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Capital Preservation & Income

April 2010

Muni Supply Boost Helps Drive Bond Yields Higher

After rallying throughout most of the first quarter of 2010, the municipal bond market began to show a few cracks during the last full week of March. Through March 19th, several factors had combined to drive municipal bonds prices up and their interest rates down. These factors included near-zero money market rates forcing yield-seeking investors to reallocate elsewhere, investors' concerns over higher taxes increasing the appetite for tax-exempt income, and limited supply of new tax-exempt bonds for purchase. The selloff seen in the last ten days of the quarter was largely driven by an uptick in new supply, coupled with taxable alternatives that had become relatively attractive, and perhaps the beginning of annual tax-planning influences. Despite the slight pullback, municipal returns were still positive for the first quarter.

The quarter-end increase in new supply came as states and counties looked to take advantage of the exceptionally low interest rate environment. In the last week of March alone, over $13 billion in new, tax-exempt issuance was sold by municipal issuers. This compares to average weekly issuance of $9 billion for the first part of 2010. As forward-looking supply is ebbing back towards levels seen earlier in the quarter, we will be looking to see if this mini-correction has been a short-lived reaction to a sudden inflow of supply or a trend reflecting broader dissatisfaction with low yields following the municipal bull market that began in December 2008.

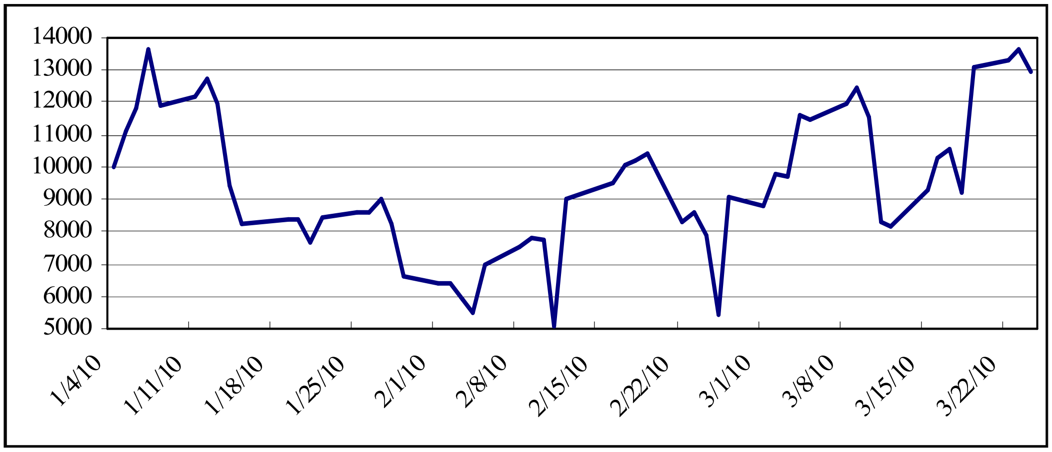

Figure 1. *30-Day Visible Muni Supply (in $millions) from 12/31/09—03/24/10* *Source: Bloomberg*

As the equity market maintains momentum suggesting increasing confidence in the sustainability of economic recovery, the Federal Reserve continues to remove non-rate related stimulus measures. The Fed's mortgage-backed securities purchase program drew to a close on March 31st and a related asset-backed securities program is scheduled to expire at the end of the second quarter. While these quantitative easing measures are removed, the Fed continues to keep its targeted Fed Funds Rate in the same 0-0.25% range and

Highlights:

- Fed maintains near-zero Fed Funds rate for tenth consecutive session
- Muni market yields trend higher for first time in 2010 amidst jump in new issue supply
- Caprin building portfolios with a laddered structure to capitalize on steepness presently offered on the yield curve
- Caprin managing to a neutral target duration of 5.0 years

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reiterated in its official statement that it would leave rates "extraordinarily low" for an "extended period." The Fed continues to point to a subdued housing market and weak employment statistics as warranting accommodative rate policy, while continued benign inflation indicators seem to provide the Fed with some flexibility for now.

Caprin Strategy

Caprin voted on March 22nd to remain duration neutral to our benchmark, roughly 5.0 years. While municipal rates remain at low absolute levels, the apparent easing of municipal supply and repeated assertions from the Fed suggest that rates may be poised to remain low for the near term. Our outlook closely mirrors that of the Fed, that the highly rate-sensitive housing market remains fragile and vulnerable to a near-term increase in interest rates. We take the Fed at its word that it will keep rates low in an effort to continue to insulate the housing market and ultimately the consumer. Therefore, our duration structure will remain neutral, but postured to restructure as the rate environment continues to evolve.

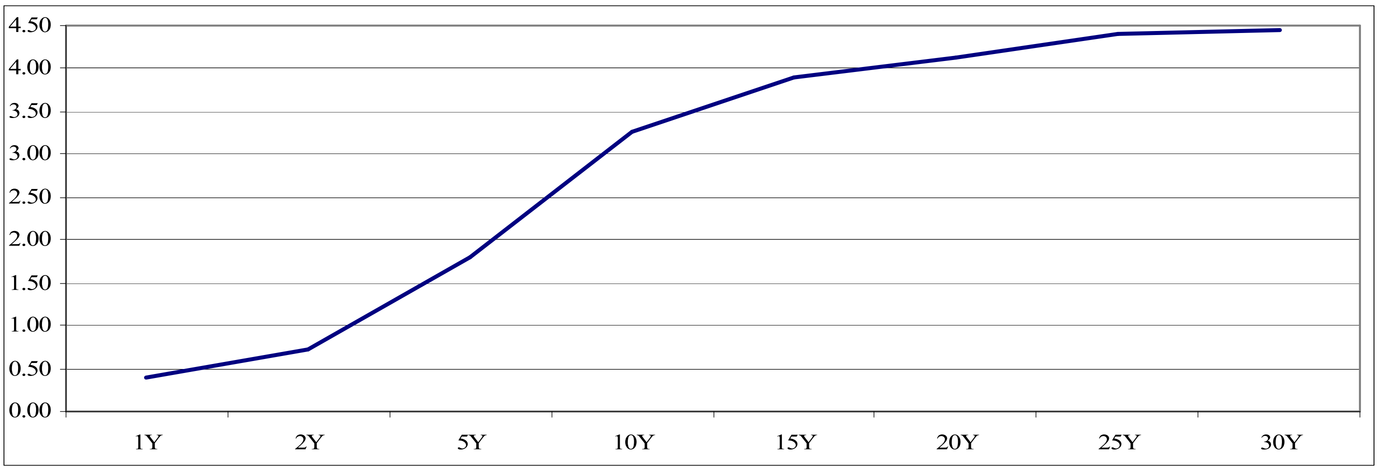

Figure 2. U.S. *Muni G.O. AAA Yields from 1- to 30-Year Maturities as of 03/31/2010* *Source: Bloomberg*

Despite the recent slight correction in yields, the muni yield curve remains very steep with meaningful additional yield afforded to investors purchasing further out in maturity. As a result, and given our rate outlook, Caprin will continue to build portfolios in a "laddered" structure for the time being taking advantage of incremental yields in longer maturities while diversifying positions evenly throughout the first 15-17 years of the curve.

Caprin also recognizes and monitors the tight financial conditions among state and local governments. While the broader economy may be showing signs of recovery, municipal finances tend to lag private sector activity. Municipalities continue to feel the strain of depressed receipts - and mandated budget balancing is forcing significant spending cuts. In this environment, we continue our emphasis on high-quality, liquid positions, especially in maturities longer than 10 years.

Bottom line: volatility and uncertainty will likely remain prominent in the fixed income markets in 2010. Caprin continues to rely upon diligent credit surveillance, high quality, and liquidity to navigate the evolution of these challenges.