Capital Preservation & Income

Caprin Asset Management, L.L.C.

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The Fed's Balancing Act

The Federal Open Market Committee continued slashing the Fed Funds rate, lowering the target level another 50 basis points to 3.00% on January 30th. Additionally, the Fed has signaled its willingness to act in a timely manner should economic conditions continue to deteriorate. Fed Chairman Bernanke's recent comments have additionally emphasized the Fed's focus on re-energizing our economy. Given the state of our slowing economy and the increasing possibility of recession, which is being fueled by weakening housing and job markets as well as consumer and business credit woes, the Fed certainly has some difficult challenges ahead in the next 12-18 months.

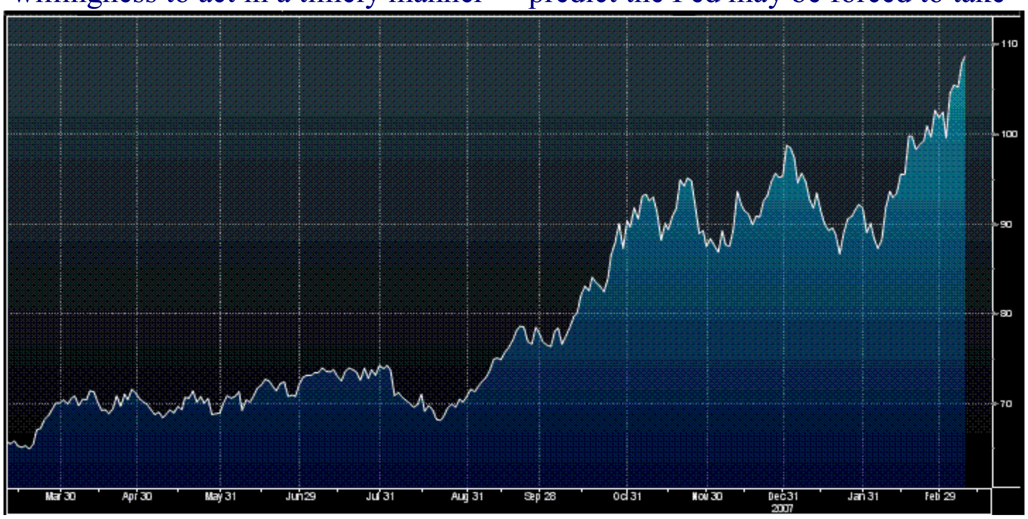

Figure 1. Oil prices over the past 12 months *Source: Bloomberg*

At this point, it seems unlikely that we have seen the last of the Fed's rate cuts. Many economists are forecasting a Fed Funds Rate between 2.00-2.50% within the next several months. Some predict the Fed may be forced to take the funds rate as low as 1.00% before we see any true stimulation in the economy. The hope is that this aggressive Fed action will lead to a softer landing and earlier recovery for our economy. There is no question, though, that the Fed faces a delicate balancing act in the coming months. Further cuts may further weaken the already battered U.S. Dollar and might add more inflationary pressures on the strained economy as imported goods, including oil, become more expensive.

Highlights:

- Fed faces weak housing and job markets
- Federal Open Markets Committee cut Fed funds rate 50 basis points in face of a potential recession
- Caprin slightly lengthening target portfolio duration to capture higher yields in longer bonds
- Continued struggles are perceived in the coming months for the domestic economy

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Caprin Strategy

As the Fed continues to aggressively lower short-term rates, the difference between short term and long term interest rates will likely increase. The yield curve is returning to a 'shape' where investors are paid higher interest rates for investments with longer maturities. The markets have not experienced this 'normal' relationship of interest rates since well before the Federal Reserve implemented its policy change in 2004.

In response to these market conditions and the increasing opportunities that they present, Caprin has decided to slightly extend its target duration in our intermediate municipal portfolios. This should provide our portfolio managers a great opportunity to capture the higher return opportunities of these longer maturity investments. As we lengthen average duration, we are focusing on high quality, liquid bonds to ensure a conservative portfolio and minimize risk as economic events continue to evolve.

Since our last newsletter to you, the municipal bond market has been undergoing stresses in relation to monoline bond insurers and auction rate securities. Many articles have appeared in the financial press about how investors and markets have been impacted. Caprin portfolios have not invested in the much publicized auction rate securities so your accounts have not been impacted by the liquidity difficulties. Because these scenarios have created a supply-demand imbalance in the market, yields on municipal bonds have recently risen for most maturities and generated additional income and return options for our client portfolios.

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