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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2004 Twists in Interest Rates

When people talk about interest rates, it often sounds as if they are speaking about one number. One example of this misperception is the statement that interest rates are going up. In 2004, the Federal Open Market Committee, under the leadership of Alan Greenspan, raised the target Fed Funds rate and the discount rate (short-term rates) at five consecutive meetings by a total of 1.25%. The plausible reaction to short-term rates being pushed higher is for the yield on bonds of every maturity to rise. That is not what happened in the second half of 2004, as yields on short bonds rose while yields on longer bonds remained the same or, in some instances, fell.

Numerous factors influence short, intermediate (the belly) and longer-term interest rates. In the short-term, the two largest influences are Fed action and a flight to quality. We are experiencing the first now, but have experienced flight to quality reactions many times, the most recent being after 9/11/01.

Intermediate-term bonds are influenced most significantly by supply and demand. Currently, the two primary factors are a growing amount of supply stemming from the substantial budget deficit and a significantly large demand, much of which is coming from overseas and influenced by our large trade deficit. One of the big risks to the markets today is whether foreign investors will continue to own US Government debt as the US dollar has declined in value.

The major influence on long-term maturities is inflation. When discussing inflation in the US, there are clearly two sides: government statistics and consumers. According to the Federal Reserve Governors, they are no longer more concerned about deflation than they are about igniting inflation. Using their favorite statistic, the PCE deflator, inflation is still in check, and they are taking action to have it remain that way. On the other hand, consumers feel pinched as gasoline prices, home heating expenses, and health care prices all continue to rise. The largest component influencing both sides' perspective is the labor market, where wages remain relatively stable. Wage pressure is the single largest component of the inflation measures. Since wages aren't going up, the statistics remain in check, and consumers have less in our pockets to cover any rising costs.

Drawing a new yield curve based upon the above influences has resulted in a flatter slope of the yield curve because short-term interest rates have been pushed higher while long-term rates remain low because inflation is in check. These are unusual times and worth noting.

Municipals

There was a positive tone to municipal bonds during the fourth quarter, however, the overall low level of interest rates led us to remain conservative. As mentioned above, when the Federal Open Markets Committee raised short-term rates and promised to continue raising rates at a "measured pace," we bond investors tend to expect all rates to rise. Therefore, we remained focused on preserving principal by having a shorter than benchmark duration target and a large portion of the portfolio due to mature or be called within the next year or two. To offset the heavy weighting in very short securities, we also continued to invest in bonds that mature around ten years out as they continue to offer significant yield pickup.

In this environment we have conscientiously purchased securities with high coupons. We have to pay a premium upfront for this, but these bonds hold their value more when interest rates do eventually rise. They also provide a nice cushion of income for you should you need to generate a certain amount of cash flow from your portfolio.

On an after-tax basis, municipal bonds outperformed like maturity Treasuries throughout most of the year. There are two reasons that may continue to have a positive influence in the future. One is an expectation that supply will diminish after three years of the largest issuance on record— over $350 billion per year. As the economy improves, localities' tax receipts increase and there is then less need to increase debt to pay for all of the city, county, or state services.

The other major positive influence may be tax reform. There was far less talk this election season of needing to cut taxes to stimulate the economy. On the contrary, there were renewed discussions of needing to create balanced budgets.

Cash Management

Since our October newsletter, the Fed has continued its policy of raising rates in 25 basis point increments at each of its meetings. Following such moves in November and December, the Fed Funds rate now stands at 2.25%. The February 2 meeting is expected to bring yet another increase.

Following sluggish economic data in early fall 2004, the spread between Fed Funds and the two-year Treasury narrowed to about 75 basis points – less than half what it had been in June – amid speculation that the Fed increases could soon reach a plateau. With far less pickup available from extending and no hints from the Fed that its policy had changed, we allowed our allocation to short term investments (30-60 days) to rise from about 15% to a current 25%.

The last quarter of 2004 produced a more positive tone as job creation picked up and the Christmas retail sales season proved a success. With energy and other commodity prices remaining high, inflation fears intensified and concern increased that the Fed would not only continue its policy but could even accelerate its move toward higher rates. Consequently, the yield curve steepened. The two year reacted by rising faster, causing the Fed Funds to two year spread to widen to 100 basis points. With our short term investments near the high end of our target allocation, and with the market providing some yield pick up, we are investigating selective opportunities in the 12-15 month range with the objective of holding short term investments near current levels. As always, our strategies strive to generate a competitive current yield while promoting responsiveness to market trends.

Equities

Although we are a fixed income firm, we continue to monitor all markets as they can have a sizeable impact on our own. In the 4th quarter, the equity markets finally came roaring back to life, posting high single digit returns for the year.

The question equity investors' face for 2005 will surely be whether corporations will be able to improve upon what seem to be already high profit margins. Also, the bullish optimism projected from the re-election of George W. Bush seems a bit long in the tooth, at least on an intermediate term basis. Analysts' estimates for 2005 earnings for the S&P 500 are about 73-74 dollars. The multiple looking forward on those estimates is about 16 to 17 times earnings; this is historically not cheap.

Having said all of the above, we believe equity holders in extremely well managed, high quality, low debt, strong balance sheet corporations will do much better than the averages. We are in that part of the bull market cycle where we can assess the beginning stages of a strong performance from the large capitalization growth stocks. This year promises to be a year of "quality growth" mixed in with a large dose of corporate events such as spin-offs, restructurings and takeovers. Of course, all of this remains to be seen. However, we are confident that the equities you do hold will perform well.