Fed Watch

As is quite often the case one must watch the Fed and not just listen to the Fed. After all, actions speak louder than words! On April 30th, the Federal Open Market Committee (FOMC) once again elected to reduce the level of short term funding by 25 basis points to 2%. With the cut behind them, most market participants viewed the Fed to be on hold through August. During June however, those beliefs became unhinged as Bernanke increased his inflation fighting rhetoric.

At an economic conference on June 9, the Chairman commented that there has been only limited pass-through of soaring material costs to consumers. With that said, he remained concerned about the outlook for price stability and said that he will “strongly resist an erosion of longer-term inflation expectations.” Perhaps more important was Bernanke’s assessment of the overall economy. Specifically, he stated that “although activity during the current quarter is likely to be weak, the risk that the economy has entered a substantial downturn appears to have diminished”.

Is Bernanke somehow making a case that the economic outlook is brightening? Is he looking at his charts upside down? With very little to point to in the way of improved economic data, we can only conclude that the Chairman had an ulterior motive in making his remarks, such as trying to stabilize the US dollar. Is there a better way to stop the buck from sliding than to put the market on notice about possibly raising interest rates?

Risky Business

While Bernanke’s hawkish rhetoric did serve to temporarily help the currency, it came at a price. The U.S. Treasury market quickly recalibrated the risk of a Federal Reserve rate hike and began pricing in a quarter point rate change in advance of the August FOMC meeting. This created a severe sell-off in shorter-maturity bonds as yields on 2-year bonds climbed from 2.50% on June 2 to 3.04% on June 16.

In the past, we have observed that the Fed needs to find a new antibiotic for this strain of financial flu. As we noted in our 2008 Outlook, "The economic environment over the last several months has been challenging, but may only serve to offer a taste of some events that could unfold in 2008." At RSW, we remain gripped by the concept that the turmoil in the single-family housing market is just the beginning of a "fundamental transformation” of our business practices and extends beyond real estate to the broader economy.

Just as in Poker, eventually you must lay your cards on the table. Bluffing about raising rates may produce unintended consequences that won’t get to the root of the problem: enticing creditors to lend, consumers to spend, and corporations to borrow.

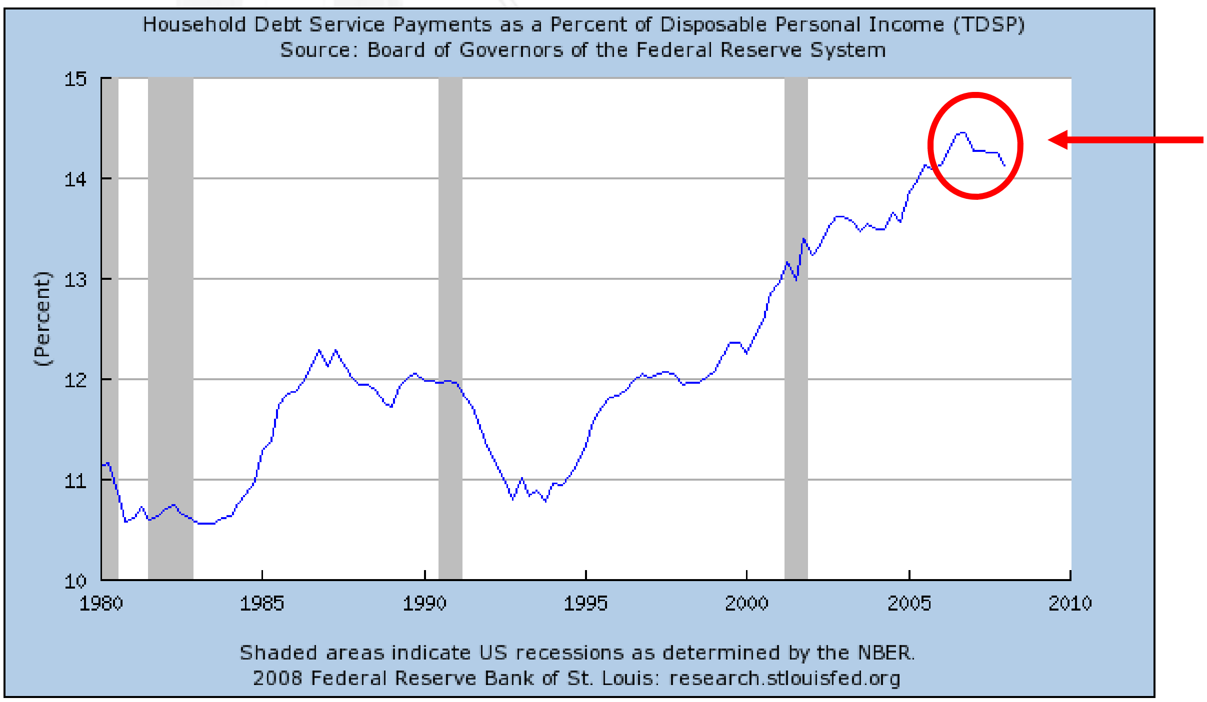
Inflation, Deflation, or plain old Aggravation

Recently, there have been many articles published about the scary inflationary spiral that is about to engulf the U.S. and other parts of the globe. Although we weighed in on these fears in our June newsletter, we feel compelled to once again analyze the facts (as we see them) about Deflation and Inflation.

There are many forces at work that should lead to Deflation. A key element is the relationship between the amount of Household Debt and Disposable Personal Income. Why is this interplay important?

As economic activity begins to slow, producers of goods are willing to lend money to consumers at below-market financing terms in order to increase their sales. In essence, they are willing to give away a part of their profits to enhance their revenue.

So where's the rub? Let's explore the other side of the mountain. While rising food and fuel costs are elevating the current pace of inflation they should eventually cripple the ability of consumers to spend on discretionary items. Therefore, continuing to call for a higher inflation trend can only be based on an assumption that consumers still have sufficient levels of disposable income, access to credit, or remain confident about the future. The chart below depicts a consumer that may already be “tapped” out. Debt accumulation as a percentage of disposable income is rolling over (please see the arrow)



When borrowers can no longer make their debt payments three things should happen: (1-) the debt accumulation stops, (2-) the demand for "stuff" collapses, and (3-) the price of goods falls. We believe we are early in this process as two and three have not begun in earnest.

Historically, as this correction unfolds, producers should scale back their levels of production, the unemployment rate should rise, and the FED comes to the rescue with lower interest rates. Many will argue that this is where we are today , as a typical business cycle is unfolding. We believe differently. The parabolic level of debt service payments relative to disposable income was created over the last ten years and it is hard to imagine that a short and shallow correction (see arrow) is now complete. Like all other bubbles that burst, a modest retrenchment is probably not in the offering.

Bottom line

Bond market participants are confronted with two enormous opposing forces:

- The fiscal implications of bailing out every financial institution that plummets towards insolvency
- The economic implications of failing institutions, a tapped out consumer, housing depression, and rocketing fuel costs.

While the market still believes that inflation is the problem, the additional pressure of the government being the financier of last resort has already created an overall upward pressure on interest rates.

If as RSW believes, the market begins to understand that deflation is the coming problem then the recessionary forces that are relentlessly building will, we believe, trump the fiscal concerns.

Municipal Market Commentary

The global de-leveraging process (credit crisis) that has engulfed the financial markets has also left its mark on the municipal bond market. In some respects, the tax-exempt business more closely resembles the marketplace of the mid-1980's than a year ago, mid-2007. Below are some of the key differences and the implications of this changing environment.

With the health of the financial guarantors on life support, credit quality spreads (differences between lower-rated bonds and highest quality) have widened dramatically. Similar to the mid- 1980's understanding the issuer of the bonds is the key to ensuring the timely payment of principal and interest, rather than a reliance on the extra layer of protection known as the financial guarantor. This has provided an opportunity to collect the extra yield afforded by the issuers that do not carry a "natural AAA"-rating.

The mix of buyers and sellers is also reverting back to the past. For the last ten years leveraged players have become the dominant buyer of municipal bonds. These entities were afforded an opportunity to finance their higher yielding, longer-maturity positions using lower yielding short-term debt. The floating-rate securities market was crucial in facilitating this arbitrage opportunity as money funds and individual investors were buyers of the short term floating rate bonds. This part of the market is shrinking quickly as the hunger for leverage has collapsed and access to credit is constrained.

The broker/dealer community is beginning to take on a new look. As in the 1980's many regional broker/dealers were actively involved in distributing and trading new-issue and secondary market bonds. Until recently, the importance and role of the smaller niche oriented broker/dealers was diminished as Wall Street firms and the leveraged entities dominated the trading volume. In fact, the huge demand for larger blocks ($10+ million) caused these securities to trade at lower yields than comparably rated smaller blocks (less than $2 million). With Wall Street's capital base eroding the bid-to-ask spread of outsized positions is widening. Fewer entities have the ability and/or risk appetite to position large blocks of bonds. We must be mindful that liquidity can only be measured in a tumultuous market.

The characteristics mentioned have certainly pressured the returns of the municipal bond market for the first half of the year, but what will the future hold? There are reasons to believe the volatility that the municipal bond market has -experienced this year may begin to ease. Perhaps most importantly, we are on the threshold of an important change with respect to the credit ratings of tax-exempt bonds. Moody's has announced that they are planning to revise their standards used to assess the credit worthiness of municipal bonds. By recalibrating their tax-exempt risk analysis to be on "par" with corporate bonds, many municipal issuers will have the effect of being "upgraded." This dynamic coupled with the relative "cheapness" of municipal bonds compared to Treasury securities should create renewed buying interest in the market.

Within the larger picture, municipal bonds have suffered their own personal storm: distressed selling, reduced market participants and a revaluation of municipal debt due to the financial crisis. This has caused the yield for high quality securities to be offered at the same level as Treasury bonds. This is a rather rare phenomenon given a top tax rate of 35% and primed to go higher.

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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.