KLS PROFESSIONAL ADVISORS GROUP, LLC
Complete Financial Management

Fixed Income and Credit Market Update

The fallout from the credit crisis continues to unfold. During the past months, financial institutions have recorded substantial losses with respect to mortgage-backed securities. They have also significantly increased loan-loss reserves as mortgage delinquency rates have increased and real estate values have continued their precipitous decline. The resulting constraints on financial institution capital have reduced the availability of credit that, in turn, adversely impacts prospects for economic growth. With the release of second-quarter earnings, we have seen this reflected in further write-downs and operating losses in the financial services industry.

We have also seen the federal government enact an emergency rescue plan for Fannie Mae and Freddie Mac. This underscores the magnitude of the systemic risks to the economy including homeowner losses, bank failures, inflationary pressures, currency devaluation and interest-rate risks. While the government's action mitigates immediate risk to the financial system, we continue to believe that only the completion of credit related write-downs and a robust raising of fresh capital by financial institutions will allow us to put the crisis behind us.

Reports of decreased revenues for municipalities and states as a result of a slowing economy have begun to take on a higher profile. We also are awaiting information with regard to potential write-downs in municipal pension funds that may have invested in mortgage-backed securities. Such losses would further strain the related states or municipalities who may find themselves with greater than anticipated unfunded pension liabilities. Without credible insurance in place to support municipal bonds, downgrades in credit quality would result in investor losses. To date, there has been no progress made with respect to the reorganization or recapitalization of municipal bond insurance companies. Each of these companies has either been downgraded or placed on negative-credit watch for downgrade during the past year. We continue to assess the risks associated with these municipal credit market issues and to be highly selective in the acquisition of municipal bonds.

Finally, to date there have been limited write-downs attributable to mortgage-backed securities by insurance companies other than those who have undertaken obligations to insure mortgage-backed securities through credit default swap agreements. Nevertheless, many of these insurance companies have substantial positions in mortgage-backed securities and other structured fixed income securities in their investment portfolios. Significant write-downs could adversely affect their capital.

We will continue to monitor these issues as they affect life insurance and property and casualty insurance companies. We note that with respect to property and casualty insurance a downgrade in the credit worthiness of an insurance company does not result in an immediate loss to the policyholder. The policyholder generally will have time to react to the downgrade by transferring his insurance coverage to another carrier. By contrast, a life insurance policyholder must not have experienced a change in health if he is to transfer his coverage to another carrier at competitive rates. We, therefore, suggest that exposure to life insurance credits be diversified among different insurance companies.

It is likely that, in the near term, we will learn of additional losses sustained by insurance companies and will address these on a case-by-case basis as we meet with our clients. Should you have any questions or wish to discuss this further, please call your KLS Managing Director.

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