Caprin Asset Management, L.L.C.

7100 FOREST AVE., SUITE 303, RICHMOND, VA 23226

January 2008

Fed Cuts Key Target Rate Once Again

In the weeks since The Federal Reserve Board Open Market Committee (FOMC) last met, little has changed with the economic environment or its outlook. As 2007 came to a close, the Fed found itself in the midst of a balancing act, simultaneously striving to address liquidity concerns, a slowing economy, and inflationary pressures.

At its December 11th meeting, the Fed again lowered the Federal Funds rate by 25 basis points to 4.25%. The explanation for decreasing this closely watched rate restated several common themes that have influenced the FOMC's policy-making for the past several months - a slowing economy and a housing correction that promises to worsen into 2008. Although some data suggests that the worst of the real estate market may be behind us, it is too early to draw meaningful conclusions. The fact remains that home foreclosures continue rising at a heated pace while the decline in housing prices persists. Furthermore, despite core inflation numbers moderately improving towards the end of the year, energy and commodity prices continue to climb, creating pipeline inflationary pressures that the Fed continues to monitor closely.

Figure 1. Existing home foreclosures in 2007 (in millions) *Source:*

The Fed's statement warned that the recent developments had caused increased uncertainty surrounding our economic outlook. Caprin's Investment Committee decided at its December 17th meeting to maintain its target duration of 4.5 years (which is longer than our benchmark) as we expect the Fed to focus on supporting

Highlights:

- Housing market struggles remain a drag on the U.S. economy
- Federal Open Markets Committee cut fed funds rate 25 basis points in response to mixed signals
- Caprin maintaining target portfolio duration in anticipation of further market fluctuations
- Economy should avoid recession in a challenging 2008 environment

"With no clear-cut end to the downward pressures on our economy, a preference for safer investments may persist for the near future."

the economy and maintaining liquidity in the financial markets. The Committee also adopted a 10% upside margin for the target duration to allow additional allocations to longer maturity bonds as a means to capture yield and return enhancement opportunities when they arise.

2007—A Recap

2007 was a turbulent year in domestic financial markets due to increasing risk factors. A weaker dollar, the credit crisis, and the fall of the U.S. housing market all contributed to large swings in the prices of both stocks and bonds. We saw a large-scale "flight to quality" as investors sought safer havens for their assets, and the bond market was a popular destination. With no clear-cut end to the downward pressures on our economy, this preference for safer investments may persist for the near future.

2007 market returns were rather modest across the board. According to Merrill Lynch, the broader municipal bond market returned roughly 3.25% in 2007, while the total return for Caprin's municipal portfolios in the aggregate was around 4% as our portfolios were less invested in the poorer performing maturities of the last half of the year. On a taxable-equivalent basis (assuming a 35% Federal tax bracket) that return equates to roughly 6.2%. Relative to S&P 500 returns of around 3.5% for the calendar year, Caprin's management delivered respectable returns for clients in a challenging market environment.

Figure 2. Weakening of the dollar in 2007 relative to the average of the world's six other major currencies
Source: Bloomberg

As 2007 progressed, attention increasingly focused on those companies providing insurance for certain municipal bonds. Our last newsletter discussed the challenges these companies might face in maintaining their AAA ratings given their exposure to bonds backed by sub-prime mortgages and other risky collateral. The environment continues to remain stressed, though some of the insurers have taken steps to augment their capital and support that rating. We continue to maintain our principle that the best protection against such a downgrade risk is to purchase bonds based on their underlying credit strength, regardless of whether the bonds are insured.

Caprin Asset Management, L.L.C.

A Forecast for 2008

In the upcoming year we expect market volatility to remain high with continued economic struggles. The Fed will need to be diligent as it attempts to keep our economy from falling into a recession and strives to moderate the amount of inflation the economy has to absorb.

We expect yields on shorter maturity bonds to move lower as expectations for a slower economy persist, as nervous investors flee to the safe haven of short term Treasury Bonds, and as the Fed helps facilitate liquidity in a credit-challenged environment. At the other end of the maturity spectrum, we believe yields for longer maturity bonds will rise as investors demand compensation for taking maturity risk in the face of longer-term inflationary pressures.

As we start 2008, we do not foresee a recession for the U.S. economy: U.S. corporations are benefiting from a strong export market and the upcoming campaign may stimulate anticipation of better times and programs from a new Administration. The outlook for 2008 is nonetheless challenging. We continue to believe proactive management of bond portfolios will provide opportunities as well as a cushion of relative stability for any bumps along the way.

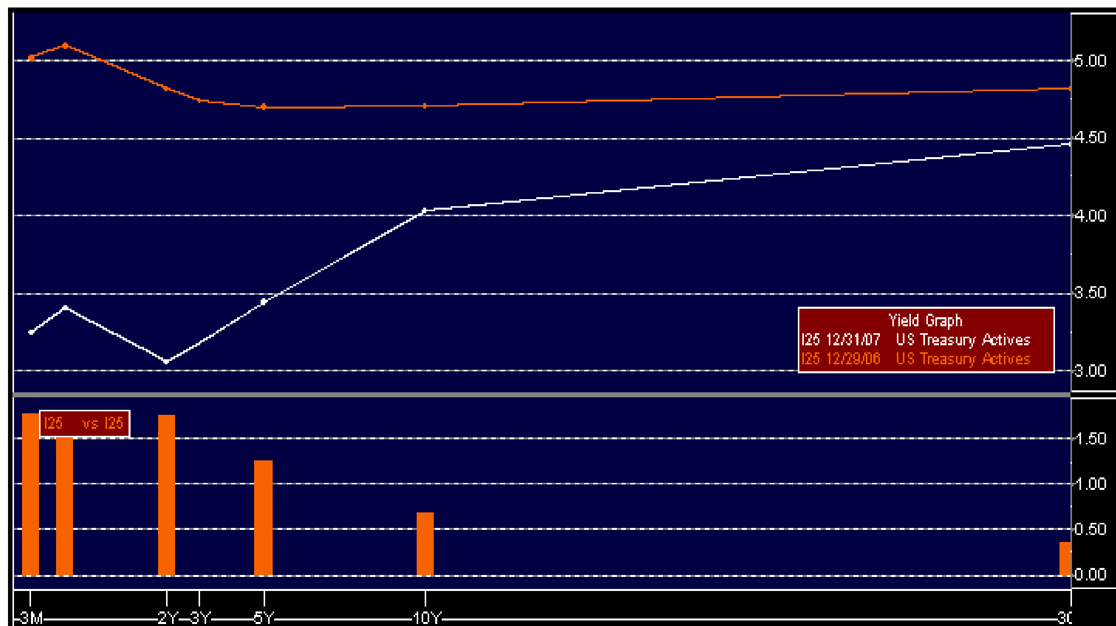

Figure 3. Treasury yield curve change from beginning (in white) to **end** of 2007 *Source: Bloomberg*

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.