Lost in Space

"Just because an investment does not produce the return that you "need", doesn't mean that the other options become safer, nor does the probability of achieving a higher return in those asset classes, increase".

Some of you may remember the catchphrase: "Warning Wil Robinson, Warning" from the 1960's/1970's television show *Lost in Space*. Fearing that Wil was in imminent danger, Robot B9 was programmed to assume the role of protector.

At RSW, we are not attempting to fill B9's shoes (I mean wheels), but instead, we are being vigilant, and have assumed our "post on the wall", and will report back with news and views from our vantage point.

Where There's Smoke, There's Usually Mirrors

Houdini would have been proud. Federal Reserve Chairman Ben Bernanke, playing to a sold out crowd, has been attempting to levitate the prices of riskier assets by sinking the yields of higher quality bonds. The Fed's feature event, "sawing yields in half," received a standing ovation. The Chairman's theory was that lower rates would spur the purchase of new homes and durable goods, and encourage businesses to invest and hire. In addition, Bernanke postulated that investors would be enticed to flee the lower yields offered by high quality securities, and replace those investments with riskier, higher-yielding assets.

To ensure that market interest rates moved lower, the Fed's "center ring" showcased non-traditional policies. Namely, Quantitative Easings (QE; printing money to purchase Treasury and mortgage bonds), followed later by the "Twist" and the "Twist Again" on June 20, 2012 (the Federal Reserve sold their holdings of short-term bonds to buy longer-dated maturity bonds). The maneuvers seemed to produce the desired outcome, as many individuals ventured into asset classes that they may have considered "too risky" in the past, but not today. It could be said that the investor's behavior was "robotic" in nature, as they became programmed to flee lower yielding securities in order to reach for instruments that could provide higher returns.

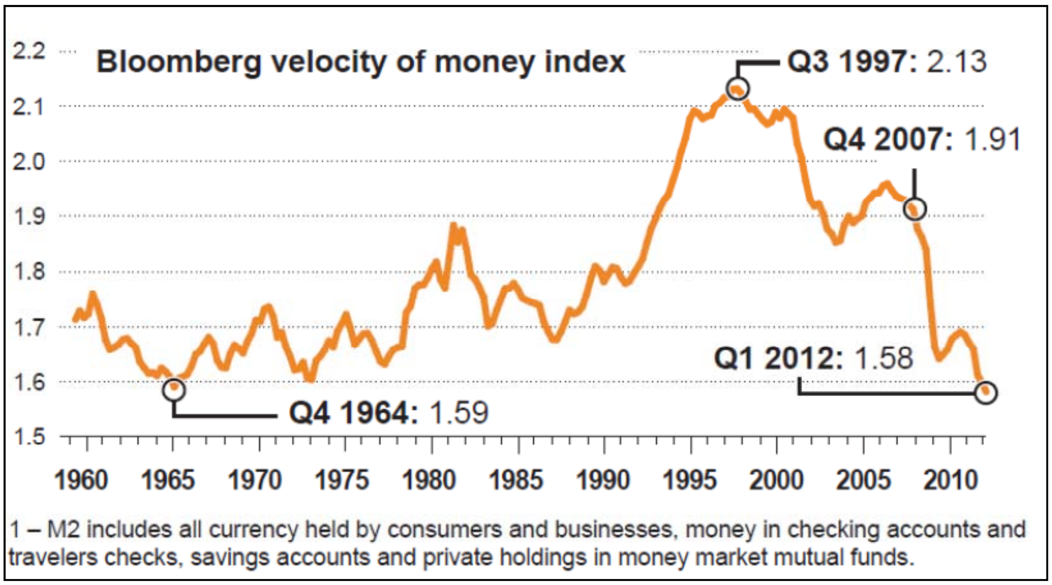
Shifting one's investment style out of frustration, or in order to "hit" a certain bogey, is usually not a formula for success over the long term. Many, including "professional investors," often increase their risk profile, and diminish their level of market liquidity, just to earn a "sub-particle" of additional yield. The latest notable casualty of yield "gone bad" is JPMorgan Chase. The firm reported a $2 billion (with estimates growing toward $9 billion) trading mishap that appears to be the direct result of a "reach for yield" strategy. JPM is today's headline, but the challenge to produce a return on deposits extends currently to a vast number of commercial banks.

As loan demand shrinks, and with limited availability of creditworthy borrowers, banks are left with a "casino" of chances to hit their equity return targets. Much to the chagrin of taxpayers and shareholders, commercial banks may opt for an "all in" investment approach, as investment vehicles yielding close to zero percent are just not feasible alternatives. Under the column of here's one for the law of unintended consequences: Bernanke's low yielding environment may not only be "forcing" retail investors to exit low yielding securities and move out along the risk spectrum, but banks, pension funds, and other professional investors as well.

Remember back in prior recessions when "bad news" was "good news" for risk assets? Weak economic data increased the likelihood that the Federal Reserve would swoop into action and cut interest rates. However, that was during the "good old days" when the Federal Reserve's policy packed a wallop as interest rates were historically high. At today's low levels of interest rates however, the traditional tools of the Fed are less potent. This explains the use of "nontraditional" policy tools. Unfortunately, the economic data is weakening again, and the tools on the Federal Reserve Chairman's belt are getting rusty. So what's next? The answer seems obvious. When the Fed can no longer stand the pain of weaker economic data, falling risk markets, deflation, or any and all of the above, then QE3 will most likely be launched.

As in the past , financial markets not only seem to be priced as if QE3 is imminent, but it appears to us that markets are also pricing in the "success" of another round of asset purchases in reviving the economy. To-date, lower interest rates have done little to stimulate economic activity. Notwithstanding the 10 Year U.S. Treasury note hitting the lowest level in over the last 200+ years (1.45%), economic activity is still decelerating. Unfortunately, despite traditional and untraditional methods of Federal Reserve stimulus, the demand for borrowed funds has dried up. This can best be seen in the chart below which depicts the velocity of money.

Simply put, velocity is a fancy way of quantifying the rate at which money in circulation is used for purchasing goods and services. As you will note, the level of velocity is now back to levels that we have not seen since 1964.



Source: Bloomberg, LP

Mr. Bernanke has been unambiguous that one of the key objectives of the Fed's unprecedented accommodative monetary policy is to induce investors to take more risk. From all appearances it looks like they have accomplished their mission. Witness the movement of all risk assets prices since the announcement of the first round of quantitative easing. While the media and many in Washington tout only the benefits of the Fed's "slight of mind policies", there are negative side effects that we find disturbing.

As we reflect back on history, it becomes painfully obvious that on many occasions the Federal Reserve cures problems -- but in the process tends to create others. Namely: "blowing more bubbles". We have always believed that the current risk of "throwing money from a helicopter" is not inflationary. If inflation was really today's boogey man, then answer this question: While globally, money has been flooding in to the financial system at epic levels, why then have low levels of interest rates failed to reignite the borrowing and spending habits of the "good old days"??? This answer: this time is different and requires behavior that is not "robotic".

What makes this time different?

Historically, many market participants have evaluated the relative attractiveness of "risky" fixed income securities by comparing their yields versus those offered in the U.S. Treasury bond market. Specifically, the spread (basis point difference between higher yielding bonds and U.S. Treasury debt) becomes the foundation of their "decision tree". The problem with this analysis is that it does not consider how the "world" and the valuation of U.S. Treasury debt have changed.

Some examples include:

- The recurring use of non-traditional monetary tools.
- The Fed purchased over 60% of all new Treasury bonds that were issued in 2011.
- The worldwide supply of "riskless" assets is declining sharply.
- The creditworthiness of sovereign countries is being called into question.
- Fragile European banking system.
- Demise of the Euro.
- A National debt of $15.8 trillion.
- Persistent and deflationary forces are being imported from overseas.
- Stagnant and uneven domestic and global economic activity.

If you take a step back and think about it, investors tend to have patterned responses to events. It appears that many are investing in higher yielding assets not because they think they are of value, but because they are fleeing yields or return profiles that can't satisfy their return goals. When investors' focus is on yield, return and growth, to the exclusion of risk, outcomes are often bad.

In our opinion, the Fed has been forcing the price of a benchmark security (U.S. Treasury) higher to make the spread product (riskier asset) look more attractive. Let's examine this concept.

If you were in the market for a used car and someone tried to sell you a "Ford Edsel", you would probably say that you were interested in an automobile, not a lemon. Now if I told you that the only other car for sale was a "Yugo" (Classic cold war clunker made in Yugoslavia), the Edsel might appear as an attractive option. The question that you would need to ask yourself is: "Does the Edsel suddenly look like a better car, or has an illusion been created?" – the illusion called relative value.

While RSW's investment strategy occupies a relatively "safe" investment in today's "goat rodeo" (see RSW's Q1 2012 Commentary) world, in our opinion, the "spacial" difference between risk asset classes must be viewed differently in today's new environment – giving due respect to Robot B9.

In some ways, this whole period has exhibited similarities to the housing debacle. Make rates artificially low, create exotic financings, and provide the illusion of desirability and profit potential. With that said, here is a question that every investor should ask themselves: If the Fed announced tomorrow that there will be no more QE's, and because of a back injury caused by carrying the vault full of Treasury bonds they bought there will be no more twisting, then what assets would you still be a buyer of? If you find yourself buying something that you would not buy, based solely on its merits, than you are probably the potential proud owner of that "Edsel".

Since we are seeing things happen that we have never seen before, why is it foolish to believe that interest rates could "stay lower, and stay lower longer than anyone expects"? This has been, and remains, RSW's base case. Was a 1.50% UST 10-year yield a realistic target? Yet it was reached! The impossible has been proven possible.

Looking ahead, historical experience may not be the best guide as to how act in the future. Just because some high yield or other asset class yields "x" number of basis over Treasuries, we suggest that one treat the data with the care that it deserves. While historically, the current level of spreads may have told us to shift assets to "that" sector, doesn't mean that the same "Pavlovian" response should automatically be produced. Secondly, just because an investment does not produce the return that you "need", doesn't mean that the other options become safer, nor does the probability of achieving a higher return in those "other" asset classes increase.

As the economic pestilence persists, it is imperative and incumbent on all of us to look at the investment landscape differently. We all need to think outside the "metal" and not act robotically.

Municipal Bond Market Review

We Don't Chase Yield!

Sometime in June, the *Wall Street Journal* published an article entitled "Will Junk Munis Bite Back?" The article states that investors, YTD, have aggressively been adding to their municipal portfolios at a rate higher than in recent history. The article goes on to state that just over 20% of these newer investments have found their way to "junk", or below investment grade municipal bonds. That represents a lot of money chasing the smallest and most illiquid sector of the municipal market.

In any event, what this is telling us is that despite the nasty headlines coming from just about everywhere, a significant part of investor funds is chasing yield at precisely the wrong time as:

- U.S. Treasury yields are at historic lows while muni yields are near such lows.
- Credit spreads are narrow.
- Federal budget issues remain unaddressed.
- The banking industry has been subjected to multiple downgrades.
- The Federal Reserve continues to employ non-traditional tools in order to lower long term rates.
- Global slowdown and recessionary pressures persist.
- The U.S. Census Bureau just released tax revenue growth for state and local government for the first quarter of 2012 which grew by only 1.5% from the same period last year, as compared to 2.3% growth for the last quarter of 2011 and 5.3% year-over-year growth for the third quarter of 2011.

We suspect that as the cookie continues to crumble many of these newer funds will find their way back to the high grade muni market at a time when quality bonds, relative to bond retirements and redemptions, are in short supply. This is especially relevant as estimates for the YTD through July show bond maturities and redemptions exceeding new issuance by an extraordinary $35 billion.

In short, in our opinion, a flight to quality continues to be a better strategy than chasing yield, especially at a time when capital preservation should dwarf most other concerns.

Tomorrow's Headlines May Have a More Lasting Effect than Prior Pronouncements

Meredith Whitney's prior clarion call ("*60 Minutes*: Dec 2010") for billions of municipal defaults, created a massive 2011 buying opportunity by roiling the market and creating a window of opportunity for high-quality municipal investors. While the "*60 Minutes*" segment was a made for TV "drama queen moment", this window eventually closed later in 2011 as cooler heads ultimately prevailed.

We suspect that the next round of headlines -- which will be coming shortly -- will have a longer and more lasting effect on the perception of the municipal market, if not a negative impact on credit ratings.

Public Pensions Will Soon Look Worse -- Rules of the Game Are Changing

Most of the recent headlines regarding municipal pensions have been relatively positive. States have been taking various actions to slow down the growth of pension liabilities, employees are being asked to contribute more, and various court decisions, to date, have on average, been supportive. These actions for the most part will have a positive impact in the future and tend to affect newer employees. Voters in San Diego and San Jose recently followed San Francisco's prior actions and approved reforms that will lower future pension obligations.

The Governmental Accounting Standards Board (GASB) will be implementing new standards for pension valuations and reporting that will, in most cases, especially for the weaker funded pensions, add to the reported liabilities while weakening funded ratios. While these changes are not expected to take place until 2015, the new requirements have been previously released, and therefore we suspect that many states and jurisdictions will adopt the new proposals relatively soon.

As of 2010, the average funded ratio of state pensions was approximately 72%, with a wide range encompassing Delaware, Wisconsin, New York, and North Carolina at over 95% funded, to as low as Puerto Rico (8.5%), Illinois (45%) and Connecticut (53%).

Various industry studies suggest that adoption of the new accounting standards for public pensions will cause the average to fall into the 50% range. We believe that this will result in a series of new headlines that may again roil the municipal market and change perceptions for impacted states and localities. However, unlike the Meredith Whitney induced headlines, we believe the story behind these headlines may have a more lasting impact on the municipal market.

While a detailed analysis of the new public pension guidelines are beyond the scope of this commentary (however feel free to contact us for further discussion), the following points should be considered:

- Despite a truer and weaker depiction of pension liabilities, we foresee no immediate credit downgrades as pensions remain a long term issue whereas most states have sufficient assets over the intermediate term.
- Accounting rule changes should provide further impetus for accelerated reform.
- Those states and jurisdictions that continue to kick the can down the road will be subjected to downgrades over time and widening spreads.
- State and local governments will continue to confront budgetary distress as the global slowdown and continuing demands for social services in a tax increase adverse environment will make for hard choices.

State and local governments are in the early stages of tackling difficult and challenging structural issues; some of them once referred to as the "third rail" of politics. As we have always said, solutions to problems are rarely forthcoming until politicians stare in to the abyss and the anger of the taxpayers. At RSW, we remain vigilant, and believe it is not the time to "chase yield", but instead focus our efforts on an investment discipline that emphasizes strong credit quality.

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