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FOMC Summary: Fed Commits to Low Rates for 2 Years

Since our last newsletter, politicians in Washington brought the debt ceiling debate to the brink of "default", the United States' credit rating was downgraded, and the European debt crisis escalated. The confluence of these events served to severely undermine confidence in the economic recovery here in the U.S., driving equity volatility and fears to levels not seen since the financial crisis of 2008. Despite the downgrade (see *Caprin Commentary – The S&P Downgrade – August 8, 2011*), U.S. Treasury yields have actually fallen meaningfully (higher in price) since the last week of July. U.S. Government debt clearly remains the safe haven for those seeking shelter from volatile markets.

In the midst of all this, the Federal Open Market Committee maintained its Fed Funds target rate at 0-0.25% where it's been since late 2008 as a policy tool to combat the recession and economic malaise. FOMC meeting pronouncements have reiterated the Committee's intention to keep the target rate near zero for an "extended period," but a targeted time frame was never expressed – until now. The FOMC announced its intention to maintain this target through mid-2013, pointing to a lack of improving economic conditions both here and abroad.

Releasing a target horizon created dissent from three of the Committee's voting members who preferred the noncommittal "extended period" language. The dissenters were concerned that setting the low rate expectation for a 2-year horizon was unwise given the inability to forecast a timeline for the economy's recovery. In addition, such a statement from the FOMC conveys to many market participants a meaningful lack of confidence in the recovery's prospects. However, the majority of the Fed's policymakers felt that the weak employment and U.S. growth picture warranted a firmer commitment on behalf of the FOMC.

State	Primary Exposure to Federal Funding
Maryland	Federal employment, federal procurement contracts
New Mexico	Federal employment, federal procurement contracts, Medicaid
South Carolina	Federal procurement contracts, Medicaid
Tennessee	Federal employment, Medicaid
Virginia	Federal employment, federal procurement contracts

Figure 1. Moody's Aaa States on Negative Outlook **Source: Moody's**

It's clear that Bernanke's Fed is wary of the current economic environment and is feeling less optimistic than just six weeks ago. Their more pessimistic outlook for the U.S. recovery has created speculation that a third round of quantitative easing may surface in the not too distant future. The Fed has already stated it will reinvest principal payments from securities acquired during QE1 and QE2, which are estimated to total $300 billion over the next 12 months. This indirect policy tool gives the Fed a mechanism to keep the money supply elevated in hopes of stimulating growth (without giving the action an official label).

Municipal Market Dynamics: Treasury Rally Fuels Munis

Municipal bond prices and yields have trended with the Treasury market. As of this writing, 10-year AAA G.O. yields, according to Bloomberg Fair Value, are 53 bps lower in the

Highlights:

- Fed maintains 0-0.25% fed funds rate; commits to target level through mid-2013
- Fed reinvesting principal payments from QE1 and QE2 to continue economic support
- Low supply and flight-to-quality advanced Muni rally in late July and August
- Caprin portfolios structured slightly longer than neutral to benchmark

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month of August, an extraordinary achievement given how low yields were prior to the U.S downgrade and worsening European debt crisis.

The full impact of the S&P U.S. Government downgrade and its effect on Muni ratings continues to evolve. S&P warned that some state ratings might be lowered later this year if the budget compromise process materially impacts federal funding to states. On July 19, Moody's placed five AAA-rated states on Negative watch that it deemed most reliant on federal dollars *(Figure 1)*. The ratings agencies will reevaluate state fiscal strength ratings on a case-by-case basis as budget and funding outcomes surface. To date, there has been little if any price and yield impact as a result of these potential state downgrade 'statements'. Demand for highly rated paper and the lack of supply have supported state debt prices through the recent headlines.

The dearth of tax-exempt supply has been well-documented here and elsewhere for the majority of 2011. State and local governments' austere budgeting has constrained issuers from introducing new debt to the Muni market all year. More recently, the U.S. debt debate and the uncertainty of the ratings environment caused several prospective Muni issuers to shelve their plans for new issuance in a market already starving for more supply. Demand has far outweighed available tax-exempt supply for more than three months and counting.

Caprin Portfolio Strategies

Caprin continues to manage portfolios to a duration target slightly longer than neutral given the most recent FOMC policy declaration. We are utilizing a fairly laddered maturity structure ranging from 2 to 15 years; however, we have placed a slight emphasis on maturities around the 7-year area. We are seeing relative value in this space where a one year maturity extension provides over 30 basis points of additional yield. The longer end of the yield curve (maturities 15 years and beyond) remains relatively flat and fails to provide ample compensation for the added maturity risk exposure.

Our issuer and sector focus continues to seek incremental yield for intermediate portfolios (i.e. strong hospitals, power, education, housing, and airport), with a consistent emphasis on issuer quality. Furthermore, where we see relative value that outweighs tax implications in states outside of a client's state of domicile, we continue to add exposure to augment yield and performance opportunities.

Lastly, though municipal issuer ratings assessments are dependant on Washington and are a few months off, we are evaluating the potential impact on state and local government issuers most reliant on federal funding. We do not expect ratings changes or budget cuts, should they occur, to materially impact an issuer's ability to satisfy its debt obligations. However, the return characteristics of bonds issued by certain names or in targeted sectors may deviate from our expectations when we purchased those investments. As such, we will reduce exposure to debt with elevated downgrade risks where necessary in order to maintain desirable volatility and return profiles for our client portfolios.

Caprin's Short Maturity Strategy remains consistent with the FOMC's policy proclamations maintaining a duration target slightly long of neutral to the strategy's benchmark. The constrained supply environment makes opportunistic purchases in yieldier sectors (again, consistent with the Intermediate Strategy) crucial to generating income in the front of the yield curve. As with any strategy, these purchases are on a name-by-name basis, focusing on those with stronger credit profiles.

As economic and political headlines continue to shape markets and drive volatility, we remain focused on building and maintaining portfolios with a higher quality orientation that maintain liquidity and seek lower volatility in their return profiles.

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product made reference to directly or indirectly in this piece, will be profitable, equal any corresponding indicated historical performance level(s), or be suitable for your portfolio. Due to various factors, including changing market conditions, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion of information contained in this piece serves as the receipt of, or as a substitute for, personalized advice from Caprin Asset Management. To the extent that a reader has any questions regarding the applicability to their situation of any specific issue discussed above, they are encouraged to consult with the professional advisor of their choosing. A copy of our current written disclosure statement discussing our advisory services and fees is available for review upon request.