How Many Breaths Can You Take While Underwater

Hitting The Debt Ceiling Again

During the second quarter 2011, no shortage of issues existed to expose the fragility of the domestic economic recovery and worldwide financial markets. To begin, on April 19th Standard & Poor's (S&P) changed its outlook on the U.S. government's finances from "stable" to "negative", based on its eroding fiscal situation. They stated: "We believe there is a material risk that U.S. policymakers might not reach an agreement on how to address medium and long term budgetary challenges by 2013". Simply put, S&P is politely saying that our elected officials need to knock-off the political shenanigans and fix the nation's debt problem on their own terms now, with substantive and credible policy changes, or the financial markets will punish them for their failure later.

This move by S&P served to raise the stakes in the political game of chicken that has emerged between Democrats and Republicans over the nation's debt ceiling. The scuffle began several months ago as Republicans insisted on meaningful cuts and significant reforms that would reduce federal spending without increasing taxes. The Republicans have made it clear that in order for their caucuses to vote Yea to increase the debt ceiling from $14.3 trillion, tax increases must be "off the table". On the other side of the aisle, Democrats are negotiating for smaller cuts in entitlement programs, tax hikes on the wealthy, and closure of some tax loop-holes that would serve to increase the effective tax rate on the most well-to-do citizens. The two sides are attempting to strike a deal before the August 2 deadline.

Due to political posturing about the debt ceiling, some myths and scare tactics are being disseminated by both parties; primarily, that a failed compromise by August 2nd will result in a de facto default by the United States on its debt obligations. In the spirit of brevity, please see below for RSW's thoughts about this topic:

Facts

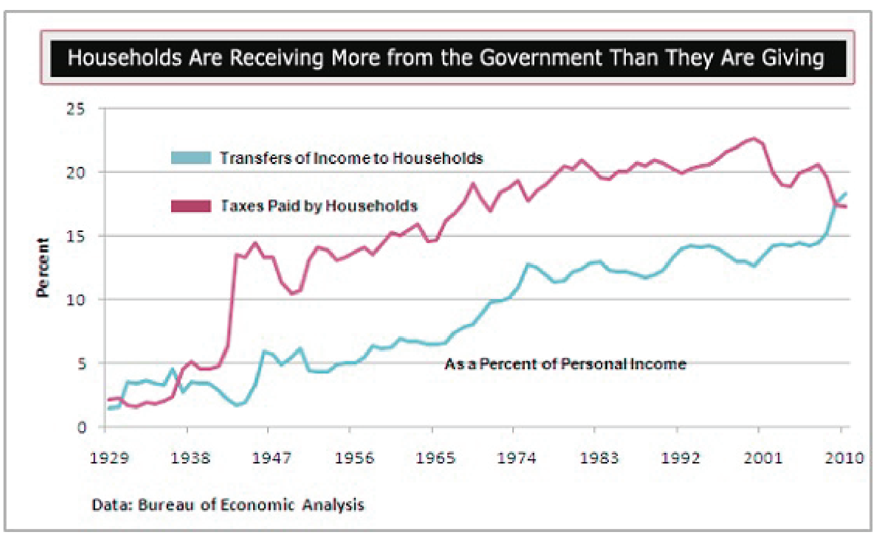
- Examining FYE 2011 rate of tax receipt collections, there are only enough receipts to cover approximately 60% of 2011 expenditures.
- If the debt limit is not increased, roughly 40% of all government expenditures would have to be eliminated.
- On August 4th, the U.S. Treasury Department is due to pay off $30 billion in maturing short-term debt.
- If the debt ceiling is not increased on August 2nd, a law would have to be passed by August 4th prioritizing the Federal Government's payments.
- In this event, one would expect that the monies to pay bondholders would be of the highest priority, and other actions such as furloughing federal workers, delaying welfare payments, etc. would then have to be implemented.

Where The Rubber Meets The Road

- Failing to increase the limit could result in a global loss of confidence among U.S. citizens and global investors.
- This is the key reason why, at RSW, we believe that defaulting on the national debt will not be the first choice of the elected officials.
- With that said, the bills for Social Security, Medicare, Medicaid, national defense and interest on the debt comprise about two-thirds of all federal outlays and can't all be considered sacrosanct indefinitely.

The debt ceiling matter has become the biggest political football that we have seen in many years, and fumbling won't be good for either party. We believe that in the end, there should ultimately be a resolution resulting in some form of compromise before August 2nd. The most likely outcome, however, is a weak agreement with both revenue enhancements and the size of the budget cuts being too small to have any meaningful long-term positive impact on economic growth. As we reflect back on the days when municipal bonds were on the front pages of most newspapers, we often said that politicians will only make the difficult decisions once their backs are up against the wall, and that time is now.

While the debt ceiling issue may not serve to be the crisis that pins the politicians' backs against the wall, the problems won't disappear on their own. In fact, time appears to be of the essence. The core challenges our country faces can best be highlighted by the relationship between what the Federal Government is transferring to households (entitlement programs, etc.) compared to their tax burden. For example, for the first time since 1936, government assistance now exceeds taxes as a percentage of average household income receipts. Please see the chart below:



Although the phrase “kicking the can down the road” is overused, we believe we are approaching the crossroads where we can see the dirt and gravel ahead. As is usual in these matters, over the long-term, the markets may be called upon to be the ultimate judge to determine whether or not the country is guilty of financial negligence, and eventually force the hand of the accused.

In The Wake of QE2

On June 30th, The Federal Reserve’s QE2 (second round of quantitative easing) ended its seven-month voyage. While in effect, the Federal Reserve purchased $600 billion in U.S. Treasury bonds with newly printed money. Goals of the program included: adding funds to the economy that could circulate and provide additional liquidity, holding down the level of interest rates, boosting asset prices, and reigniting the “animal spirits” of risk takers.

While some pundits argued that the expiration of the program would bring cataclysmic consequences, we at RSW saw little risk in this outcome. We have felt that the program didn’t fulfill its objectives, and therefore would not cause negative consequences that would “boomerang” to disrupt the economy.

In reality, the second round of QE produced some negative effects such as: a weaker dollar, higher commodity prices, and higher interest rates (10-year Treasury yields as a proxy). In addition, QE2 delivered higher asset prices (except housing), but failed to boost consumer confidence and spending. The lackluster results of the program haven’t gone unnoticed by the Federal Reserve Chairman. At Bernanke’s June 22nd press conference, Ben said the process of bringing down the unemployment rate was “frustratingly slow”. In addition, in October of last year, Alan Greenspan, said that quantitative easing may not be enough to get “money moving” and lead to stronger economic activity.

PIIGS Roasting on a Spit

In RSW’s second quarter 2010 market commentary we asked: “Is there enough lipstick for those PIIGS (Portugal, Italy, Ireland, Greece, and Spain)?” With the latest events unfolding in Europe, we now have our answer: There isn’t, and the crisis can no longer be concealed. As we also mentioned: “Just as countries once worried about the spread of swine flu, nations are now concerned about the contagion brought about by Europe’s mounting debt problems, austerity measures being implemented to reduce the debt, and the resulting impact to the region’s economic activity.”

It was only a year ago when the Greeks received their first $146 million bailout package from the International Monetary Fund (IMF) and European Union. With that bailout needing a bailout, the Greeks made headlines once again. This time, the Greek lifeline was tied to their ability to implement significant austerity measures.

The spending cuts didn’t sit well with Greek public sector employees who took to the streets and caused the level of business activity in Athens to all but cease.

With this crisis far from averted, the Greek debt disease appears to be spreading as events in the Eurozone remain fluid and appear to be metastasizing. Recently, the credit ratings of Portugal (Ba2) and Ireland (Ba1) have fallen to junk status. In addition, the contagion is engulfing Spain and Italy, with $9 trillion of public and private debt between them. In fact, for the first time since the debt crisis began, the markets are “roasting” Italian bonds as their yields have recently soared to their widest spreads in more than a decade.

For months we have heard that a Greek default is inevitable, but it has yet to happen. This is certainly not a comment on what the future holds, but there are strong reasons why there is a concerted effort by the Europeans to bail out Greece. In particular, France and Germany are leading the bailout task force because their banks have significant exposure to Greece, Spain, and other weak links of the EU. While the troubled nations owe roughly €1.5 billion to the Eurozone banks, the French and German banks hold roughly one-half of that total debt exposure.

When all is said and done, a Greek default in and of itself is far from pleasant, however, it is viewed as a manageable situation to the global marketplace. The real hazard of a Greek default lays in the possibility that it could be the first domino that sets off a chain reaction. The event could make it difficult for these economies to refinance their debt, and their solvency could be called into question. Furthermore, the destabilizing effect to the banking system and world economies could be significant.

In the wake of the crisis, it is not surprising that the European Central Bank and the Asian central banks may be busy supporting the bond markets of Portugal, Italy, Ireland, Greece and Spain. In particular, it appears that China is capitalizing on Europe's debt problems by providing funds in order to stabilize these deteriorating sovereign debt markets as well as expand its sphere of influence throughout the continent. While propping up its largest trading partner, China’s extended hand could cause Europe to become more financially dependent, much like the U.S.

Just like millions of households have found over the years – you cannot spend more than you earn in perpetuity. The enormous debt levels being created by sovereign countries will haunt many for years to come. As far as the PIIGS are concerned, the austerity measures will continue, new forms of bailouts will be structured, and the resolve of the taxpayers will be tested, as they suffer from bailout fatigue.

The Need To Exhale

Since 2007, we have consistently believed and communicated in RSW's commentaries that U.S. economic activity would remain "stuck in the mud" at sub-par levels. We reasoned that for many years prior to the end of the housing boom, debt levels rose to extreme levels for individuals, municipalities, and governments (both foreign and domestic). To be sure, those in Washington that played a key role in building the mountain of debt now serve as an impenetrable barrier to the future of reasonably strong economic growth. By their design, the response by government to a slowing economy is quite predictable. The antidote is usually one or a combination of lower interest rates, tax changes, and fiscal policy.

Their persistent involvement however, ignores the fact that it is healthy, normal, and perhaps necessary for growth levels to expand and contract. It's a cleansing process, which can be analogous to the sport of swimming where the inhaling and exhaling are among the most important skills to master. Think back to the last time you were in a pool. Regardless of the number of strokes you take, at some point you will feel the need to take a breath. However, this strong sensation of needing to breathe is actually not caused by a shortage of oxygen, but instead, by a surge in the level of CO_2. By holding your breath, you are keeping the CO_2 trapped in your blood stream and lungs, making you feel desperate for air.

With individuals drowning under high debt loads (aka CO_2) their inhaling process has run its course, and the exhaling process is now well underway. This serves to explain why despite an extensive and accommodative U.S. fiscal and monetary policy, credit growth is virtually non-existent. Simply put, providing easy credit in current conditions is analogous to offering a drowning man a glass of water. In our view, many of the factors that are causing consumers to "de-lever" (pay down their debts) should continue for years to come. These include: a sagging real estate market, persistent high unemployment, near zero real income growth, low levels of consumer confidence, and a ratio of debt to income that is still out of whack.

U.S. fiscal policymakers seem reluctant to face the fact that the consequences of decades of overconsumption and a bursting housing bubble cannot be eliminated with a series of "quick policy fixes". Zero percent interest rates and all other forms of stimulus won't stimulate consumption, given the backdrop outlined above.   The process of debt reduction, (deleveraging) is a painful and long drawn out compromise. Without financial lubricant (loans), growth suffers as consumers, businesses, and governments, scale back their borrowing needs and seek to pay down their levels of debt.   Whether it be a reality, or just a sensation of being under water (high debt levels), we continue to believe that this phase of the process may linger for years to come.

Municipal Bond Market Review: Turmoil to Stability

Municipal bond prices rebounded sharply during the second quarter as new issue supply was relatively scarce. In fact, the notional value of bonds priced in the marketplace plunged by roughly 44% from the same period last year. Bond origination is constrained, as the finances of municipalities remain tight. In addition, the politically charged climate of austerity should result in issuers refraining from increasing their borrowing appetite. The relative scarcity of issues has made it easier for bond prices to move higher and yields lower.

A powerful Treasury bond market rally also served to propel strong price appreciation in the tax-exempt asset class. After 10-year Treasury bond yields crested at 3.77% during February, they declined by 61 basis points to close at 3.16% on June 30th. In comparison, 10-year tax-exempt "AAA" rated yields declined by 64 basis points to close the quarter at 2.75%. Lastly, a meaningful decline in the number of "apocalyptic" news stories caused retail investors to slow their exodus out of municipal bond funds. As you may recall, it was the forced mutual fund selling during the fourth quarter 2010 that perpetuated the tax-exempt bond market tumult.

The News Is Better But Still Mixed

As the 2011 fiscal year closed for many states on June 30th, there are many notable positives with respect to the finances for state and local governments. These include:

- State revenues improved for the 6th consecutive quarter.
- More than half of states collected more revenues in the latest fiscal year.
- At least 28 states reported tax collections for the recent fiscal year exceeded expectations.
- According to a report by the National Governors Association and the National Association of State Budget Officers, 44 states expect to meet or exceed their revenue estimates for FYE 2011.

While the improvement in state revenues is impressive, we would be remiss if we didn't point out some continued challenges, which include:

- Despite rising, the revenue increase is not strong enough to close budget gaps. For the fiscal year started this month, states have eliminated over $100 billion in shortfalls.
- While state revenues were higher for the fiscal year that just passed (compared to the year before), they were 9 percent less than the amount taken in during fiscal 2008, when revenues peaked prior to the recession.
- Nearly half of all states reported fiscal 2011 gaps at 10 percent or more of their general fund budgets.
- For fiscal 2012, governors have projected an 18.6% increase in Medicaid spending. The increase is due to the June 30th expiration of the enhanced Medicaid match rate provided by the American Recovery and Reinvestment Act.

It has now been six months since Meredith Whitney's grim prognostications for the state of the municipal bond market. For all of the recent media and analyst scrutiny, it is interesting to note that the incidence of default actually declined during the first six months of 2011, compared to the same period last year. To date, through June 30th, the number of tax-exempt defaults has been virtually sliced in half from the same period a year ago. Only 26 issues defaulted in 2011, compared to 2010's number of 60. The dollar amount of the defaults fell to an even larger extent, as issuers totaling $818 million filed for bankruptcy protection, versus $2.8 billion during the six month period in 2010. It is also worth noting that the largest default was Florida's Tolomato Community Dev District, a "non-rated" speculative-grade borrower.

The expression "where the rubber meets the road" may serve to highlight the plight that some municipalities face as they slash spending to conserve taxpayer funds. An example of this can be found on some obscure streets in several states such as Brown County South Dakota. In some instances, transportation budgets are under so much pressure that in order to save future maintenance expenses, some local governments are using machines to convert lesser-used asphalt roads to gravel.

As always, the news cycle will ebb and flow. We would certainly expect that there will be future news that may cause some investor anxiety. However, state and local governments are in the process of tackling difficult and challenging structural issues -- some of them once referred to as the "third rail" of politics. While we have often said that "the environment will continue to be challenging for municipalities", we have also concluded that "state and local governments will do what they need to do to survive". With that said, the environment is not smooth or even, and "pot holes" are always a concern irrespective of the low probability of outcome. It is with this appreciation, and respect for risk, that we will remain judicious with our outlook, tempered by a disciplined approach to credit, structure, and interest rate risk.

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