yields trended higher through the final three weeks of October, a move that provided a compelling opportunity to more actively purchase bonds. During the September rally, munis were strongest in the 5- to 10-year maturity range; however, this portion of the curve saw the most noteworthy sell-off in October. Caprin identified relative value in this range following the sell-off and concentrated purchases there for much of October and early November. Volatile swings in bond value and periods of opportunity such as these may characterize the muni market for several more months. We continue to believe this type of environment can be productive for seizing opportunities to create the desired credit and duration profiles for client portfolios.

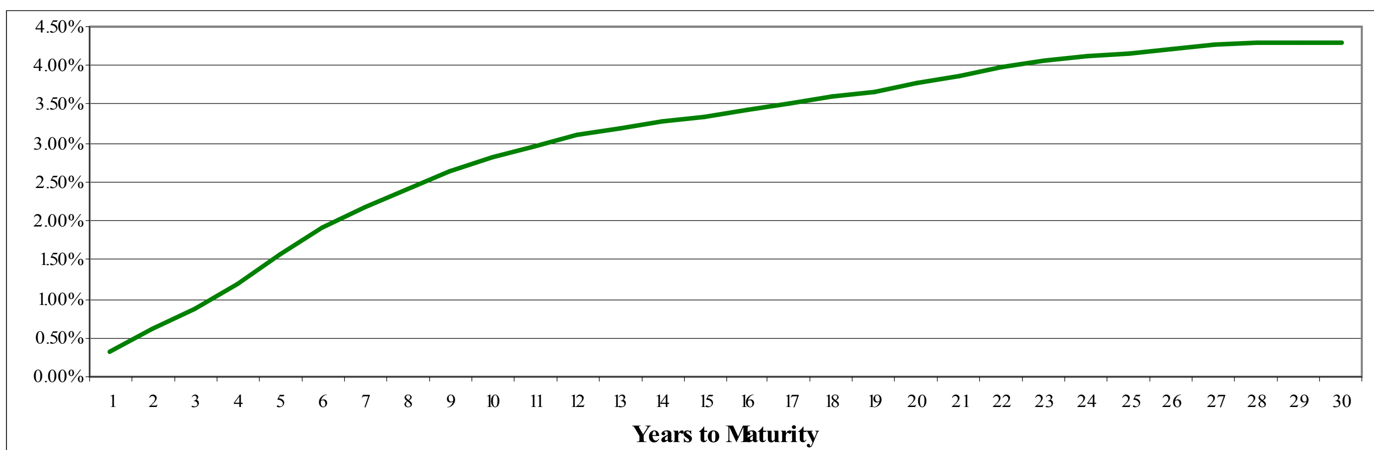


***Figure 2.*** *Muni Bond Yields from 1- to 30-Year Maturities as of 11/23/2009* *Source: MMD*

Recently, municipals have been offering investors more attractive yields in the 10- to 20-year maturity range compared to just a month ago. Caprin's activities at these longer maturities impose a standard for higher-quality and more liquidity. We believe maintaining this quality emphasis helps reduce risks should municipal finances come under further stress in coming periods. Opportunities to enhance yield have been generated in shorter maturities with slightly lower credit ratings (i.e. utility bonds, healthcare bonds) without taking on the risk of similar bonds with long maturities.

Looking out over the investment horizon, certain regions may be better positioned to weather an extended period of financial rehabilitation while others may struggle. Recent media reports on revenue shortfalls and the need to curb operating expenses imply that cash flow equalization for some issuers may still be many months away. This environment suggests the need to seek diversification where higher financial or credit risks might surface or persist. As a result, certain situations may arise for buying out-of-state municipals.

Structurally, Caprin decided a target duration of 5 years is most appropriate given our recent assessment of the investment and economic landscapes. We have low expectations for inflationary pressures over the next couple of years, and there is little pressure in the credit markets. We will to continue to reassess the economic environment for changes in sentiment and fundamentals, seeking to adjust our strategy as conditions warrant.

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