Caprin Asset Management, L.L.C.

Caprin Asset Management's disciplined investment process is dedicated to helping investors navigate the complexities of the fixed income markets by preserving and enhancing investor wealth through thoughtfully constructed, professionally managed portfolios.

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A look back

Almost two years ago we wrote, "Much to no one's surprise, the Federal Reserve increased the Fed Funds rate by 25 basis points at their June 30 meeting. Additionally, they indicated their intention to remain vigilant in their fight against inflation by standing ready to increase rates at a "measured pace."" It seems that little has changed since July 2004, unless of course you factor in that the Fed has raised its target Fed Funds rate 25 basis points (1/4%) 15 consecutive times, and it now stands at 4.75 percent, and there is a new helmsman behind the Fed's wheel, Dr. Ben Bernanke.

Although the Federal Reserve no longer included the phrase "measured pace" in its statements issued January 31 or March 28, the Bernanke era was ushered in with little disruption, and the markets showed modest volatility as the Greenspan Era ended. Bernanke, a former economics professor and the former Chairman of the President's Council of Economic Advisors, took over from Greenspan February 1. Perhaps the two greatest expectations the markets have for the Bernanke Era are greater clarity and the possibility of being given an inflation target (a rate range within which the Fed is comfortable seeing inflation run). So far that's exactly what we seem to be getting.

What started out as a positive environment for bonds in January and February changed radically in March, essentially wiping out all positive returns so far this calendar year. One of the biggest influences was a reduction in demand for U. S. treasuries as Japanese corporations looked to "window dress" their balance sheets as of March 31. Concurrently, Japan announced that they would no longer need to remain quite so accommodative with their own rates and the ECB also raised short rates .25%. These foreign influences coupled with two Fed increases precipitated the US market's rise in yields. Point to point for the quarter; we finally saw the parallel shift higher in the yield curve as both short and longer term interest rates were rising, a scenario that has accompanied most Fed tightening cycles.

Despite the increase in yields, the Ten year Treasury note has maintained its trading range although influences are mounting for it to break through. Surging oil and commodity prices, strong domestic growth as well as upward pressures on interest rates globally could compound to break out of the range. A possible offset to rising rates could be a continued cooling of the domestic housing market, a significant slowdown in consumer spending or an international crisis providing the momentum to reverse the upward trend and produce an inflection point where rates head lower.

A look ahead

As your fixed income manager, we constantly are challenged to nimbly and efficiently position portfolios to weather the interest rate cycles as they ebb and flow. Having now witnessed through 1Q 06 the parallel shift in the yield curve with short and longer term interest rates rising together, the markets continue to focus on inflation, the avoidance of deflation, the consumers' appetite for spending, the job market, the strength of the economy, etc..

So what are we likely to see in the coming quarter and year? Most economists are forecasting that the Fed will pause at either 5% or 5.25%. According to the 4/19 survey by Bank of America, Fed Funds futures are expected to peak around 5.15% in mid August 2006. Additionally, in examining current Fed Funds futures contracts, a 25 basis point increase to 5% is fully priced in for the next meeting on May 10. If history can tell us anything about the future, we are likely to see increased volatility surrounding the market inflection point- we will see an increasing number of data points arguing equally for strength and weakness, and the market may likely be whipsawed as it quickly digests each tidbit. As the market anticipates the end of the Fed's tightening phase, we should see a re-steepening of the treasury yield curve where the short end outperforms the long end- this has happened over each of the last three tightening cycles.

Fed moves typically take at least six to nine months to filter into data. We are now seeing the effect of the first series of rate hikes which were clearly only to reduce an accommodative interest rate policy, and as the remaining hikes filter in, we may see telling changes in the corresponding data that will warrant changes in our portfolios.

Municipals

Municipal bonds significantly outperformed their taxable counterparts for the first quarter of 2006. Historically municipal bonds are less volatile than Taxable bonds, and this quarter was a particularly good example. Municipal indices were essentially flat -- the S&P Trust Index returned .08% for 1Q06 -- while Governments, Agencies and Corporates lost nearly 1%. Long Treasuries were down nearly 4%. Mortgages were only slightly negative.

The volatility of the municipal market is in part attributable to supply and demand of new issues. Fortunately, this time supply is dramatically less than last year, somewhere on the order of 25% decline, and there is a lot of cash on the sidelines looking for the right entry point. So, as U. S. Treasury rates have moved higher, municipal rates have lagged and we expect this pattern to continue for the remainder of the year.

Although the first quarter was essentially flat, the increased probability of interest rates declining later this year, coupled with the opportunity to capture high current income today, gives us the opportunity to generate positive returns for the remainder of the year.

Cash Management

Investment opportunities in the realm of cash management steadily improved over the course of the first quarter 2006. Yields early on held toward the lower end of the range as market participants expressed uncertainty about the new Fed chairman and the course of the economy. As sentiment on both these fronts improved over the quarter, yields on new investments rose to 5 year highs.

We were skeptical that the low yield levels of January would hold, and thus we took a defensive posture in our portfolios by investing in shorter maturity (30 – 45 days) investments. As the market and Federal Reserve signaled that higher yields were on the horizon, we allowed this allocation to shorter maturity investments to rise over the quarter. The market did, however, present periodic opportunities to lock in higher yields in the 12+ month maturity range, and these were selectively undertaken.

The onset of the second quarter brought continued upward pressure on short and long term interest rates, and we held our short maturity allocations toward the higher end of recent ranges. With increasing signals that a change in Federal Reserve policy is nearing, we will pursue opportunities in longer maturity investments with yields that will enhance current yields over a respectable horizon. We view the market as entering a period of transition from a deliberate Federal Reserve policy to one

that is more conditioned on demonstrated levels of economic activity and inflation. As such, our assessment of the market and our strategies will remain adaptable as future trends begin to unfold.

Equities

Equities climbed a wall of worry to post low single digit returns in the first quarter. According to Standard & Poor's quality rankings, those stocks rated A or "highest quality" have gained just 1% year-to-date while those stocks rated B- or "lower quality" have gained over 10% in the same time span. Even more interesting is the fact that those stocks rated C or D "lowest quality" have gained 16.7% year-to-date. The question equity investors might ask themselves is "should I care?" Since Caprin and our clients traffic in "high quality" investments, this is an important discussion. We could write at much greater length and depth on this subject, however, our conclusion is that although the S&P, Russell 2000 and other equity indices are being led by fewer and fewer stocks, and those very stocks are not of the highest financial quality does not necessarily mean if the "market averages" fall that all stocks will follow. In fact, we believe both individuals and institutional investors will seek the safe haven of the very best companies in the world. This phenomenon should make for very interesting markets going forward.