HIGHLIGHTS

- Obama's re-election locks in more Bernanke Fed
- The super-easy Federal Reserve tells us we're still years away from the onset of the next rate cycle
- Anticipating a post-Election, Fiscal Cliff-driven mood of Risk-Off, we became more defensive
- Our traders are actively pursuing better opportunities in the secondary debt markets, where the occasional diamond in the rough can still be uncovered

1802 Bayberry Court, Suite 202
Richmond, Virginia 23226
804] 648-3333
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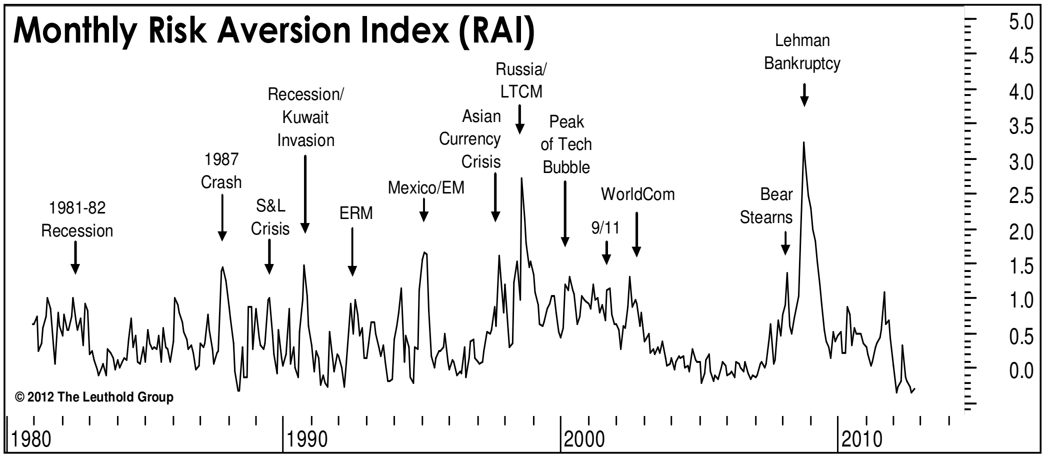
A Tale of Two...

"It was the best of times, it was the worst of times. It was the age of wisdom, it was the age of foolishness. It was the epoch of belief, it was the epoch of incredulity…"

Charles Dickens could have been writing on today's state of affairs in fixed income. In the span of four years, the market has gone from once-in-a-lifetime panic to the widespread complacency of "yield at any cost." The concept of the harsh realities of risk, which the financial crisis supposedly tested like never before, once again feels overrated:



The Risk Aversion Index combines ten market-based measures including various credit and swap spreads, implied volatility, currency movements, commodity prices and relative returns among various high- and low-risk assets.

Source: Leuthold Group

Today, bond investors and issuers enjoy record-low spreads on Municipal bonds and corporates. In junk bonds, LBO bubble-era terms are back in style. Fund managers are having a hard time resisting the siren call of Puerto Rico.

The obverse of this joy, however, is that it's the worst of times if you're in the market for attractive, risk-adjusted income. The market offers little, so our traders are actively pursuing better opportunities in the secondary debt markets, where the occasional diamond in the rough can still be uncovered.

Maybe we've wrung out as much from curve as we can. But the super-easy Federal Reserve tells us we're still years away from the onset of the next rate cycle. It's practically taunting us to buy yield, to take on additional risk. But what of the law of diminishing returns? How much upside can possibly be left? What about downside?

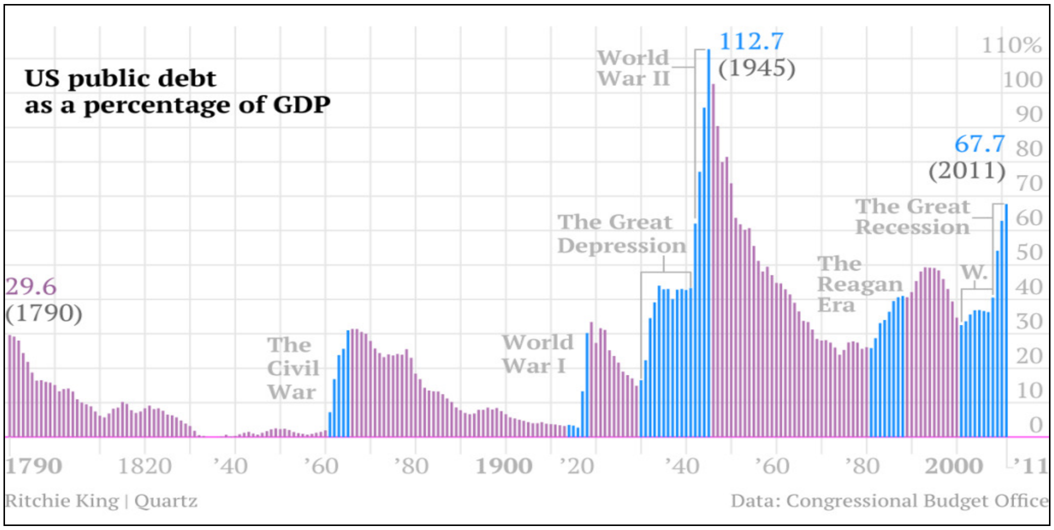
Don't fight the Fed, right? If this advice had merit in the past, when the Fed's tools were largely limited to buying and selling treasuries in targeting the Federal Funds rate, then we need to pay particular attention today when the Fed is wielding the kitchen sink strategy of its multi-trillion balance sheet purchasing all kinds of fixed income securities across the maturity spectrum.

At least Obama's reelection adds some certainty that Ben Bernanke or a like-minded individual will be guiding the Fed for the next several years. And clarity on this front is very important to us.

But we are also mindful of the amount of inflationary pressure in the system. Low levels of inflation, at least as measured by the Consumer Price Index, have given Bernanke & Co ample cover to inject unprecedented liquidity via unprecedented methods. But the idea of low inflation flies in the face of the reality that we see daily with our own eyes. The price of oil, gas, cotton, corn, copper, steel, gold, and silver are all well higher than the bottoming out in 2008/2009. Somehow through this period of higher input prices, we have seen a relatively tame Consumer Price Index. This is because producers rather than consumers have absorbed most of this price increase.

But we see some real pressure building up, and one way we monitor this pressure is through the Capacity Utilization Rate. While the rate of improvement in capacity utilization has fizzled recently, we are far closer to that point where we see potential for high input prices to begin to make their way from producers to consumers.

All this comes as our Federal government runs huge deficits, which have been a notable contributor to economic activity. At some point, this historical tailwind will become a headwind.



Well, the fiscal cliff is threatening to impose this on the US economy starting January 1. Remember back in 2011 that little debate in Washington over the debt limit? Our "leadership" extended and increased it to give time for a "Super Committee" to make meaningful reforms to the Federal budget to address longer term deficits.

"Washington's debt 'Super Committee' came and went with nary a whimper, and we have seen 14 months of no progress whatsoever towards budget reconciliation, so we find ourselves six weeks away from this Fiscal cliff."

Said committee came and went with nary a whimper, and we have seen 14 months of no progress whatsoever towards budget reconciliation, so we find ourselves six weeks away from this Fiscal cliff. Falling off could mean return to recession in 2013. Kicking the can down the road another 12 or 18 months could mean further downgrading of US debt. The Fiscal Cliff is the penalty that Congress and the White House put in place as incentive to do their jobs and tackle the budget. Because the election took priority over addressing the fiscal situation, the economy is set to suffer the consequences.

Shifting to the Municipal Bond market, the election hasn't resolved some of the biggest questions for investors. We still aren't sure what lies ahead for the tax treatment of Municipal Bonds. We see a very high likelihood changes are ahead, and the range of possible outcomes is quite broad. While some have suggested that Munis might lose their tax exempt status entirely (as was proposed by the much romanticized Simpson-Bowles plan), we see this severe outcome as highly unlikely. At least at the state and local level, we believe such a proposal would inspire levels of bi-partisan agreement and unity not seen in quite some time.

Every single treasurer, Democrat or Republican, would be up in arms about potentially higher borrowing costs.

We do suspect that the most likely outcome is some kind of cap on the exemption for higher

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Richmond, Virginia 23226
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income individuals, which we see having a marginal, but not devastating, impact on the market as a subset of buyers view Muni interest no differently than corporate bond interest, at least from a tax perspective. We will watch.

In the meantime, this strikes us as a tactical, name-by-name, traders' market, where opportunism must necessarily dominate. We've seen a steady decline in Municipal defaults as a stabilizing economy, disciplined budget cuts, and in some cases tax increases have all helped alleviate stresses for many, but not all Municipal issuers. There are still pockets of weakness out there. As seen in California, longer term promises of pension and post-retirement benefits to state and local employees threatens longer term solvency. Some areas won't be able to tax, cut, and grow their way back to health.

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After Sandy essentially shut down Wall Street for a week, a backlog of Municipal supply has been squeezed into the final days of the calendar year. Storm-ravaged New York and New Jersey face a fair amount of infrastructure spending that will require new issuance.

Our longer term macro outlook remains intact. The Fiscal Cliff is just the latest in the series of headaches that continue to impair broader confidence and impede healthy sustainable recovery. We continue to follow the Fed's lead, for now, with a long duration and maturity bias across strategies. If the outlook for a sluggish 2013 holds, we expect this profile to benefit total returns, just as we realized in 2011 and thus far in 2012.

In evaluating sectors, we're now less enthusiastic about aggressively snapping up revenue bonds -- where yields have compressed -- than we are opportunistically buying attractive, risk-adjusted offerings across sectors in the secondary market. For some time, we had sought to overweight higher-yielding corporate and taxable munis in taxable strategies and AA and A-rated revenue opportunities in Caprin Muni strategies. But with a softened outlook and tightened valuations, we're now more discriminating – taking a more bottom-up approach and seeking the right names at the right levels.

Anticipating a post-Election, Fiscal Cliff-driven mood of Risk-Off, we became more defensive in the autumn, reducing investment-grade corporate and eliminating high-yield corporate exposure in our managed ETF portfolios. Similarly, in taxable municipals we lightened up on Build-America bonds to hedge ahead of the fiscal cliff and potential sequestration. This repositioning has thus far proven to been a prudent management of risk.

Now more than ever, "know what you own" are words to live by as a bond investor.

We wish you the best for this holiday season.

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