Stop the Presses – 10/15/10

Firm Footing Or Stuck In the Mud?

On September 20, the National Bureau of Economic Research declared that the 18-month recession, which began in December 2007, officially ended in June 2009. The longest and deepest economic contraction since the Great Depression is now over. At least we hope so!

While we are delighted to hear this news, we think it's worth noting that this post-recession economic rebound has proven to be relatively anemic compared to other periods of recovery. For example, the growth rate for the three quarters following the 2008 recession averaged 3.7%. This compares to a more robust 7.2% for the first three quarters following each recession dating back to World War II. Making matters worse is that forward momentum seems to be losing ground, with 2nd quarter 2010 GDP coming in at a very modest rate of +1.6%.

While credit-led recessions are notoriously different in the way they affect growth and recovery, the Fed and Wall Street have consistently pegged this round of post-recession growth at overly optimistic levels. It was, after all, only several months ago that the "Street" and the Fed were categorizing the recovery as being on track, and showing some signs of being self-sustaining. Remember the talk of exit strategies, and removing some of the extraordinary stimulus programs? For example, during the 2nd Quarter 2010, while the U.S. economy was growing at a 1.6% rate, the Fed mentioned their expected growth rate was between 3 – 3.5%.

Such early confidence and optimism has morphed into concern, as the asset inflation brought on by the Fed's purchase of $1.75 billion Treasury and Mortgage obligations (QE1) has failed to translate into sustained economic activity in the "real economy." Having run out of rates to cut, the Fed is left with few policy options, and is presently considering one of its few remaining choices: the crude policy of "quantitative easing" (printing new monies to buy securities such as U.S. Treasury Bonds) to try once again to jump start the economic "animal spirits."

To date, the various programs from TARP to QE1 have all succeeded on a few levels: they averted a systemic financial failure, boosted asset prices, got the credit markets functioning again, and caused credit quality spreads to contract substantially. While welcome and helpful, rising asset prices should not be considered the yardstick to measure whether or not the program is successful. Wall Street sometimes forgets that these outcomes were not entirely what the Fed intended. Sparking a rally in the financial markets was supposed to be the means to an end, not the end in itself. Success should be more broadly defined as: getting the banks to lend, boosting confidence, stabilizing housing, and ultimately improving employment. While all market participants need to hope that the next round of quantitative easing (QE2) has more success, we offer the same cautionary note that we did in our 2008 Outlook. We stated: "this particular type of financial stress is highly contagious and like none we have seen before. Therefore, we must keep an open mind to the possibility that the Fed *may be left without any remedy for the challenges that lie ahead."*

Insanity and the Law of Unintended Consequences

Once again, as before, the market is not only priced as if QE2 is imminent, but it seems to us that they are also pricing in the "success" of another round of asset purchases in reviving the economy. As optimism grows in the marketplace, our observation, noted in our 2010 Outlook still applies: "These extraordinary measures are our economic training wheels and Washington has its hand firmly on the seat. However, only time will tell if we can truly ride on our own when Washington removes their supporting hand and the training wheels are unscrewed."

It seems fair to make the observation that GDP declined throughout the $1.75 trillion purchases of securities during QE1. While we hope for a better outcome with QE2, we will withhold judgment on whether such a policy move will provide the continued helping hand we need to sustain growth, or, whether the economy will still ultimately require a good helmet. We must admit that some aspects of the Fed's proposed strategy seem to fit one definition of **insanity**; i.e. "doing the same thing over and over again expecting a different result." If something doesn't work then just do more of it. By that criterion, can "Stimulus 2" be far behind? Reasonable people can disagree on the advisability of QE2, but it could be worth noting that former Federal Reserve Chairman Alan Greenspan shares our apprehension. He recently weighed in on the topic stating: "It is very difficult to think though the scenario by which you induce commercial banks to lend." And he added "if you don't do this, quantitative easing can't do anything to speak of."

We at RSW never enjoy sounding too negative on these matters, but we believe a reasonable skepticism is justified. Along with an unending number of stimulus programs in the last twenty years, Japan has also initiated a quantitative easing policy. Since none of these policies produced the desired results, why are U.S. policy makers so intent on following Japan's lead? QE1's lack of success here and Japan's similarly failed strategies are only one aspect of our skepticism. Other forces have already emerged that work against QE2's potential success.

This policy has helped significantly lower the value of the U.S. dollar, commodity prices (namely food and energy) have spiked, and lower interest rates have not encouraged spending, but instead have punished savers. While some agricultural and energy-based commodities have jumped enough to excite "Inflationists", the reality is that policy measures taken to-date, have only served to unleash deflationary pressure. ***The law of unintended consequences*** is at work here, as necessities that people consume on a daily basis are rising in price, unemployment remains high, and there is a tremendous strain on wage growth. With consumers being ganged up on from all sides, and still uncertain about the future of the U.S. economy, is there any wonder why their appetite and ability to spend on anything but essentials has been impaled?

Are Real Solutions in the Offering?

After decades in the making, our nation's economic underbelly is exposed, and the extent of our predicament has come to the fore. With respect to spending and debt, "the first step in curing an addiction is first recognizing the problem." Now, progress can be made since solutions to problems are rarely forthcoming until politicians stare into the abyss and the anger of the taxpayers. Topics of reform are now being discussed that were once considered the "third rail", namely: social security and pension benefits. Now, at long last, these topics, the previous lightning rods of conversation and debate, are no longer unmentionables. Meanwhile, Ben Bernanke is continuing to contemplate "pumping the patient full of drugs," thereby postponing difficult decisions to a later date. While politicians are famous for kicking the can down the road, we are running out of road. As a result, real solutions may not be far behind.

The Recession's Over? Go Tell It to State and Local Government Budget Officers.

Municipal yield levels moved off the lowest levels recorded since the 1950s during the third quarter. However, the increases in yield levels remained marginal and incremental, at best. From Labor Day through early October, yields on the long end of the municipal curve increased by an insignificant 5 to 10 basis points. Ten-year municipal yield levels rose by approximately 30 basis points during the same period. For the most part, the increase in the intermediate-maturity range reflected a spike in new issue supply, and was not necessarily caused by an anticipation of a fundamental economic recovery. The minimal rise in longer term tax-exempt rates also mirrored the weak jobless recovery to-date, and a large amount of taxable BAB (Build America Bond) issuance. In short, municipal yields remain at generational lows, while credit concerns remain at generational highs.

Staying the course - It is with this in mind, that our commitment to our clients remains unchanged ….. "We remain judicious with our outlook, tempered by a disciplined approach to credit, structure, and interest rate risk. This strategy has served clients well, and we believe should continue to do so at a time of uncertain economic recovery persistent credit strain."

Our philosophy for maximizing after-tax total return with adherence to capital preservation, while managing credit and interest rate risk reflects the following:

- While there has been some widening in credit quality spreads, there remains little value in "chasing yield" in a low interest rate environment with a weak regional, national and global economic backdrop.
- State governments have confronted budget shortfalls in fiscal years 2009, 2010, and to-date in fiscal 2011 (most fiscal years start on July 1), that have totaled $425 billion. Gaps have been closed by combinations of: federal stimulus monies, reserve draw downs, tax and revenue increases, and expenditure cuts. At the same time, local governments continue to deal with similar issues.
- Many states and local governments are already encountering mid-year fiscal 2011 budget gaps with depleted resources, and despite various tax increases.
- Approximately 40 states already identified gaps estimated at $110 billion to $140 billion in planning for fiscal year 2012.
- The exhaustion of federal stimulus funds in fiscal year 2012 (only $6 billion estimated to be available as compared to $60 billion in the previous year), coupled with the jobless recovery to-date, will continue to strain state and local governmental resources.
- The public has little, if any, appetite for tax increases, especially in states that have raised taxes while still confronting budgetary pressures.

We therefore continue to avoid investment in many states and sectors as we see no diminishment of current credit concerns. In fact, further deterioration in many jurisdictions will continue, as pension benefit issues, an ongoing jobless recovery, the conclusion of the federal stimulus, the tax revolt, and a growth rate in expenditures (despite cuts) that continues to outpace revenue growth will provide significant challenges to states and local governments going forward.

Robert S. Waas Managing Member	Robert K. Coates Senior Portfolio Manager	Matthew T. Werner Portfolio Manager	Mark J. Tenenhaus Director of Municipal Research	John A. Carlson Director of Business Development	Marites A. Vidal Data Analyst	Randy J. Fox Operations Associate	Jon P. Skoog Operations Associate

RSW Investments, LLC • 47 Maple Street, Suite 304 • Summit, NJ 07901-3647 • (908) 608-9600
www.rswinvestments.com