“V shaped”, “U shaped” or “Λ shaped” Economic Recovery?

At RSW, we are genuinely surprised at the pace of economic activity, as we projected a more moderate recovery than the one that has unfolded. So, where do we go from here?

A year has now passed since mass panic and hysteria engulfed our financial system causing it to convulse. It was at that time, where no scenario seemed too unimaginable or negative. The contrast between the mood of investors now and then could not be more disparate as fears of a total collapse of private credit seem like distant memories today. Instead, market participants are back to fretting about the possibility of a spike in bond yields. Some would take this development as a sign that the economy and the markets are returning to life as we once knew it. After all, worries about surging bond yields traditionally crop-up when the economy is surging and financial conditions are favorable. In fact, many would deduce that this is an indication that we are back to business as usual. Yet, we at RSW believe that it is a mistake to reach such a conclusion.

While we expect the recovery to continue throughout 2010, there are formidable headwinds:

- Mortgage foreclosures are rising (up 8% from year ago levels) and the trouble is spreading to the prime loan arena. Likewise, high vacancy rates and trillions of dollars of debt expected to roll over in the next several years continue to add stresses to the real estate market.
- High unemployment has led to weak income growth and a low level of consumer spending.
- The poor fiscal health of state and local governments should continue to act as a drag as budget cuts are implemented and taxes continue to rise.
- Federal stimulus monies to the states are set to expire in 2011, which should cause further economic strain and dislocations.
- Federal deficits will likely exceed $1 trillion annually, keeping interest rates higher than would otherwise be the case.
- The Federal Reserve has concluded their program of buying mortgages and this could exert upward pressure on mortgage rates.

In contrast, there are also important forces that could continue to buoy economic activity:

- The United States (and other countries) have applied enormous amounts of stimulus to spark economic growth. This has enhanced the pace of U.S. exports, particularly in the Asian markets.
- Global short-term interest rates remain very low.
- Low inflation expectations may allow the Fed to keep short-term rates low.
- Pent-up demand by business for capital expenditures (cap ex) has added to GDP activity, and could serve to propel growth for the balance of the year.
- U.S. corporations have done an excellent job of managing their cost structure resulting in relatively healthy balance sheets.

Uneven Recovery: Strength In Large Firms Versus a Weak Small Business Sector

Aside from some of the concerns highlighted above, we remain troubled that the relatively robust economic data witnessed as of late won't be self-sustaining. While the pace of growth has been gathering strength for the last several months, we believe that much of these gains are related to the economic strength of multi-national corporations. For example, businesses have been busily replenishing their depleted inventories, and satiating their pent-up demand by investing in capital expenditures (cap ex). However, recent reports suggest that inventories are now back in line with sales and that the inventory cycle is mostly over. It is therefore unlikely that this segment will continue to provide the same support to GDP as further increases in production now will depend on increases in consumption or exports.

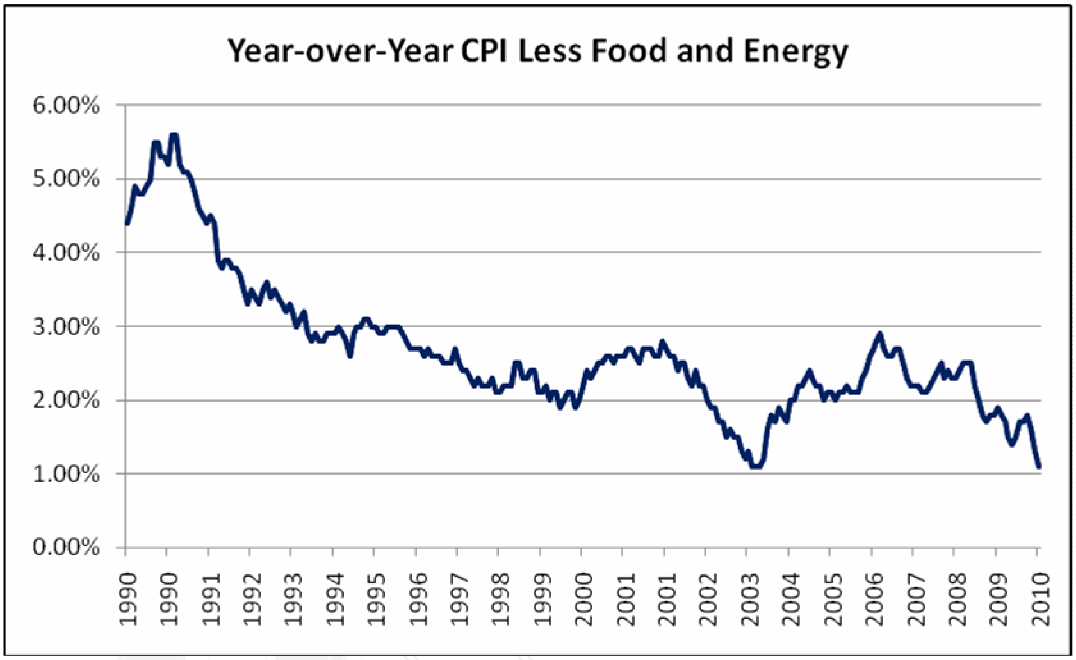
Contrasted with the relative financial health of large corporations, the small business sector is still "stuck in the mud." Small business is a proxy for the health of the general economy, as the segment employs over half of all private sector employees. Unfortunately, small business owners are becoming less optimistic about their business prospects and may be scrapping their plans to re-hire given the tepid demand for their goods and services. Higher taxes and health-care issues, a higher minimum wage, and uncertainty about policy are also concerns. Bottom line: small businesses are struggling amid concerns about sales, credit, and declining prices. This may be in stark contrast to the experience of the managers of larger corporations.

Just Say No To Credit

There is evidence that consumers are continuing their deleveraging process by shunning new credit obligations, and paying-off or defaulting on outstanding obligations. At the same time banks aren't incentivized to loan monies to "John Q Public" as they are busily lending money to "Uncle Sam". This is occurring as banks are borrowing money at an interest rate close to zero and using the funds to purchase intermediate maturity Treasury bonds which pay a relatively high interest rate. The problem with this activity is that Depositor money is not being used for productive purposes such as building manufacturing plants, and other related investments that will create jobs and grow the economy. Because of these forces, the level of outstanding loans at U.S. commercial banks has nose-dived by roughly 8%. This phenomenon hasn't gone unnoticed by Fed Chairman Ben Bernanke and company as they slipped in a warning that bank credit "continues to contract" in their latest statement.

What Inflation?

If the U.S. economy is truly on solid footing, then why does the core rate of inflation (consumer price index excluding food and energy costs) continue to fall? Please see the chart below which shows the historical level of the core CPI (consumer price index) since 1990. As "Needle Ben" (Federal Reserve Chairman Bernanke) "injected" mind numbing amounts of liquidity into the heart of the economy, there has been a growing chorus of those fearing that the Fed's "open spigot" monetary policy would be highly inflationary. However, deflation remains the more potent of the two forces. Companies seem to have figured out how to do more with fewer resources. This higher level of efficiency has created a great deal of slack in the economy. Low capacity utilization levels in the industrial sector, rising vacancy rates in the commercial real estate arena, and high unemployment are further evidence of an ongoing deleveraging process which should prove to be deflationary at all levels.



Municipal Recap

During the first quarter 2010, amidst an endless stream of gloom and doom municipal news articles, the tax-exempt market continued to provide slow and steady returns. One way to measure the reduced volatility of the municipal bond market is by comparing 10-year Treasury and municipal bond yields. Since the start of the year, 10-year tax-exempt yields have been relatively resilient, even as 10-year Treasury bond yields have fluctuated more dramatically.

In our 2010 Outlook, we forecasted that 10-year Treasury yields could rise during the first half of 2010 and reach 4.25%. In addition, we anticipated that if this were to occur the increase in tax-free rates would be more modest. At this juncture, although Treasury yields did “back-up” to 4.01% in April, we still expect some additional upward pressure on interest rates. However, we would certainly view this occurrence as an opportunity to extend the average maturity of our holdings. The goal here would be to enhance the value of our client portfolios as higher yield levels are locked-in, therefore better positioning the accounts to capture the price appreciation in a declining interest rate environment.

Aside from movements in the Treasury bond market, there are awesome technical forces at work that should ensure tax-exempt yields stay relatively low. One key aspect is the positive consequences of the Build America Bond program (BAB’s). Here municipal issuers have the opportunity to offer bonds in the taxable bond market. What makes it cost effective for issuers to raise much needed capital in this arena is the reimbursement they are receiving from the Federal Government for the increased coupon rate. Currently, issuers are being paid a subsidy equal to 35%, but as the program is extended beyond its original 2010 sunset date, the subsidy may drop to 30% in 2013.

With state and local governments taking advantage of this program, new issue supply is being diverted from the tax-exempt segment to the taxable market. In other words, as we move through the year there should be limited product to choose from at a time when demand is poised to heat-up. In fact, because of an overwhelming amount of coupon payments, maturing securities, and bonds being called, investors will be flush with cash that could be reinvested in the tax-exempt area. When we consider the amount of bonds that are scheduled to be offered in the tax-free segment and subtract from it the anticipated demand, we find that the market may actually be in a shortage situation. Said differently, the demand could actually exceed the supply by $63.4 billion during the May through July period.

Aside from this powerful force that is serving to support tax-free bond prices, we also need to speak to the rating methodology that rating agencies are using to quantify municipal credit risk. Please see below:

Municipal Bond Ratings Will Never Look The Same As Credit Ratings "Recalibrate" To Global Rating Scale

During the month of April, both rating agencies: Moody's and Fitch, replaced their longstanding methodology for rating municipal bonds based on a comparative scale with a global rating standard. In short, municipal ratings have been migrated and mapped to a "global rating scale" that now allows for direct comparisons to corporate and other fixed income credit sectors. While the market impact of the new credit rating criteria is difficult to ascertain at this point in time, we will offer some observations. One thing that is certain however is that the past is no longer prelude to judging credits in the municipal market.

The prior municipal ratings have disappeared, will no longer be published, and have been replaced by new global scale ratings. Approximately 18,000 municipal issuers and 70,000 Moody's ratings have been changed as a result of this process. Standard and Poor's, whose municipal ratings, on average, tended to be higher than both Moody's and Fitch ratings, would argue that their ratings already reflect a global outlook as more than 4,000 ratings were upgraded during the course of 2008 and 2009, despite the declining economic environment, and as compared to approximately 400 downgrades.

Virtually all investment grade general obligation, tax-backed, public university, water and sewer, and non-generating utility bonds, with few exceptions, will see their credit ratings "migrated" upward by one to three notches from the prior municipal rating. The largest "bang for the buck" will occur at the lowest municipal investment grade rating levels. A previously rated Moody's general obligation bond rated "Baa3", the lowest investment grade rating, maps to either a "Baa1" or "A3" global scale rating. A municipal "Baa1" general obligation bond maps to a "A1" global scale rating – a full three notch upward migration.

Even the most casual observer of the bond market would question this "upgrade" of municipal credits in the eye of the worst economic environment since the Great Depression. However, in fairness to the rating agencies, the initial planning and consideration for the shift from a municipal to global rating scale predates the onset of the recession and in fact was postponed by the advent of the economic slowdown.

Nevertheless Why The Shift To a Global Rating Scale At This Time?

- The rating agencies would argue that the significantly lower default rates associated with investment grade municipal bonds when compared to other sectors was not captured by the municipal rating scale
- The new taxable municipal Build America Bonds ("BAB's") introduced in April 2009 mandates comparisons to taxable sectors
- The demise of municipal bond insurance put greater focus on municipal credit ratings
- Congressional pressure reflecting the rating agency role in the structured finance and mortgage bond debacle
- State Attorney General threatened lawsuits

What If Anything Does This Mean For The Municipal Market?

- Higher credit ratings for most of the municipal market are not a harbinger of lower yield levels
- Higher credit ratings means credit compression in the higher investment grade categories
- Credit distinctions and the ability to discern nuances will not be easily distinguishable in a market where credit ratings will be "homogenized" at higher levels
- Future credit downgrades and upgrades should occur with significantly less frequency
- Credit sectors not subject to the upward migration such as housing, health care, and private schools, could see lower relative yields as the supply of Baa/BBB bonds declines dramatically

Summary And Conclusion

While the new municipal mapping to a global rating scale makes comparisons to corporate sectors meaningful, individual investors in the tax-exempt market remain focused on making such credit distinctions within the municipal market. The demise of the long standing municipal credit scale will make such judgments more difficult for the casual investor.

Our Philosophy Remains Unchanged

We will continue to do independent research to ascertain value for clients that seek to maximize income within the parameters of minimizing interest rate and credit risk, while adhering to the maxim of capital preservation in an unsettled and volatile market environment.

Sincerely,

Robert S. Waas
Managing Member