

## Fed Watch

A multitude of forces such as: broad based asset declines, a de-leveraging of the financial system, an unwillingness of the banks to extend loans, burgeoning credit quality spreads, and a sagging economy have perhaps transformed the investment landscape for decades to come.

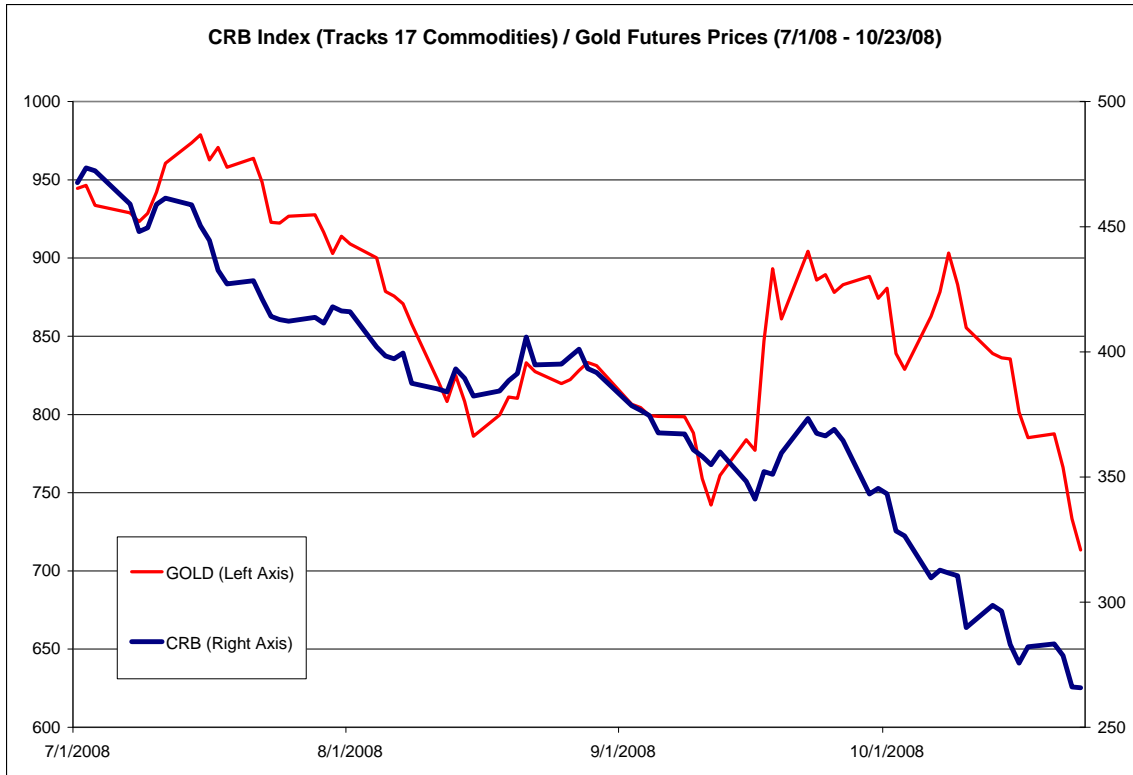
You may recall that on June 9th Chairman Bernanke stated that “although activity during the current quarter is likely to be weak, the risk that the economy has entered a substantial downturn appears to have diminished.” At that time he also sounded the alarm about heightened inflation risks. With these comments seemingly divorced so far from reality, we inferred that this communication couldn’t possibly reflect the Chairman’s core beliefs. After all, buying his rhetoric would only lead one to conclude that the man was “out-of touch.” We therefore deduced that Ben must have had an ulterior motive for his rhetoric. Convincing the bond market that an interest rate increase was in the offering was probably intended to propel the value of the dollar higher, and restore investor confidence. To this we wrote: “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. Since then the Fed has changed their tactics, shifting to an “all-in” approach from merely bluffing after the cards are first dealt.

The Fed and the markets now appear to be focused on the real threat, and it’s not inflation but deflation, caused by sinking asset values and contracting credit. Within our own borders, we have witnessed the collapse of Bear Stearns, Fannie Mae, Freddie Mac, Country Wide, AIG, Lehman Brothers, Indy Mac, and more are in the pipeline. The common denominator of the financial problems experienced by these firms is outrageous amounts of leverage. With virtually all companies within the global financial system now trying to de-lever, a new crisis has developed. Cash has become scarce and the central banks around the world are continuing to pour dollars into the system at an unprecedented pace. For example, under the TARP (Troubled Asset Relief Plan) the Government will be purchasing illiquid assets from the balance sheets of troubled companies. In biological terms, the Treasury is acting as the financial equivalent of the liver, whose function it is to cleanse the system of all impurities. However, it is because of all of that cleansing that one must wear a hazmat suit when entering the Treasury’s vault, the contents will include sub-prime mortgage bonds, differing flavors of collateralized debt obligations, equities, corporate commercial paper, and faltering consumer loans. Other forms of toxic waste may soon be added to the growing list.

## Inflation, real or mirage?

Like water in the desert inflation may prove to be a mirage. As much as commodities foretold the rise in inflation over the last several years, their precipitous decline may foreshadow a secular deflationary trend. (Please see chart below for the recent trend of the CRB Index and Gold futures prices). As early as the third quarter of 2007, we were fearful that the seeds of deflation were already being sewn. We lamented that quite often it is the very spike in the level of inflation that ultimately causes deflation. Oil was a microcosm of that phenomena as crude prices surged, thus sealing the fate for a consumer led recession and a general broad-based price decline for “stuff”. Is the Government taking this threat seriously? You bet! Remember Mr. Bernanke is a great student of the depression and the

resultant deflation and vowed to throw money from a helicopter if that's what it took. Fighting and defeating this opponent trumps their fiscal concerns, and they are responding accordingly.



### Face to face with the abyss

In the last several weeks almost anything seemed possible. A panic, the likes of which we have only read about but not lived through engulfed the financial system. While I have lived and managed through market crashes, I can think of none that have been attributed to the end of the financial system as we know it. As this crisis gained momentum there were fundamental reasons for institutions and individuals to begin a process of risk reduction. However, it was a dramatic shift in psychology, and the interconnectivity of asset classes that caused the debt laden system to convulse.

The problem was aggravated further by headlines and pictures of breadlines (ala Great depression) as no scenario seemed too impracticable or too negative. For over twenty-five years I have watched psychological swings run rampant between optimism and pessimism. Looking at the recent past a few quotes still ring in my head:

- There is a mountain of liquidity that can never dry up (almost everyone)
- Tranche and selling risk to those who can better understand it reduces the overall risk in the financial system (Greenspan)

- We are entering a period of inflation that will rival the 1970's (Stubborn Bond Bears)
- Be careful not to borrow what you can't repay. (My mother)

During the crisis lots of things seemed like they were about to happen but that didn't mean they were going to happen. As always, we must not only think about what could transpire, but the probability that these things are going to occur.

We need to be mindful of what the market is attempting to price in whether or not the events actually occur

### **Back to the Future**

Looking at the actions of the worlds' governments and central bankers, we must deduce that they will do whatever is necessary to deal with this strain of economic pestilence. With hindsight being 20/20 the Fed has certainly made its fair share of mistakes. Letting Lehman fail now looks like one of them. The collapse of this firm seemed to spark a renewed level of panic which contributed to the freezing up of the commercial paper market, causing money market funds to "break-the-buck." Certainly, we should expect that some more mistakes are likely to be made in the future. However, governments have more than amply demonstrated that they possess the resolve and determination to prevent those future mistakes from pulling down the financial system.

Maintaining a functioning financial system is only a part of the solution. We still need business people who are confident enough in the future to lend money to those who need it. There will be no quick fix for this aspect of the problem as losses have mounted, capital destroyed, and psyches damaged. Over the ensuing months, perhaps late next year, I suspect that we will see the Fed's advance to banks being re-loaned and not just "prettying up a balance sheet." In the meantime, we believe that some of the latest actions, such as the coordinated rate reductions by the worlds' central bankers will stimulate the flow of money, but a protracted recession should still be in the offering.

### **Municipal Recap**

Akin to the taxable fixed income asset class, liquidity in the municipal market entered the frozen tundra during the month of September. After posting positive returns during July and August, municipals hit an ice patch, scoring their worst performance in more than 20 years. In fact, I can only recall two periods over the last couple of decades where liquidity in the market was equally as poor. The most recent being 1994, which was also the result of a deleveraging episode that began in the Treasury bond market and spilled into the tax-exempt arena. At the end of this commentary, I have enclosed the reasons behind the mid September/ October severe market "sell off" which I wrote about last week.

As quickly as yields spiked higher amidst hedge fund and open-end mutual fund selling, it virtually disappeared on Monday. In fact, in only three days bond yields have recaptured more than one-half of the rise in interest rates exhibited over the prior thirty days. As is usually the case, as quickly and out of left field as the selling pressure begins it ends abruptly. Now, the market is in the midst of an explosive rally driven by a surge in interest of individual

investors, and cross-over buyers. The latter being investors who do not need the tax-exempt interest but are attracted to the market because of its abnormally high relative yields.

As one would expect the rise in municipal bond prices has also been accompanied by a pick-up in the level of new issuance. The new issue calendar has been virtually non-existent since the yield surge began. Now, the marketplace is ready to accommodate deals coming to the market.

*From the 10/15/08 RSW Municipal Market Update:*

[Until now, the traditional “real money” investors have co-existed with the leveraged crowd, but this time is different. Several weeks ago, as the level of short-term interest rates spiked higher, losses were inflicted on the “leveraged community” as their financing cost exceeded the rate of interest on their long-term municipal bond. In order to stave off further losses they headed for the exits in droves. Simply put, the problem is that these motivated sellers are seeking to sell an abundance of bonds that dwarfs the capital base of the broker/dealer municipal bond trading desks. This has created a buyer versus seller imbalance the likes of which we have never seen. Similar to the housing market, the price set by an extremely motivated seller is the new benchmark (“comparable”) for the next transaction.

With the broker/dealer community nervous about the next round of selling pressure, they are showing a heavily discounted price when they are bidding for bonds. This has caused the bid to ask spread (the difference between the value of the bond and what someone pays) to widen dramatically. Currently, when a bid does emerge, the differential between what we think a bond is worth and the actual price a buyer will pay can be as much as 5 points (5%).]

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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.