We Have Met the Enemy and He is Us (10/7/11)

It has been the better part of five years since RSW sighted the deflationary storm that has now made landfall. Although this rare phenomenon has been slow moving, it has been relentless and steady. While the debate continues to rage as to whether or not the United States will roll back into a recession, we never sounded the "all clear" siren. Instead, we believed that the series of short term fixes that were being prescribed in Washington could temporarily suppress the speed of the wind, but not alter its final course or eventual intensity.

The signs of economic malaise are undeniable, as many indicators around us are in a "race to zero". These include:

- Consumer confidence
- Number of remaining Federal Reserve interest rate cuts
- Yields on high quality bonds
- GDP growth rate
- New home construction
- Pace of credit expansion
- Approval rating for members of Congress, the President, and both parties in general
- Number of policy "tools" left on Bernanke's belt

There are scores of reasons why we find ourselves in the midst of this economic morass (many have been outlined in past newsletters), and there is certainly enough blame to go around. At the core of our conundrum is the fact that we had been a consumer oriented economy that thrived on credit expansion. Rising wages acted as "the enabler" to facilitate the public's ability to take on greater levels of debt.

Today, we are witnessing an environment in which wages are stagnant or declining. This has forced individuals to "pay-down", rather than increase, their pile of IOU's. This sea change has slowly morphed into a breeding ground for sub-par economic activity. Simply put, the following negative feedback loop has emerged: individuals are forced to hunt for goods at the cheapest possible prices; to meet their demands multinational corporations deploy assets in the country's with the cheapest pools of labor to manufacture their goods; investors cheer the higher profit margins which reinforces the "ship the jobs overseas" behavior as they demand higher investment returns; the "worm" turns yet again as the economy continues to slow, and an unsustainable household debt burden forces individuals to deleverage. Individuals repay their debt (or not), and the demand for new loans remains virtually non-existent. During this entire process, individuals, the media, our leaders in Washington, and the “unfortunate” search for the next villain.

Where does this observation take us, and how does it impact what we do as investment professionals? First, we explain that many of our socio/economic problems have become structural, and are resistant to QE’s, traditional monetary policy, or the Fed’s latest adventure called “Operation Twist”. In this operation, the Fed sells short maturity bonds, previously purchased during the Fed’s Quantitative Easing program, and uses the proceeds to acquire longer maturity Treasury bonds. Ultimately, their goal is to put further downward pressure on longer maturity yields in order to lower interest costs for borrowers.

To us at RSW, the strategy would be more appropriately named “Oliver Twist”, after the Charles Dickens novel set in England during the early 1800’s. Specifically, we are referencing a particular portion of the book where Oliver, an orphan, rose from the table after finishing his first bowl of gruel, and approached the headmaster with his bowl and spoon in hand and said: “Please sir, I want some more.” As much as the markets, pundits, and the citizenry seem to chastise the Federal Reserve for its policies, as soon as markets swoon, or the economic recovery stalls, the outcry is the same: “Please sir I want some more”.

We only wonder why the outcry exists. If the traditional and non-traditional tools would have sufficed to combat this strain of economic pestilence, than we never would have embarked on the voyage of the QE2 and “Operation Twist”. None of this is said to belittle the strong efforts of Mr. Bernanke. He is in a most unenviable position and we must admit to having a growing admiration for him. However, it is troubling that a dependence on the “Government” has become part of the nation’s psyche -- from special tax treatment for capital gains, to free medical care for retired teachers, to home mortgage deductions, to earned income tax credits. Every one of these items has a constituency that can give you 10 reasons why each one is important. While we make no judgment on their propriety, we can observe that what was dropped from the nation’s thought process was how do we pay for it all? Or said differently, the assumption was that the economic engine would power the boat through all storms without springing any leak. Unfortunately, the planning did not provide for plugging any leaks should the U.S. enter a deflationary phase.

Over the last several decades, our attempts as a nation to supplement (entitlement programs) what business couldn’t, have left us with a debt structure that now endangers our economic well-being. When business would not or could not provide increased wages, and better benefits for much of the developed western world, many governments felt it was their role to step up and supplement the growing shortfall. Most would agree that there is a role for government to accomplish what the profit motive doesn’t, won’t or hasn’t. In short, what we and much of Europe have done is given ourselves most of what we want. This was done without any thought as to how to fund it, only to discover that now we can't agree on how to pay for it.

If you agree with RSW's assessment that what ails us is less cyclical than some pundits understand, you will see why we often present a less optimistic view than the crowd. It isn't that we enjoy taking this position, but we believe that our attempts to cure our nation's ills are not attacking the real underlying problems. For us as market professionals, we are left with an inescapable conclusion that these dynamics will leave us in a prolonged period of low interest rates, high unemployment, anemic economic activity, stagnant incomes, high debt levels, and therefore lower investment returns than those witnessed historically.

Bottom line: we remain fixed that our problems were created over decades and the solutions and their implementation won't come from monetary policy, QE's, cruise ships, or other "manufactured" solutions.

"Please sir I want some more"...We have met the enemy and he is us.

Municipal Bonds Provide a Strong Anchor in Volatile and Choppy Seas

A tumultuous third quarter saw the DJIA and S&P 500 decline by 12% and 14% respectively, and the U.S. lose its "AAA" rating (Standard & Poor's downgrade to "AA+"). There is no question that the strong performance of the municipal asset class during this period reflected the attributes of capital preservation and certainty of income, as volatility in equity and overseas markets carried the day.

Going forward, we expect the municipal market to continue to be a relative safe haven, as prospects for a meaningful pick-up in economic activity prove elusive, and expectations for a long-term sustainable solution to the European debt crisis remain low. That is not to say that state and local governmental finances are without challenges. Nevertheless, for the majority of relatively highly rated credits, such issues remain manageable with minimal prospects for significant credit deterioration.

Consider the following:

- ***"Just the facts Ma'am, nothing but the facts" –*** Despite Meredith Whitney's prior prediction of large scale massive municipal defaults, there have been only 2 rated defaults, year-to date, among Standard & Poor's 17,000 rated issues (a health care and housing issue, sectors typically that are not consistent with RSW's investment criteria).

- ***U.S. Census data -*** as of 2008 (last year available), interest payments on debt, as a percentage of state and local spending, was just over 4% -- a percentage equivalent to 1979 figures. Debt is not the driving force of municipal budgetary strain.
- ***This is not Greece -*** where debt is approximately 150% of GDP- U.S. state and local debt is roughly 16.7% of GDP.
- ***Keeping a sharpened pencil –*** Standard & Poor's downgraded 378 issues during the first half of 2011. However, the ratio of upgrades to downgrades was still a positive 1.9 to 1 during the second quarter.
- ***State tax revenues show marked improvement -*** preliminary 2nd quarter data shows an 11.4% increase from the same period last year, culminating in 6 consecutive increasing quarters on the heels of 5 previous quarters of declines. However, these revenues remain approximately 8% lower than the same period 3 years ago.
- ***Municipal credit ratings remain relatively strong -*** All but 2 of the 50 states are rated "Aa" or better by Moody's- with only California and Illinois rated in the "A" category. Less than 1% of U.S. nonfinancial companies are rated are rated "AA" or better by Moody's.

Discerning risk and opportunity - As previously suggested, the municipal market is not without risk. Budget busters include rising social service costs, unaddressed pension and postemployment health benefits, the demise of federal stimulus funds, labor costs, and in many cases unrealistic budget and revenue projections. We continue to favor essential service revenue bonds and tax-backed general obligation debt supported by unreserved fund balances and the ability to address fiscal ills in a timely fashion. This is especially relevant as global and national economic prospects remain weak.

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	Brian E. Pawl Operations Associate