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NEWSLETTER OCTOBER 2011

HIGHLIGHTS

- Fed unveils Operation Twist, its third attempt at economic stimulus
- Global and domestic economic weakness drove U.S. Treasury prices to all-time highs; Munis lagged Treasury rally
- Muni-specific supply dynamics and potential tax legislation changes have caused Muni buyer hesitancy over past several weeks
- Caprin portfolios maintain target duration slightly longer than neutral; continuing selective yield purchases

FOMC Summary

At the conclusion of the FOMC's September 21st meeting, the Fed unveiled a third round of economic stimulus (dubbed "Operation Twist") that will involve purchasing $400 billion of Treasuries with 6 to 30 year maturities in an effort to suppress longer interest rates. The security purchases will be funded by selling Treasuries already held on the Fed's balance sheet with maturities out to 3 years. The hope is that lending rates that use longer-dated Treasury yields as their benchmark (i.e. mortgages, car loans, large business loans) will be restrained and support a U.S. economy that the Fed has labeled as weak with "significant downside risks." Operation Twist's "sell short-buy long" methodology distinguishes the plan from QE1 and QE2, which funded mortgage-backed and Treasury securities purchases by 'printing new money'. Critics of QE1 and QE2 deemed the plans overly inflationary due to the vast stimulus injected into the U.S. monetary supply but inflation, thus far, has remained subdued as economic weakness persists.

The Federal Reserve and Washington have a challenging path ahead. Operation Twist may be effective in lowering long-term interest rates, but it does little to address the crisis of confidence that continues to fester both here and abroad. A lifeless labor market, falling equity prices, and stagnant real estate activity continue to weigh on the consumer. The U.S. fiscal situation remains tenuous, with burgeoning 2012 politics a potential obstacle towards meaningful resolutions. Ongoing uncertainty over sovereign solvency in Europe continues to weigh on global markets, particularly the financial sector where contagion fears are most prevalent. Interest rates have already been at or near record lows since 2008 while spending and lending have remained muted – it is hard to fathom that a slight reduction in these already dramatically low rates could suddenly reverse sentiment.

Admittedly, the cross-currents confronting the worldwide economy are daunting, and we have acknowledged that the deleveraging process can be long and painful. To date, political and regulatory tactics that have attempted to ease that pain have done so without much meaningful success. Many have argued that a free markets solution would pave the way for an expedited recovery while others have stated that the risks are too great. So we are in the midst of persistent policy debates and political tactics. Think about the European handwringing over a debt crisis solution, the near disaster in Washington over our debt ceiling, and the current debate over tax and jobs programs and it is no wonder that businesses and consumers lack confidence. Our view is a successful recovery will incubate when visionary and constructive leadership paves the way.

Muni Market Dynamics

Volatility in the Treasury market has served as the primary driver of Municipal bond performance for the majority of 2011. Coming off the 2010 supply boom, this year's Municipal debt issuance has been markedly sluggish because of required and desired budget belt-tightening. This muted issuance has caused the Muni market to feel somewhat rudderless at times, lacking the clearer sense of fair value that is created by a healthier supply calendar.

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Munis have looked to the Treasury market time and time again for direction for much of this year. Treasuries enjoyed a summer-long rally with steadily declining yields, responding to the worsening debt crises in the Eurozone, the Middle East turmoil, and the U.S. recovery's deteriorating outlook. Historically, Muni's have offered roughly 80%-90% of the yield of Treasuries with the same maturity, given the tax benefits. Though Munis have rallied strongly in concert with their taxable counterpart, Treasury performance has outpaced Munis over the past several weeks, creating extremely attractive Muni-to-Treasury ratios (110%-130%). This begs the question: why have Munis not rallied to the same degree as Treasuries and closed some of the ratio gap?

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We believe several factors contribute to the answer. Since early September, the amount of tax-exempt supply scheduled for sale has been growing. Currently close to $10 billion, 30-day visible supply touched $12 billion on September 12th, its highest total volume since mid-December 2010. This jump in supply may be difficult for the market to digest at low absolute yields.

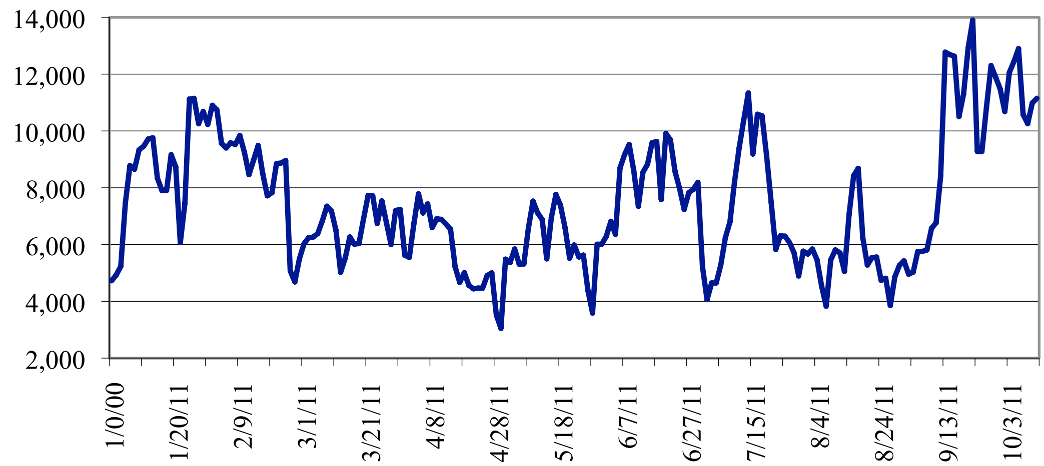

Figure 1. 2011 YTD Total Muni Issuance (in millions) **Source: Bloomberg**

Furthermore, the Obama administration revealed their preliminary details of the American Jobs Act. The President's plan seeks to create new jobs through new infrastructure projects and includes provisions that could reduce the tax benefit associated with owning Municipal bonds. Such a change to the tax code would disrupt the Municipal market (the same market through which infrastructure projects will need to be funded) and create higher borrowing costs for state and local of issuers. In our opinion, the chance of a reduction to Muni's tax-exemption is fairly remote – as we have seen similar threats like this come and go in the past. Still, it seems the threat itself has been enough to foster some weariness among prospective buyers.

Moving forward toward year's end, we expect to see continued volatility in the debt markets as a result of global headlines, the execution of Operation Twist, and mixed economic sentiment. Munis should benefit from relatively attractive ratios to Treasuries, but they may be challenged if supply proves difficult to digest. On the credit side, Municipalities have reported improving revenues and tax collections for almost two years after five straight quarters of declines originating in 2008. State and local governments, by in large, have confronted the recession through aggressive cost-cutting measures to shore up budgets. If broader economic softness persists, though, we will carefully reassess the momentum and strength of improving municipal credit characteristics.

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Caprin Investment Strategies

Caprin is currently managing intermediate portfolios to a duration target slightly longer than neutral given our favorable view of the debt markets and the Fed's ongoing commitment to accommodative monetary policy. We are utilizing a fairly laddered maturity structure ranging from 2 to 12 years. The 5 to 10 year region of the Municipal curve continues to be very steep and currently offers historically attractive ratios versus Treasuries.

We continue to purchase Muni names and sectors that provide incremental yield to portfolios in this low rate environment. Through careful credit selection, we have been able to find what we think are stronger power, healthcare, and housing names that are providing additional performance opportunities for Caprin portfolios. As state and local governments adjust to new fiscal constraints, diligent credit surveillance is an absolute necessity to ensure portfolios are not exposed to outsized credit risks. This includes assessing issuers' financial track records and analyzing multi-year revenue, expense, and reserve trends. Lastly, where we see relative value outside of a client's state of domicile that outweighs tax implications, we continue to add exposure in an effort to augment portfolio yield, performance, and diversification.

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Caprin's Short Maturity Strategy remains consistent with the Intermediate Strategy. The duration target has been set slightly long of neutral to the strategy's benchmark, taking direction from the Fed. The extremely low yield environment makes opportunistic purchases in yieldier sectors (power, hospital, utility, and housing bonds consistent with the Intermediate Strategy) crucial to generating income in our Short Maturity strategy.

Over the past decade, a well-constructed municipal bond portfolio has been a lower risk vehicle for preserving wealth and generating attractive total returns. At Caprin, we remain committed to these principals as we navigate this historic set of economic circumstances.

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