Friends, Central Banks, and a Rodeo

At RSW, we have always put a premium on communication, whether the topic was unpleasant or calming. Our goal is to "call them as we see them", in a manner which reflects a view that does not believe the "end is near", nor reflects the belief that Central Banks can save the world. Moreover, our analysis and opinions are borne from a conviction that events over the last five years have materially altered the socioeconomic world to which we and our fathers have long grown accustomed. Therefore, we must venture beyond our historical expertise and comfort zone in order to better understand our current predicament.

So what should you expect from today's missive?

Our usual discussion of Debt, Growth, Deflation, Deleveraging, and Jobs will be here, but only indirectly for, in our view, they are only the "elephant's leg" of this tale. Said differently, a mention of those economic concepts today without proper perspective is the equivalent of a blindfolded man successfully identifying an elephant with just the use of his hands. As we have often said, we are approaching this "new world" with caution and trepidation. We believe that many current hazards are underestimated because they are not well understood, and because many market participants put too much weight on being "back from the brink". When we think about it, this complacent phase is potentially more dangerous than when the "wolf is at the door", and one is forced to act.

If you are curious about what caused this wave of introspection, it began with a dinner I had with two friends (Jim and Glenn). They were confused about what was happening in Europe, how it applied to us here in the States, and one friend even mentioned the possibility of a housing bubble in China. They thought I could shed some light on certain aspects of these conditions.

With beer in glass, I decided that an analogy might be the best way to explain a rather complex problem. Although not perfect (few analogies are), I asked them to assume that we had a friend in common (named "Tip") who was in deep financial trouble. Let's assume that Tip draws a paycheck of $50,000 a year, but managed to accumulate $400,000 in mortgage, auto, credit card, and other assorted debt. Furthermore, let's assume that Tip is experiencing a cash crunch and we agreed to lend him $5,000 each for the next three years at an interest rate of 1% per annum.

Tip's situation is improved from the point of view of immediate insolvency, but the most important factor for there to be a good financial outcome (i.e., us getting paid back), is that one of two things has to happen. Tip must secure a much higher paying job, and/or significantly reduce his debt load. The time that our collective $15,000 buys him is only important if Tip uses that time to change the circumstances that caused his financial quagmire. I told my friends that they should now have an understanding of Europe, and perhaps even, the essence of our problems in America.

Relax, it gets more interesting. I also asked Jim and Glenn to assume that our created friend Tip was actually a pig, Ok I mean PIIGS (Portugal, Italy Ireland, Greece, and Spain), and that we three lenders were the European Central Bank (ECB). I explained that now the real work begins. These countries (Tip) need to find a way to grow, to reform antiquated pension and medical plans, and to slow their burgeoning debt load. While the PIIGS work on reforms, authorities continue to push for larger bail-out programs via the EFSF, EFSM, and currently ESM, (aka Band-Aids), International Monetary Fund (IMF) aid packages (aka gauze pad), and may inevitably negotiate a true European fiscal union (open heart surgery!). While Europe has vowed to tackle all of these challenges, and has heard commitments to act, we can only opine on what has actually happened so far. Yes, you already know the answer: Not enough!

As the Great Recession began, the ability of many households and private institutions to meet their debt obligations was impaired. Central banks swooped in and purchased some of these weakened debt obligations by expanding their balance sheets. The problems escalated however, as the risk of default spread to sovereign countries. In response, the European Central Bank, in the spirit of buying some time for the economy and the financial system to heal itself, established an entity called the LTRO (Long Term Refinancing Operation, aka tourniquet) that can lend money to Euro-Zone banks at a rate of 1%. This is the European style of "Quantitative Easing" (QE), whereby the banks use these funds to buy more sovereign debt of dubious credit worthiness, and put the bonds on deposit at the ECB. This can benefit the banks as they can earn the spread between the yield that they collect on their bond investment, and the 1% financing cost. Is it also designed to create another source of demand for the sovereign bonds, thus serving to drive down their market yields.

On cue, as the bond buying begins, market interest rates fall and the financial markets rejoice that the problem is "solved"…Not so fast! The downside of this strategy is that the banks have increased their exposure to "troubled" sovereign debt that they now own with borrowed money (leverage). It is therefore possible that the very banking system that the Central Banks are attempting to provide assistance to have actually been weakened. Said differently, the economic and systemic risks have not been squelched but instead amplified as the “boomerang” could come back around. The “hazard” has been transferred from the banking sector back to the Central Bank as banks may be less likely to be able to pay the funds back to the Central Banks. This could impair the financial health of the “Lender of Last Resort”, serving to put a hole in the “safety net”.

This European Central Bank has been busy installing this arrangement, as their balance sheet totals nearly $4 trillion, an amount that is approximately 1/3 the size of the Euro-Zone’s entire GDP. As we all know, these activities aren’t new to us in the States, as the Federal Reserve has expanded their balance sheet to include roughly $2.8 trillion of debt that includes longer maturity Treasury bonds and mortgage securities. This may be an appropriate time to mention that we are in no way trying to minimize the Central Banks efforts to resolve the crisis -- just that we believe the real work has yet to begin. The reality of the situation is that the LTRO, in making the three year liquidity loans, almost certainly saved Europe from at least a run on the banks, and probably some bank failures. However, the problem remains that the banks in Europe are overvalued, undercapitalized, and wildly overweight with exposure to sovereign debt.

In thinking about how liquidity should be considered a solution in and of itself, we reflect back to 2007 when Bear Stearns (former investment bank) was managing two hedge funds that were stuffed with securities backed by risky home loans. The financial markets convulsed as market participants speculated about the demise of the entire investment bank. In order to calm the financial markets, the Federal Reserve announced that they would provide all of the liquidity that the market would need. The stock market rejoiced, and rallied 10% because the Fed “solved” the problem. What the Federal Reserve did was necessary, but it did not stop the housing bubble from imploding, nor Lehman Bros. or Bear Stearns from failing. Sorry to break the news to you my newfound friend “Tip”, but added liquidity can buy some time, but in and of itself, it cannot produce a desired outcome.

In mid-March, the Federal Reserve conducted a stress test to determine which banks had enough capital if the unemployment rate hit 13% or housing prices dropped another 21%. While it was good news that 15 out of 19 banks “passed the test”, we believe that the test was given to the wrong banks. Perhaps, it would make more sense if they stress tested the Fed! This state of affairs reminds me of a scene from the 1978 *Superman* film, where there was an exchange between Lois Lane and Superman. As Lois Lane is falling from a skyscraper, Superman flies under her, saving Lois from a fatal fall. Superman says to Lois Lane, “Easy Miss. I’ve got you.” Lois Lane replies, “You’ve got me, who’s got you?” It appears that our lender of last resort (Superman) has fallen sick, and one has to begin to ask: How many Band-Aids are left in the box?

Is it possible that the U.S. is really Europe except with a six hour time difference? Our relative size and resources, our reserve currency status, and our position as “the least dirty shirt” buys us some time. Deleveraging, extreme debt levels and low wages should ensure that U.S. growth rate is on a low or flat trajectory. At least in Europe, legislators seem to be somewhat aware that they have a problem. I am not sure I can say the same for our lawmakers. Here, we seem to get more “lip service” than concrete solutions. In spite of Ben Bernanke’s pleading with legislators to begin to deal with our fiscal problems, there is nothing being done. Maybe we should put together a blue ribbon commission and call it Simpson Bowles.

There is a school of thought that believes “while the challenges are numerous, elected representatives will find solutions, over time, to deal with the predicament at hand”. A main tenant of this thinking is that Central Banks around the world will formulate innovative means to battle the crisis. At RSW, we are not attempting to “arm-chair quarterback” and comment about whether this view is right or wrong. Nor are we about to join the fray that recommends the avoidance of an investment in Europe, overweight the financial assets of developing economies, or high yield, and equity markets. Investors have a range of risk and return profiles that seldom warrant “100% in any investment”. We merely seek to make two essential points.

First, as we have often written, the financial markets seem to race upward or downward depending on their momentary view of the world. However, whatever you believe about the global landscape, one needs to admit that the world we have known for the last 50 to 100 years is not the world we “occupy” today. You don’t have to wear a “sandwich sign” that reads that the end is near to believe that the developed economies of the world are threatened with insolvency if they cannot formulate growth policies, employment reforms, and long term debt reduction. In short, depending on the specific country, debt is growing two or three times as fast as GDP. OECD central bank balance sheets now comprise an unprecedented 30% of global GDP. Not only is this growth in debt not sustainable, in our view, it is truly dangerous.

The second point is that it is only prudent to admit that maybe there isn’t a foolproof navigation system that will ensure that the global economy will never be “driven right up onto the rocks”. Therefore, it may be necessary to look at the world in the future like a global “Goat Rodeo”. This is an expression used by aviation people to describe a scenario that requires about 100 things to go right at once if you intend to walk away unharmed. A second definition describes a chaotic situation that involves many people each with a different agenda and a different view on what it takes to solve a problem. Does that sound familiar?

Municipal Commentary -- Why We Keep a Sharp Edge on Our Pencil

Right on cue, like so many times over the past decades, tax-exempt yields declined during the month of January. As you may recall from many of our earlier missives, this period is known by market participants as the “January

Effect" in which investors redeploy the relatively large level of cash they received from bond calls, coupon payments, and maturing securities at year-end. Given the hiatus of municipal issuance that usually occurs during this period, historically, prices tend to rise as demand exceeds the available supply of bonds.

During February/March, the pattern tends to "flip" as the pace of new issue supply rises and the level of investor demand shrinks. Quite often, this phenomenon serves to explain why tax-free bonds have scored the weakest total rates of return during the March through April period. In fact, yields reversed much of the decline from the January effect. The yield on bonds maturing from 1 to 15 years ended higher than when the year began. In addition, rising U.S. Treasury bond yields have put further pressure on tax-exempt rates, as both markets tend to move in similar direction. Aside from the "seasonals", Treasury yields have recently jumped as investors are encouraged by the stronger economic data released during much of the quarter. As the top portion of this commentary inferred, we believe that the financial markets may have priced-in a higher level of growth and higher level of inflation rate than may actually materialize.

Municipal bond investors see what appears to be a recurring headline with only the name changing, be it Jefferson County Alabama, Harrisburg Pennsylvania, Stockton California, or Any Town Rhode Island. In a marketplace with over 60,000 issuers it is important to keep in mind that there will certainly be some defaults. However, these isolated occurrences of missed coupon payments should not be a harbinger of widespread defaults, or Chapter 9 filings to come.

As always, the news cycle will ebb and flow, and we would certainly expect that there will be future news that may cause some investor anxiety. While it is true that the headlines about state budget deficits will be painful, and the political horse trading to close the gap excruciating, states (except Vermont) must balance their budgets annually. This is one of the key strengths inherent in the creditworthiness of municipal issuers, and one that certainly distinguishes them amongst other sovereign entities.

As always, proper perspective is required. Keep in mind that the average investment grade credit rating for the municipal market, as a whole, is still in the "AA" category, while the corporate bond market average credit rating remains below investment grade. The few "AA" corporate credits are dominated by financials and utilities, with virtually all the financial credit ratings under major duress with the potential for multiple downgrades in the very near term.

- Nevertheless, municipal credit downgrades continue to exceed upgrades in a tepid economic recovery.
- State tax collections for the 4th quarter of 2011, compared to the same period in 2010, increased by only 2.7% (Rockefeller Institute) – a significant slowdown from the 11.1% and 6.1% year-over-year growth reported in the second and third quarters of 2011 respectively.
- Social service spending continues to drain governmental revenues.
- While 43 states took various actions to reduce pension problems, pension issues remain problematic for many state and local governments.

As we have said for years, "this is an environment to be anything but cavalier". The combination of falling receipts and relatively large post-employment benefit expenditures offers some insight into the struggle that many municipalities have been, and will continue to be battling. The process to reorienting their budgets with the "new reality" has been painful, but there is more work to be done.

Robert S. Waas Managing Member	**Robert K. Coates** Senior Portfolio Manager	**Matthew T. Werner** Portfolio Manager	**Mark J. Tenenhaus** Director of Municipal Research	**John A. Carlson** Director of Business Development	**Marites A. Vidal** Data Analyst	**Randy J. Fox** Operations Associate	**Brian E. Pawl** Operations Associate	**Edgardo M. Brigino** Operations Associate