For this newsletter, we are departing from our typical remarks and prognostications to allocate maximum space to Municipal Bonds. With current conditions and RSW's 2009 forecast remaining largely unchanged, let's quickly dispense with a summary of the current environment:

- The economy stinks (a technical term),some bright spots maybe, but too early to tell
- The Fed's zero interest policy should continue for many months/years
- The Federal Reserve has "played their ace in the hole" à la their "Quantitative Easing" policy (act of printing dollars to buy Treasury bonds)
- Deflationary environment is in effect
- Unemployment rate continues to surge

Over the last several months we have read a number of articles that seemed to us to be too upbeat or too pessimistic with respect to the financial health of state and local governments. Therefore, it seems appropriate to assemble our commentary into three segments: the Good, the Bad, and the Ugly. Since we never lose any sleep contemplating the good let's start with the bad.

The Bad

Listed below are the titles of some of the more pessimistic editorials that have appeared over the last quarter:

- Muni Bonds keep Buffet up at night
- Backstop sought for Muni Arena
- Red flags that Muni Investors can't see
- Moody's warns of potentially massive Muni-bond downgrade

Should the fiscal health of state and local governments worsen amid declining revenues and rising costs, additional bankruptcy and default concerns could emerge. While the media has done a remarkable job creating hype and hysteria, I can only imagine that we will see even more disconcerting tag lines as the year unfolds. Some of these may include:

The Ugly

- Every state is on the verge of collapse as budget deficits swell
- Pension benefit and health care costs are strangling cities and states
- Lurking beneath the surface are great risks that Municipal Investors don't know

Over the past several weeks, new developments have caused additional investor angst. For example, on April 8th, Moody's downgraded the credit rating of Berkshire Hathaway's monoline bond insurance subsidiary: Berkshire Hathaway Assurance Corporation. This unit's credit rating was cut one notch from "Aaa" to "Aa1". While the loss of the top ranking is newsworthy, it certainly didn't come as a surprise to many investors. During this financial and economic crisis, most sectors from manufacturing to financials have been severely impacted. From GM to GE, and Fannie Mae to Bank of America, organizations have been experiencing severe financial stress. In fact, even the credit quality of US Agencies and Government debt are being tarnished and questioned by domestic and foreign investors. Aside from a skyrocketing $10 plus trillion deficits that the U.S. is amassing, the health of the Treasury's balance sheet has been skewered as toxic assets have largely replaced US Government holdings. Does this mean that aside from having the right level of security clearance, a hazmat suit will be standard issue when government employees seek to enter the Treasury's vault? With credit concerns rising about U.S. Treasury debt, should it really come as a surprise that New York City or the State of California are experiencing fiscal plight?

As municipal investors, there are two obvious questions that we need to ask ourselves. How secure is our principal and interest? And do current yield/prices already reflect the risks of this challenging environment. To help answer these questions we feel a more thorough examination of municipalities and their related debt is warranted, which brings us to the Good.

The Good

As fear engulfs the psyche of many investors, the positive attributes about the fundamental strengths of municipal bonds is sometimes overlooked. Below is a list of the more prominent and unique powers that are afforded to state and local governments. Please see below:

- Ability to enforce and collect property tax receipts even during the most challenging times: while many individuals are concerned that an increasing pace of foreclosures presents a risk to property tax collection, this is not the case. Property taxes are first in line to be paid (priority lien) and municipal governments can foreclose on the property to recover any unpaid taxes.
- Contrary to popular belief, the revenue stream of many municipalities is quite diverse, and not just dependent on property taxes. Other revenue sources, such as sales tax, income tax, and excise tax aid municipalities in smoothing out the volatility of their income.
- Since the Great Depression, the sophistication of financial internal controls and reporting has improved markedly. Much the same way that corporate America monitors its inventory on a real time basis, (Just–in-time inventory) governments are monitoring its receipts, disbursements, and making the necessary adjustments.
- A key area of strength for municipal debt holders is the fact that many issuers must adopt balanced budgets, as some states constitutionally require.
- Quite often, higher investment grade issuer's build-up cash reserves (rainy day funds) during the good times, in order to provide a cushion during the bad times. Many of these issuers are tapping these resources today.
- The U.S. Government is providing financial aid for a multitude of issuers, à la the American Recovery and *Reinvestment Act of 2009.*
- Although municipalities are not referred to in this context, they are a virtual monopoly as they solely provide essential services.

- While unexpected shocks to financial performance do occur in municipalities, most are not “left field events” and tend to occur over longer periods of time.

Conclusions

For several quarters, we at RSW have been sounding the alarm that this economic and financial quagmire would roil the financial strength of municipalities, eventually leading to a greater than average amount of downgrades. In other words, we never minimized the severity of the crisis or attempted to “put sunglasses on a pig”. With that said, we must put the effects that the current economic calamity has on States into perspective. For example, according to Barclays Capital the average budget gap for states during the 2001 – 2003 recession was 14.4%. This is not radically different from the roughly 15% gap that exists today, or the most pessimistic projected gap of 17% by year end 2011.

While it is human nature to react to scary headlines that appear in the media, very rarely are these new topics that are being brought to light. As is typical with these musings, professional investors and traders have long been contemplating the subjects that are picked-up by the press. We need to look no further than the April 7th Moody’s release in which they assigned a negative outlook to the entire U.S. Local Government sector. While reporters espouse this action as new news the facts tell us otherwise. First, buried in the Moody’s article appears the following: “for now we believe it is important to note that Moody’s is NOT talking about a sharp increase in default risk, but rather the potential for more widespread ratings downgrades then have been the norm in previous weak economic cycles.” Said differently, we need to be mindful that there is a chasm of difference between downgrades and defaults. Secondly, “money talks” as municipal bond prices actually rose on the day of this news release. This is the market’s way of saying to Moody’s that the information is stale and that you are telling “Noah about the flood.”

Finally, this is an environment to be anything but cavalier. We, at RSW, still anticipate further erosion in the credit quality of some issuers and will work diligently to identify those that we believe to be among the strongest. To us, it is still too early in the economic/credit cycle to sacrifice on the quality of our portfolios in order to enhance tax-exempt cash flow.

Robert S. Waas
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[1]*As measured by the Lehman Brothers Municipal Bond Index.*