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September 2010

Supply-Demand Imbalance Keeping Yields Very Low

Six weeks ago, our July newsletter described the unsettling of the financial markets as turmoil in Europe remained unresolved and economic data showed signs potentially of reversing recent improvements. Investors feared that several macroeconomic indicators, which had shown promise in the first part of the year, were stalling and could be foreshadowing a difficult second half. On August 10th, market participants' fear received at least some validation as the Fed announced intentions to reinvest principal payments from agency debt and mortgage-backed securities back into Treasury securities. Many viewed the action as a new form of easing, evidence that the uncertainty of recovery has policymakers concerned about the prospect of a "double dip" and potential deflationary forces. Investors responded accordingly. In the three days following the announcement of the Fed's intentions, the 10-year Treasury note's yield plummeted 17 basis points from 2.76% to 2.59%, according to the Bloomberg Fair Value U.S. Treasury 10-Year Curve (*Figure 1*). Since the Fed left their target borrowing rate in the same 0-0.25% range (and still have nowhere lower to go), how the Fed decides to deploy its balance sheet may serve as the barometer for policymakers' views on economic health. Until the Fed begins to lighten up its hefty investments in the Treasury securities it is about to purchase, it would appear that the Fed is *at least* one step removed from the next tightening cycle.

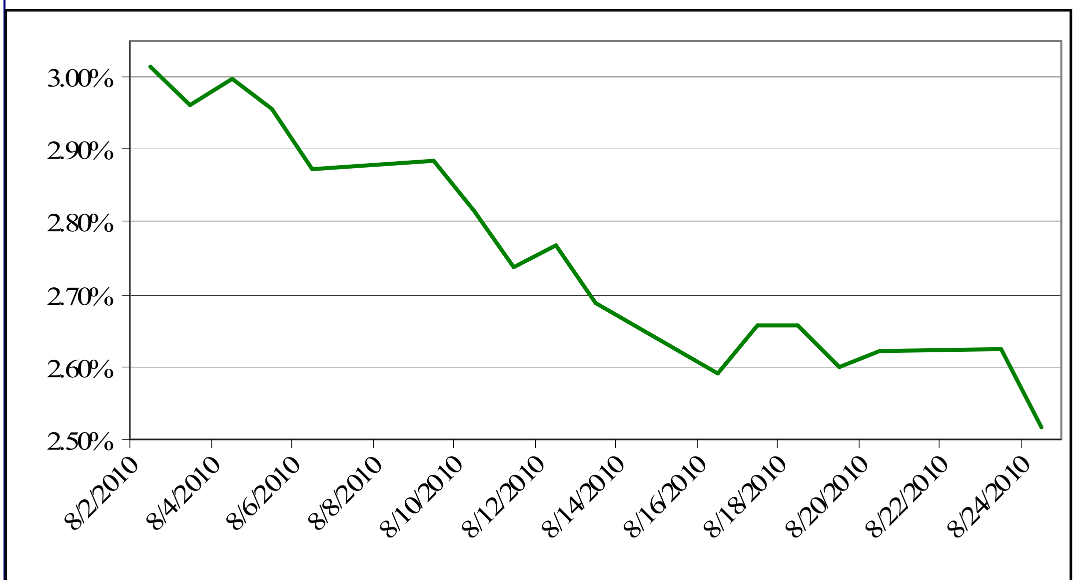

Figure 1. *BFV U.S.Treasury 10-Year Yields (August 1—24)* Source: Bloomberg

The Fed is expected to concentrate its new Treasury Bond purchases in the 2-10 year maturity range to keep the overall maturity structure similar to that of its previous mortgage-backed and agency holdings. These purchases are likely to be implemented at a rate of $20 billion per month, roughly 15% of the total available supply of Treasury

Highlights:

- FED MAINTAINS 0-0.25% FED FUNDS RATE
- MUNI AND TREASURY YIELDS CONTINUE TO RALLY TO HISTORICALLY LOW LEVELS DUE TO FLIGHT-TO-QUALITY
- CAPRIN BUILDING PORTFOLIOS WITH A SLIGHT "BARBELL" STRUCTURE, EMPHASIZING LONGER AND SHORTER MATURITIES
- WE CONTINUE TO MANAGE TO A NEUTRAL TARGET DURATION OF 5.0 YEARS

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securities. Increased demand by the Fed is a meaningful addition to the already voracious appetite for treasuries from the flight to quality investors, both domestic and global. What appears to be developing is an inversion of the economic theory of "crowding out." Crowding out suggests that as a government issues more and more debt to fund deficits, the increasing supply of debt will drive interest rates higher for all debt issuers. In this case, the Fed's purchases are competing with an already healthy market demand, driving interest rates to further lows.

Caprin Strategy

Municipals as an asset class have continued to rally in the first few weeks of August. Treasury and Municipal markets historically have moved in conjunction with one another; however, the recent rally in Treasuries has outpaced that within the municipal sector. As a result, munis are left with very favorable treasury-to-muni ratios – in other words, municipals appear cheap when compared to treasuries. Moreover, the municipal yield curve remains historically steep, offering more attractive yields to investors willing to take on incremental interest rate risk by moving out the yield curve to longer maturities.

The ongoing rally in municipals comes in spite of continued headlines concerning budgetary struggles in various states and local governments. Whether investors fearing potential tax rate increases are seeking tax-efficient investments or pursuing attractive alternatives to low yielding treasuries, a muted municipal bond supply environment has not kept pace with seemingly insatiable market demand. We remain focused on monitoring the financial stability of these governing bodies; however, our stance that these budgetary issues have been sensationalized in the media remains unchanged. Caprin recognizes the stress that municipalities are experiencing in the wake of the downturn, but we believe that the threat of widespread municipal defaults is still being overstated. As we work through the fiscal season and budget battles are resolved, we should hear less about budget shortfalls and doomsday headlines for these states and localities.

However, the broader economic picture remains cloudy, and significant drags to the economy, specifically housing and unemployment, still hinder recovery. As a result, we expect ongoing accommodative fiscal and monetary policy for the foreseeable future. In their last session, the Fed reiterated their language calling for low rates for an "extended period." Based on the expectation that the Fed is back on hold until recovery signals re-emerge, Caprin will keep managing portfolios to a neutral target duration of 5 years. We continue to invest a slightly higher concentration in the 1-3 year and 12-15 year maturity ranges. This strategy builds "barbelled" portfolios that seek to capture extra yield in the longer region of the curve without creating portfolios with longer than benchmark average maturity and duration characteristics. We are mindful of the lack of value in 0-1 year maturities, and where practical and efficient, we are seeking to fund short maturing allocations with bonds longer than 12 months.

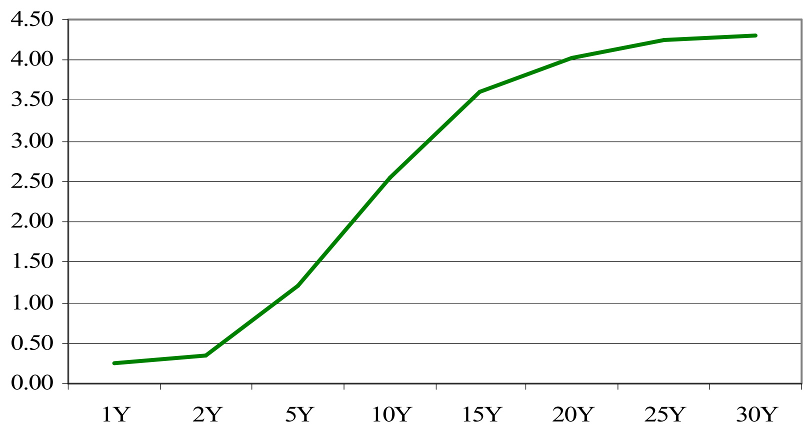

Figure 2. *U.S. Muni G.O. AAA Yields as of 8/24/10* Source: Bloomberg

Uncertainty continues to rule the day. As both taxable and tax exempt interest rates migrate towards historic lows, investors may be tempted to incur greater risk in pursuit of higher yields. Through previous cycles, low yields have resulted in the mispricing of both interest rate and credit risk, with unfavorable results. Caprin continues to monitor and manage risk, seeking yield opportunities where appropriate, while staying true to our disciplined implementation of our capital preservation mandate.