When Worlds Collide

While much has been written about the economic and monetary events of the last several years, sometimes it feels as though the underlying story goes unreported. There is no doubt that loose lending practices, extreme leverage, mindless risk taking, and owning a home even when you can't afford it were all factors in leading us to the brink. Concurrently, foreclosures, bad loans, high unemployment, and dismal consumer spending will continue to be breathlessly reported on. Without minimizing these, we at RSW feel that there are more ominous trends that history may record as the more lasting and significant.

It appears that there are three overwhelming forces that lie beneath (or undermine) the American economy and our shrinking slice of the world economic pie:

1- Dwindling incomes of the average American worker
2- Growing tax burden
3- Burgeoning Government debt

Depending on the source, wages of a significant portion of Americans have stagnated or declined over the last several decades. While many analysts feel that individuals borrowing on the equity in their homes or maxing out their credit cards is the result of declining wealth, the reality is that it's the cause of the problem. In addition, many believe that the real cost of living (not the actual government statistics) has caused Americans to fall even further behind.

Although there are periods in the last thirty years when Federal taxes have declined, the overall tax burden climbs relentlessly. Federal, State, Local, Social Security, Medicare, Sales, Property, Excise taxes, Surcharges (along with the potential for greater taxes to pay for Health Care Reform, and Cap and Trade) have all embedded themselves in the American Tax Code. Think about the dynamics on a society where incomes stagnate or decline, or the cost of living increases more than reported as the Government takes a larger share of gross income. Technology bubbles, housing bubbles, credit bubbles are surely major events; however, their effects are magnified by an enormously weakened consumer.

History may well record that everything we have discussed still takes a back seat to the 800 lb Gorilla: swelling government debt. We find it interesting that the market sees the avalanche of liquidity as a positive when it is provided with borrowed money. As we observe the actions and attitudes of the crowd, it seems like the public has largely ignored the danger of excess indebtedness. We were brought to the brink by leverage and debt, but the Government acts if they are immune to these same forces. None of what we write about here brings us any pleasure, but if we ignore these trends we become ill prepared to deal with the consequences.

All markets in our view have only started to deal with these approaching realities. In fact, many economists continue to cling to their traditional methods of forecasting and are calling the nation's high unemployment rate a lagging indicator. We at RSW feel this is a mistake, since the stresses and demands on the Government, businesses, investors, and John Q. Public, are infinitely worse when the headline unemployment rate stands at 9.8% not 5%. Additionally, we

must consider the timing of this added stress, as it emerges concurrent with other powerful and disturbing forces, namely: Medicare and Social Security are on the insolvency highway, George Bush's drug benefit plan is running a trillion dollar plus tab, the Government's role in Medical care is about to skyrocket, the potential for the Government to expand their footprint into the energy sector (cap and trade), and all of the liquidity (I mean debt) that has already been pumped into the economy by the Federal Reserve and the Treasury. While many investors keep a watchful eye on the temporary effects such as those of the next "bubble Du Jours", we believe that the real disease is the "free lunch" mentality of Government and individuals, coupled with the fiscal and monetary "chemotherapy" that is designed to heal the patient.

So where are we going with this relatively gloomy narrative? We believe that the "world" as described above, cannot coexist with the much talked about and feared "world" of Inflation. While it is true that "Wall Street" has been stabilized, this relative tranquility has not transcended to "Main Street." If an individual's desire to borrow is stifled by the new realities, and banks are disinclined to lend, central banks cannot force them to do so. This is a "world" where credit is being reduced, not expanded, where credit card and mortgage delinquency rates continue to surge, home prices are sinking, commercial real estate occupancy rates are rising, and a government's policies that squelch the appetite of businesses to take risk, start new businesses, and hire workers. This is the "world" of deflation.

Municipal Bond Market

The third quarter produced outstanding returns for tax-exempt investors. Yields continued their march lower as municipal bonds available for purchase were scarce and investor demand remained robust. The long end of the market performed exceptionally well as many issuers opted to borrow monies in the taxable bond arena under the Build America Bond program (BABs). This effectively removed new-issue supply from the tax-free market, causing a scarcity of 25 plus year maturity bonds.

It seems to us that someone who is willing to write such a murky view of the world owes it to their clients to see how it can play out in the municipal arena. To proceed let's look at one of the states that has been the hardest hit during this recession: Michigan. Their dependency on the auto sector has sent shockwaves through their economy causing the state's rate of unemployment to top 15%. Notwithstanding, their fiscal pressures, no mainstream municipal debt obligations have defaulted this year[1]. In fact, the state still maintains its weak "AA" credit rating.

It was only a scant six months ago that there were news stories, investor angst, and panic about the imminent default of many state and local Governments: i.e. State of California. To this concern our response was and remains that there is a chasm of difference between a cash shortfall and a default. Please don't think that we ever try to minimize the entire topic of defaults, but we are trying to make a point that defaults of investment grade borrowers are too often borne from local Chief Financial Officers (CFO's) shooting themselves in the foot with interest rate swaps rather than a surge in foreclosures or declining property values.

As the rally in tax-exempts gained momentum, we have sought to reduce our average maturity exposure and/or the call structure of our client portfolios. As is fairly typical in the fourth quarter, the market technicals have become less favorable as new issue supply is poised to rebound and investor demand is softened at these lower levels of rates.

In anticipation of market weakness, bond dealers have been busily reducing their positions, which has caused bond prices to reverse their course and head lower. While up-ticks in interest rates (such as the one we are experiencing now) come with a certain amount of discomfort, we have positioned the holdings more defensively and can be in a position to view it as an eventual opportunity. We will keep you informed over the coming weeks.

Sincerely,
Robert S. Waas

[1]*As per Jane Ridley of Standard & Poors; Tax-Exempt Research Analyst covering the state of Michigan.*

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