Fed Watch

It is a sign of the times when the centerpiece for RSW's "Fed Watch" section is not devoted to the Federal Reserve's interest rate policy. Pontificating about the outlook of the Fed Funds Target Rate would only serve to minimize the radical and revolutionary responses being implemented by the Fed to combat the on-going financial crisis. While the Greenspan-led Fed focused on stabilizing the economy, financial markets and the general level of inflation with one blunt instrument (Federal Funds Target Rate), Bernanke's approach has proved quite different:

- In December 2007, the Fed created a "term auction facility" (TAF) where banks could obtain loans for up to 35 days.

- On March 11, 2008, the Fed announced a creative policy whereby through a "Term Securities Lending Facility" (TSLF) primary dealers would be able to borrow Treasury securities in exchange for inferior collateral. In order to inject liquidity into the financial system the Fed agreed to lend up to $200 billion for a 28 day period.

- March 16, 2008 in spite of drastic and creative attempts to deal with the financial crisis, the 85 year old investment bank of Bear Stearns was failing. This prompted the Fed to take a lead role in enabling JP Morgan to acquire Bear Stearns. As part of a $2 a share bid (later revised to $10) by JP Morgan the Fed agreed to accept $30 billion of bonds with an undetermined value in exchange for Treasury securities. In essence, the Fed is risking $29 billion of taxpayer dollars while JP Morgan is on the hook for a mere $1 billion.

For primary dealers, what started as overnight loans have become 90-day loans. What started as a $20 billion liquidity lifeline to dealers has swelled to over $400 billion. What used to require impeccable collateral to borrow money from the Federal Reserve has been relaxed to include mortgage securities with an indeterminate value. Collectively, do these appear to be the actions of a Fed that is concerned about inflation, the US economy or about the viability of the US financial system?

Is this the beginning of the financial crisis or the beginning of the end?

Perhaps, neither! However, just as the positive effects of the current Fed action take time to work through the economy, so do the negative effects of the current crisis. We therefore believe that the full brunt of the turmoil has yet to be reflected in current economic conditions. It is possible that we are in the early stages of a shocking foot race between two powerful forces: the Fed and a severe systemic strain that is threatening the functionality of the financial system.

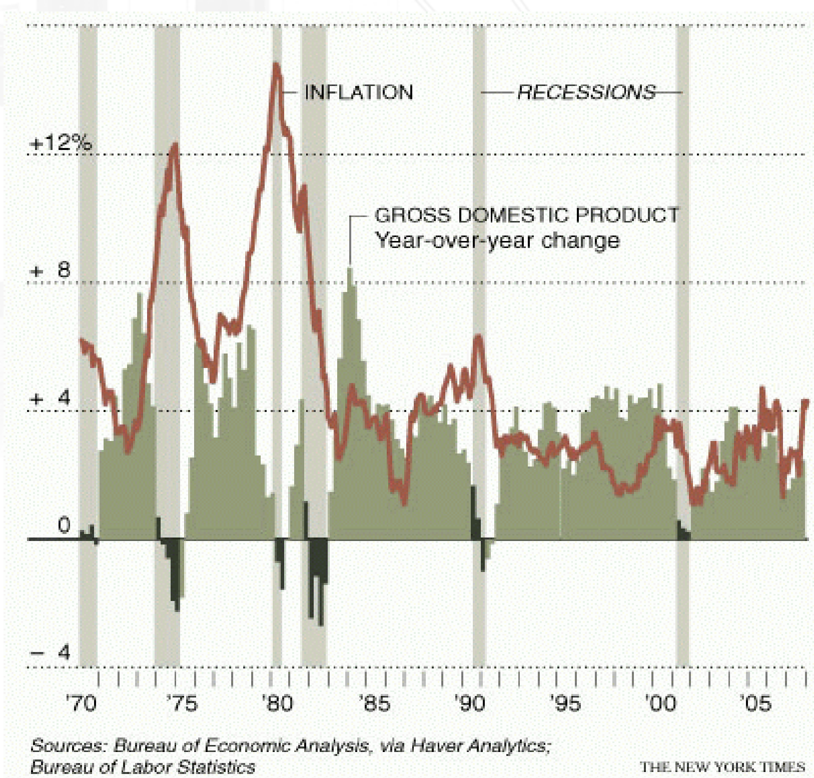
We at RSW remain concerned that the Fed dropped the baton early on in the race and is now struggling to "catch-up". To use an analogy from our 2008 market outlook, the antidote seems weaker than the illness and we may have begun administering it too late.

When an 85-year old firm like Bear Stearns goes under in two days it is a clear indication that this time is different. While liquidity is the lifeblood to most business enterprises, the serious situation that financial institutions now face is not necessarily the result of poor cash flow. Instead, investors' concerns are more squarely focused on issues concerning insolvency. While the Fed can defer the inevitable by "taking-on" Wall Streets' less liquid holdings, the valuations of these assets are still declining. This clever financing arrangement does buy financial institutions some time to get its house in order, but it may only delay the inevitable. Only when their troubled assets are sold, and the losses realized can confidence truly be restored in the financial system.

Are the renewed inflation concerns well founded?

While it is true that food and energy prices have escalated sharply, we remain confident that a price surge in broad based products will *not* materialize. The deflationary effects of a housing debacle, an implosion in the demand for credit, and a weakening job market, should soon become evident. Historically, in the post-recession months, the level of inflation has declined precipitously. Given the formidable headwinds that the economy is facing today we remain certain that the deflationary effects will be even more pronounced during this cycle.

Please see the chart below which serves to offer a historical perspective of the correlation between economic contractions and inflation. Specifically, note the path (copper line) of inflation since 1970 and compare it with the periods that the US experienced a recession (tan bars).



Municipal Bond Perspective

2008 had a rough start as the Lehman Bros. Municipal Bond Index ended the first quarter with a negative return of 61 basis points. While active equity traders may look at those results and yawn, a tax-exempt participant would have experienced more twists and turns than having driven down San Francisco's Lombard Street.

During the month of January, demand for municipal securities outpaced supply as investors were busy re-investing cash flows that they received from December's bond calls, maturing securities, and coupon payments. These activities pushed yields lower and prices higher as the index for the month of January scored a 1.28% total rate of return. February however, proved to be a horrific month, as relentless hedge fund selling drove the price of municipal securities sharply lower. The index was down (4.58%), as it turned in the worst monthly return on record. The climate changed yet again in March. Led by buying from non-traditional investors (active taxable money managers), prices of municipal securities jumped as the index rebounded by 2.86%.

Somehow, the couple of sentences written above just don't seem to be adequate given the unprecedented decline in February so let's rehash some of the watershed events. In February, Money Market Funds shunned securities that were guaranteed by FGIC, AMBAC, and MBIA, as investors began to lose confidence that these insurers would be able to maintain their "AAA"-rating. This caused a domino effect as the two largest entities who issue floating rate securities are state and local governments and leveraged players (i.e. hedge funds). By establishing a "Tender Option Bond" Program investors have the ability to borrow monies, by posting their longer-dated bond positions as collateral and issuing floating rate debt to finance their positions. As the buyers of the floating rate obligations boycotted the securities "wrapped' with FGIC, AMBAC, and MBIA, leveraged investors were effectively unable to finance their positions and thus forced to sell. With billions of dollars of securities flooding the marketplace prices fell sharply as the broker/dealer community which normally acts in an intermediary capacity lacked any buying power. As a matter of fact, many dealers ("the street") were also liquidating their trading positions as their liquidity positions were challenged due to the massive write-downs in their less-liquid holdings.

Where are we today? The level of supply-to-demand seems to have been restored as the marketplace is in the process of absorbing and distributing increasing amounts of new issue supply. The additional new issuance is a by- product of the failing Municipal Auction Rate Security market. As the auctions failed some issuers were obligated to pay a relatively steep short-term financing rate (maximum cap rates as outlined in the offering documents) to bondholders. To avoid paying these inflated interest rate levels, municipalities have been busy refinancing their floating rate obligations in exchange for fixed rate debt.

On the flipside, there are issuers that are paying below market rates on their auction rate bonds that are also failing as well. It was main line thinking that these issuers will not seek to refinance their debt because they lack the financial incentive to do so. We are seeing signs that indicate however, that no matter what the penalty rate that the issuer is paying (high or low), they just want to close out their positions and convert their debt to a fixed rate obligation. Should this occur, the amount of new issue supply will continue to be robust and tend to keep the ratio of municipal yields relative to Treasury securities at relatively high levels.

As of this writing Municipal bond prices have continued to rebound and are well out from under. As a guidepost, “natural AAA”-rated 15 year tax-exempt bonds can be purchased at the same yield as Treasury bonds. This compares to an 11 year average of 83.56%. Said differently, if 15-year Treasury’s are yielding a 4.12%, then tax-exempts could drift to a 3.44% and just be back to the longer term average. Not that we are forecasting this amount of improvement over the near term, but we still believe for longer-term investors this asset class offers extraordinary value, particularly on a risk adjusted basis.

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Managing Member

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***Lehman Brothers Municipal Bond Index, is a broad-based total return index comprising investment grade, fixed-rate, and tax-exempt issues, with a remaining maturity of at least one year, including state and local general obligation, revenue, insured, and pre-refunded bonds that are selected from issues larger than $75 million dated since January 1990. Investors cannot directly purchase an index. The returns of the index are shown for comparative purposes. When comparing the investment returns of the manager to the index, you should know the manager does not necessarily hold the same securities that comprise the index, the index may not reflect the asset allocation and portfolio characteristics of accounts managed by the manager and that the index is unmanaged.