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August 2008

Oil Drops, Fannie and Freddie Struggle Mightily

The Federal Open Market Committee's decision to hold the federal funds target rate at 2.00% came as little shock to the majority of Wall Street. Disagreement with this recommendation came from only one voting member – President of the Federal Reserve Bank of Dallas Richard W. Fisher – who pushed for a rate hike for the second consecutive meeting. Perhaps echoing Fisher's concerns about inflation, financial markets currently are forecasting one Fed rate hike by the end of 2008. However, the likelihood and timing of such a move certainly is up for debate.

There is no question that, as crude oil prices have steadily fallen well below $120 per barrel, one of the economy's major inflationary pressures has loosened its grip on American consumers. Oil's trend downward since late June is part of a larger decline in commodity prices that may help soften inflation expectations through year-end. It is likely that the Fed, along with most consumers, is breathing a collective sigh of relief at the sight of declining oil prices. However, many speculate we are in for an extended upward trend in oil prices due to strong demand and declining supplies. For this very reason, the Fed remains vocally concerned and hawkish in its approach to inflation and continues to call its future "highly uncertain."

Fig 1. *FNMA credit default spreads tighten showing increased confidence after new legislation passed*
Source: Bloomberg

Highlights:

- Oil prices decline to the delight of consumers and the Fed
- Federal Open Market Committee left fed funds rate unchanged as widely expected
- Caprin maintaining target duration close to 5 years, neutral to Lehman 7-year Municipal Bond Index
- Munis remain an attractive buy; continue to outperform equities on tax-equivalent basis

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Since our last newsletter, mortgage giants Freddie Mac and Fannie Mae have dominated news headlines. The ongoing housing correction has raised questions about the health of Fannie and Freddie, though almost all their holdings are in well-underwritten traditional mortgages. The recent concerns thus stem from expectations of worsening conditions in the housing market as falling real estate values become more widespread.

Fannie and Freddie are responsible for roughly half of all existing loans in the United States and are a fundamental component for maintaining an orderly real estate market. For this reason, the Treasury Department and Congress have approved a multi-faceted program to ensure the ongoing functioning of these government sponsored entities. The primary elements of the program are: granting the Treasury Department the power to inject capital into Fannie and Freddie, providing the Treasury with the freedom to purchase unlimited amounts of equity in the firms and to lend to Freddie and Fannie freely to protect them from collapse, creating a federal agency to insure refinanced home loans, and establishing of a stronger regulator for Fannie and Freddie and placing the Federal Reserve in a consultative role to monitor their capital. Treasury Secretary Paulson followed the introduction of this legislation by stating, "It's a very strong message we're sending to investors around the world and the U.S., that we understand the importance of these organizations to our capital markets and to our housing market."

Caprin Strategy

Maintaining liquidity in our clients' portfolios remains a primary objective amidst the current volatility in both the stock and bond financial markets. Caprin remains committed to buying high quality bonds in all portfolios, especially those bonds with longer maturities. When compared to the previous three years in the Muni market, investors are being offered improved yields for investing in longer maturities. Accordingly, we continue our strategy implemented several months ago to redistribute some of holdings in a combination of shorter (2-3 years) and longer (12+ year) maturities. Overall, our strategy has our portfolios at a target duration of approximately 5 years (neutral to our benchmark) while pursuing opportunities to capture added yield from the longer maturities. High rates in intermediate and longer maturity bonds currently make municipal bonds an attractive buy – they are yielding close to 100% of U.S. Treasuries. This 'ratio' as it is commonly referred to makes Munis very attractive at these levels, and most tax payers will benefit from owning municipal bonds.

We expect bond yields to remain in a trading range for the better part of 2008. While this volatility creates uncertainty, it also offers opportunities. Our outlook over this term looks for environments where rising yields allow us to pursue trades to lock in those levels over our investment horizon. Falling yields also give our portfolios the chance to sell appreciated assets in favor of bonds that offer these enhanced returns over time. These strategies are important elements of a managed bond portfolio, and just part of Caprin's stewardship of the assets you have entrusted to us.

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.