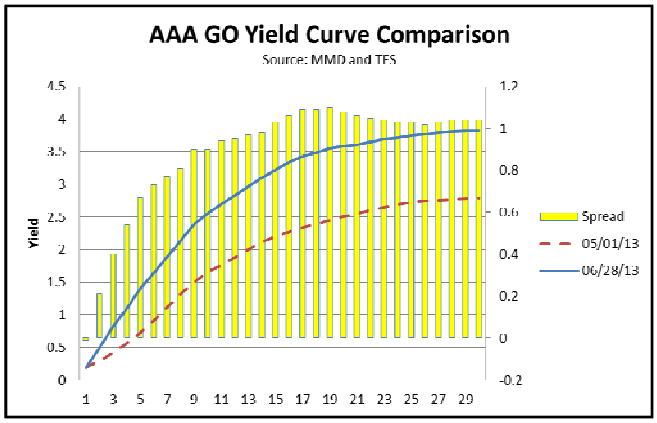
Review: Rates Go Higher

The Fed sent the Fixed Income markets into a tailspin after their May FOMC meeting. Comments were made by Bernanke that "if" the economy strengthened and "if" the unemployment rate falls, "then" the Fed would consider cutting back on it's bond purchases. These comments were an excuse for investors to sell bond funds and bonds as they anticipated rising interest rates and a stronger economy. Selling of Tax-Free bond funds intensified in June, with total redemptions of about $4.5 billion during the week ending June 26, 2013. This is the largest weekly outflow on record since data began being reported in 1992. This led to a great deal of stress in the Muni market, and negative returns of about –4.00% for long tax free maturities during the month of June. The chart below shows the yield curve shift from 5/1/13 to 6/28/13.

Muni Index	Duration	Return For June	Return For 2Q 2013
ML Municipal 3-7 Yr Index	4.05	-1.50%	-1.68%
ML Municipal 12-22 Yr Index	9.10	-4.00%	-4.14%
Taxable Index	**Duration**	**Return For June**	**Return For 2Q 2013**
ML U.S. Corp & Govt 5-7 Yr A Rated and Above	5.54	-1.96%	-3.01%
ML U.S. Treasuries/Agencies 7-10 Yrs	7.58	-2.38%	-4.09%
ML U.S. High Yield BB-B Rated	4.70	-2.64%	-1.59%



The yellow bars represent the move in bp's measured on the right side of the graph, and the lines represent the yield curves which are shown on the left side of the graph. This chart shows that for maturities of 15 years or longer yields rose about 1.00% or 100 bp's. This is a very large move for such a short period of time.

The chart below shows the change in yields for the 10 year UST bond. Since the 1st of May treasury yields have risen about 100 bp's.

Investment Opportunity?

We believe the recent rise in rates has created an opportunity for Fixed Income investors.

The Fed has said a stronger economy and lower unemployment over the next year is a condition for Fed tapering of bond purchases. However, these are not known events. Real GDP grew at an anemic rate of only 1.8% during the 1st quarter of the year. This is only half the rate the economy needs to grow during the rest of the year to show we are back to trend in economic growth. Meanwhile the unemployment rate has only declined from 7.8% to 7.6% during the 1st half of this year. At this rate of decline it will take until the end of 2015 for the unemployment rate to decline to the Fed's target of 6.50%. These tepid results occurred in spite of massive Fed purchases of bonds and lower interest rates. Since the May FOMC meeting 30 year fixed rate mortgages have risen from 3.25% to 4.50%. This will be a real test of the strength of the housing recovery to see how new homeowners react to the higher financing costs. It is our belief that higher mortgage rates, reductions in government expenditures, and higher tax rates are high hurdles for the economy to overcome and still meet the Fed's conditions for the end of QE.

Building An Income Stream

Muni investors have recently been dumping their holdings of Muni bond funds. This has caused selling of long maturity Munis by these funds to meet redemptions. The recent rise in yields caused by forced selling due to fund liquidations and the rise in Treasury yields has made long Munis attractive on both a relative and absolute yield basis. Good BBB type hospitals and utilites have recently traded at absolute yields of more than 5%. This translates into a taxable equivalent yield of 8-10%. Long munis are also cheap relative to treasuries with ratios recently trading around 110%. The spike in Tax-Free yields brought retail back into the market and should provide a base of support for Munis going forward. Most retail investors buy Munis for income, and they can now build an income steam that has historically been very attractive. After Tax yields of 8-10% are comparable to equity type returns, and beat the assumptions of most pension funds (which they have not been able to achieve during the last 15 year period.)

What Inflation?

One of the comments we hear frequently is that inflation has to go higher because the Fed is printing money excessively. Recent inflation data has not been supportive of this argument. Inflation is now running closer to 1% than the 2% rate the Fed is targeting. The chart below shows the TIP Exchange Traded

Fund (ETF). The price has been crushed and shows no evidence that inflation is out of control. Japan is still battling deflation after 20 years, and we are following with similar policies. We believe the inflation rate and the general level of economic activity are the main drivers of interest rates.

The low level of inflation and subpar economic growth are not supportive of higher levels of interest rates.

Conclusion

Most developed countries are currently suffering from over indebtedness. Past policies designed to stimulate growth by encouraging marginal borrowers to accumulate debt have left these countries with very high debt to GDP ratios. Most of these countries also have demographic trends of aging populations. The combination of high debt and negative demographics will likely lead to subpar economic growth for a long time. Governments have used unprecedented monetary tools in an effort to stop the process of deleveraging and encourage spending. The use of these tools has created an increased dependence on monetary easing in order to function smoothly. The recent rise of interest rates of 100 bp's shows just how dependent the market is upon Fed policy. Just the hint of the Fed taking away QE sent the market into a tailspin.

We believe the economy would be better served if the Fed would stop trying to manipulate it through the use of policy tools which have not worked for the Country of Japan. However, this is not our base case scenario. We feel we will be in a low rate environment for a long period of time. Short term rates will probably stay low. The recent steeping of the yield curve will likely prove to be temporary. Portfolios which are structured with some longer maturities, and consist of good bonds which are rated lower than high grades will likely provide better returns over the next few years.