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February 2010

Fed Walking the Tightrope with Stimulus Removal

As expected, the Fed left their target borrowing rate unchanged for the ninth straight session on January 27th and continued to reaffirm its intention to leave the target rate "exceptionally low" for the foreseeable future. Despite the modest recovery of the equity market and the emergence of occasionally encouraging economic data, the Fed and the debt markets seem to be looking for more convincing signs that economic recovery is sustainable. Interest rates have remained contained despite a sizable upside surprise to Q4 GDP (*Figure 1*). Much of the 5.7% growth was explained by the restocking of depleted inventories rather than strength in the underlying economy.

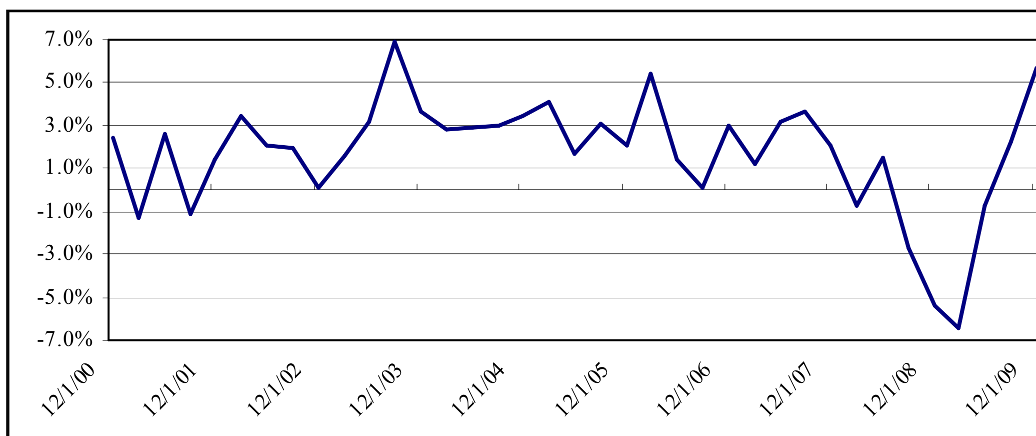

Figure 1. *Historical U.S. Quarterly GDP data from 2000—Present* *Source: Bloomberg*

The Fed now faces the difficult task of delicately removing the massive amount of accommodation injected in to the economy in response to financial crisis. If the Fed moves too quickly there's the risk of rising interest rates choking off the potential for recovery and bringing about a dreaded "double-dip" scenario. If the Fed waits too long and stimulus works further into the system, inflationary pressures may emerge as an equally daunting challenge for the Fed to overcome. As the next step in this transition, effective March 31, 2010, the Fed will discontinue its $1.25 trillion program of purchasing mortgage-backed securities in the open market. This program was put in place in 2008 to help stabilize and control mortgage rates in an effort to support the battered housing market. On the surface, the Fed's exit might seem to introduce the possibility of higher mortgage rates. In reality, the Fed is free to revisit this program if rising mortgage rates threaten the still-fragile housing market. Also, in a not-so-subtle sleight of hand, the Treasury announced unlimited federal bailout money available to mortgage providers Fannie Mae and Freddie Mac over the next three years. The Christmas Eve announcement did not go unnoticed or misinterpreted: Fannie and Freddie, now backed by the US Treasury, will fill the void left by the Fed in the mortgage market if borrowing rates need to be controlled.

Highlights:

- Fed maintains near-zero Fed Funds rate for ninth consecutive session
- U.S. Treasury to support mortgage markets and borrowing rates via Fannie Mae and Freddie Mac
- 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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For the time being, the Fed is having its cake and eating it, too, by announcing the gradual removal of accommodation without spooking the market into a rate selloff. Thus far, the Fed has been careful to provide itself with the leeway necessary to revisit stimulus if conditions warrant, and the Fed's unequivocal language anchors the market's confidence that rate increases are not a near-term likelihood. The real test will come when the Fed starts to modify the interest rate-related language of its statements, namely the removal of the phrases "exceptionally low" and/or "for an extended period."

Caprin Strategy

The landscape of the economy today looks much as it did six weeks ago at the writing of our last newsletter. Hints of recovery are emerging, albeit slowly and sporadically. The headwinds presented by continued high unemployment and rising foreclosure statistics are likely to weigh on recovery and should keep the Fed at bay for the time

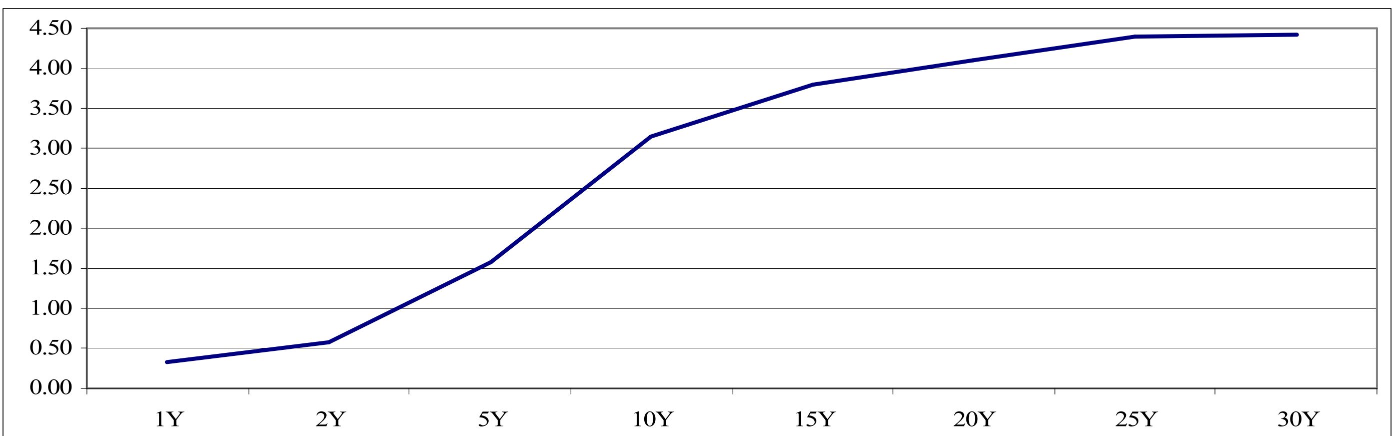

Figure 2. *U.S. Muni G.O. AAA Yields from 1- to 30-Year Maturities as of 02/08/2010* *Source: Bloomberg*

being. We take the Fed at their word and do not expect rate increases to be a near term likelihood. Therefore, Caprin will continue to manage the duration of our intermediate municipal bond portfolios to a level that is neutral to our benchmark (5.0 years). Furthermore, we are building portfolios in a laddered structure, evenly spacing our new purchases between maturities ranging from less than a year out to approximately 18 years. Longer dated maturities continue to offer significantly greater yields than shorter maturities given today's steep municipal yield curve (*Figure 2*). Caprin continues to prioritize quality and liquidity in the longer dated maturities to keep our portfolios nimble as our interest rate outlook evolves.

Looking out over the next 6-12 months, we foresee competing dynamics in play for municipal investors independent of events in the taxable market. We expect an increased appetite for tax-exempt income as taxpayers anticipate higher tax rates. Also, the extension of the popular Build America Bond program suggests less supply of tax-exempt bonds going forward. Greater demand and reduced supply should be supportive of higher prices and lower rates. However, we also expect state and local budget challenges to spread and make headlines beyond well-publicized California. The recession has hit these governments' revenues hard. We believe the claims of widespread defaults among government debt are sensational and overstated; however, we are in a period where scrutiny of state and local budgets is essential to minimizing price volatility in municipal bonds portfolios. While headline risk may chase fund flows away from the asset class, we believe that the fundamentals of supply and demand favor municipal bonds relative to taxable alternatives in the coming quarters.

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