Infinity and a Day

In the last few weeks, several Financial Advisors have asked us some very thoughtful questions regarding our 50,000 foot views. An amalgamation would sound something like this: "In light of the ECB's 'unlimited bond buying', the Federal Reserve's 'QE 3', a housing market that appears to be bottoming, and improving equity markets, has RSW's view of the world become any more constructive?" Before we provide a more complete answer to this question and challenge our long-held assumptions, it is important to first revisit our beliefs.

In order to "get into it", a refresher is necessary. In RSW's Q2 2006 commentary we stated: "Although some economists and investors dismiss the housing bubble as a sector event and not of global concern, we remain skeptical. To us, just as these professionals who called the "dot-com" bust an isolated incident that won't spill over to the entire economy were wrong, here too, they might be in denial until a sharp economic downturn occurs".

We believed then there were certain factors that we now refer to as structural that would continue to diminish economic growth including:

- An aging population with fewer less well-paid workers to support ever-expanding unfunded government mandates.
- Unchecked credit expansion.
- Rampant speculation.
- Increasingly less competitive education system.
- Wide and growing income disparity.

We often hear that the Great Recession was caused by a housing collapse, which caused a near banking collapse. While we don't argue with their enormous impact, we believe it would be more accurate to say that those events didn't cause the sustained problems we continue to face. Instead, they merely served to expose the socio-economic decay listed above and discussed below that developed over a number of decades (see RSW's Q3 2011 commentary: "We Have Met the Enemy and He Is Us"). As always, it is also important to deliberate these issues in a global sense, by not focusing exclusively on Washington or the domestic economy.

Foundation of Decay

With some noticeable differences, most of Europe, the U.S., and Japan share a very important commonality. For a period of decades, technology and the ascent of the emerging economies reduced total labor needs and related salaries. This decade's long trend saw governments trying to supplement declining incomes by providing generous transfer payments, tax benefits, and expansive retirement and medical benefits that were largely unfunded.

Benefits of all types were added during periods of relative prosperity and generally grew faster than our GDP. Unfortunately, during these "good times", incomes to pay for all of the "goodies" stagnated, or even contracted. This fact, combined with a poor demographic backdrop (aging population) in most of the developed world, compound the problem with fewer less-well paid workers to support an aging population. As the costs of entitlements exploded, current account deficits mushroomed, further pressuring competitiveness and the overall rate of economic activity.

Does Liquidity Trump Decay?

Now, with that background behind us, let's address our clients' questions head-on. We consider ourselves more constructive in one meaningful way: from a global perspective, an imminent or sudden systemic failure of a European sovereign or a European bank has been greatly reduced or eliminated in the short-to-medium term. Specifically, the LTRO (Long-Term Refinancing Operation) in which the European Central Bank (ECB) loans money at a very low interest rate to Euro zone banks has bought time for a largely insolvent banking system. Additionally, the OMT program (Outright Monetary Transactions), whereby those European governments that want the ECB to buy its bonds must agree to a program of growth reforms and austerity plans, greatly reduces the chances of waking up tomorrow or next month to a Spanish, Portuguese, or Irish default.

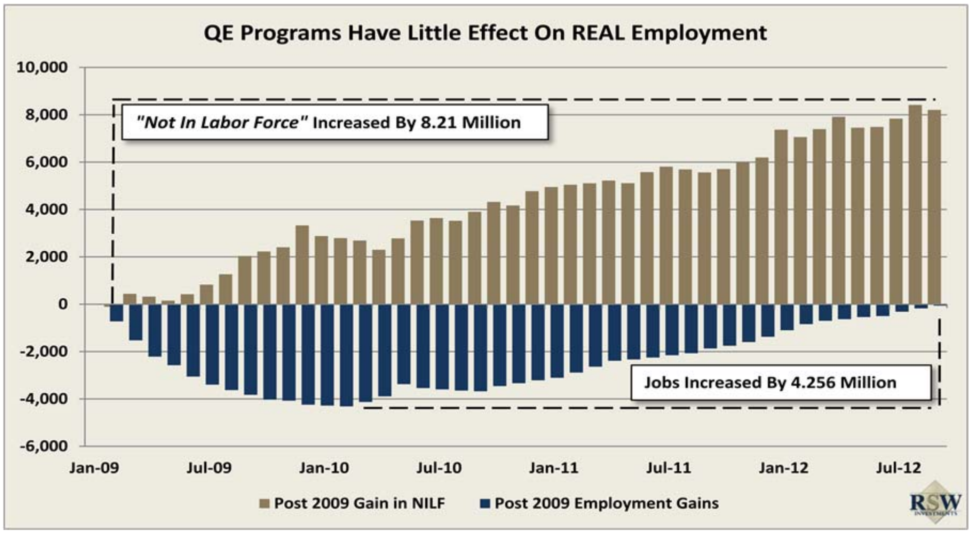
Over the long term however, optimism must be tempered. Even as we put our thoughts to paper, events are transpiring in Europe that illustrate the core of the problem. The world and world equity markets rejoiced when Mario Draghi (ECB President) announced the OMT. There are strings attached however, as the program is conditional on a given country asking for a bailout, and then agreeing to an IMF (International Monetary Fund) style of rescue that mandates customized austerity targets and a growth plan. Although Spain loves the unlimited bond buying idea, they balk at receiving a bailout fearing the implications for its sovereignty. Most notably, the accumulated austerity measures already imposed have brought tens of thousands citizens rioting in the streets, even before the additional austerity required in an OMT transaction. Similarly, Greece is once again (or is it still?) protesting austerity by calling for a nationwide workers strike.

Here at home, our solutions remain largely the same. It should be repeated here, as we often have, that while we may disagree with Ben Bernanke's policy fix, he has been forced to conjure up monetary solutions to problems that require fiscal policies. Asking Ben to do all of the heavy lifting is like asking the comedian Gallagher (remember the **"Sledge-O-Matic"** bit?) to slice the watermelon for your picnic. Having provided that one caveat, it is still fair to say that since the limited bond buying hasn't done much to alleviate the pressure on main street, it seems only logical, for the Fed at least, to continue its policy prescription to "infinity" (Fed recently announced that they will keep this QE in force until the labor market improves substantially).

History has shown us that each new monetary fix carries with it a short-term boost to the markets, followed by a down period when the program ends or nears completion. Admittedly, we are governed by the fact that markets can be very fickle in what information they choose to trade on, so much of our focus remains on what impact these prescriptive programs have on the real economy. At RSW, we remain steadfast in our belief that deflation is the enemy, and the transmission mechanism that at one time would have turned equity market optimism into rising employment and rising pay checks is no longer functioning normally. This is why we continue to sound more negative than most recent pontificators. Globally, vast pools of liquidity are being "poured" as a "fix", rather than as a "bridge", to solving long-term structural issues. The result is a weaker recovery than most expected:

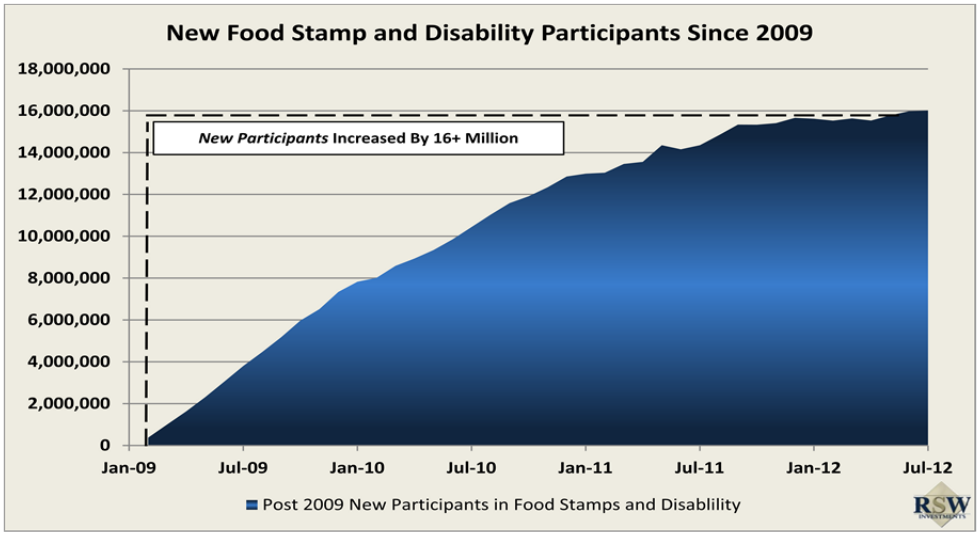
- National Rate of Unemployment at 7.80%.
- Median income has declined 8.20% since 2008.
- Since the **Great Recession** began:
    - ✓ **21% of the jobs lost were low paying** ($7.69 – $13.83 per hour)
    - ✓ <u>60%</u> of the jobs lost were <u>medium paying</u> ($13.84 - $21.13).
- During the **Recovery** phase:
    - ✓ **58% of the jobs created were low paying**
    - ✓ <u>22%</u> of the jobs created were <u>medium paying</u>.
- Recently, 2nd Quarter GDP was reported at 1.30%. (Between QE1 and QE2, GDP was reported at 1.60%).

The chart below shows the shrinking gains in employment (bottom half) since the beginning of 2009, contrasted with the number of individuals that have moved into the "No Longer in Labor Force" category (shown in the top half).



Source: Federal Reserve Bank of St. Louis, U.S. Bureau of Labor Statistics (data as of 10/9/12)

Furthermore, U.S. prosperity is diminishing, evidenced by the surge in New Food Stamp and Disability recipients. Please see below:



Source: FRAC (Food Research and Action Center), U.S. Social Security Administration (data thru 7/31/12)

While Greece is clearly insolvent, too many other countries like Portugal, Ireland, Spain, and possibly even Italy, exhibit financial dynamics that could potentially render them insolvent as well. Bond markets, sensing this fundamental weakness, push interest rates to levels where countries have difficulties funding themselves. To combat the "bond market vigilantes", Central Banks conjure up creative financing mechanisms to prevent an immediate collapse. Markets witness these government-lead massive infusions of capital, and have had a history of treating these "Band-Aids" as solutions.

As you may recall, we had our first "Greece is fixed" rally about two years ago. Only time will tell which countries go the way of Greece or find a way to change their dynamics. We are simply saying that an ESM, OMT, or a QE1, 2, or 3 is not the finish line. It is actually the starting line from which two things have to happen. Before enumerating each, I want to say that we do know how difficult both of these items will be to accomplish, and that is one reason we are sometimes called "too pessimistic".

1- Each Government will need to have an "adult" conversation with their citizenry explaining that for decades they have been living beyond their means. Furthermore, they will need to support their claim by educating the masses about the "math" of their quagmire. Lastly, an economic tutorial is called for to outline the need to spend less and develop sound plans to grow and earn more.

2- As hard as the first task is, the second step is usually where the riots start, if they haven't already started. One group will want to tax the wealthy at 75%. Another group only wants to cut pensions and benefits. The third group believes that there is too little infrastructure, or too little spent on education. It's often messy and always hard but we call it Democracy, and it can be painfully slow and sometimes all parties fight to a draw. Unfortunately, most countries are in a situation where time is not on their side. The developed countries need to "bend their cost curve" down and the growth curve up to survive and prosper. Thus far, we have seen too much government paralysis where the disease goes untreated.

We also contend that the Fed has shown a far greater ability to create food, fuel, rent, and medical inflation than they are at generating wage inflation. This has been, and remains, the basis of our long held view that pockets of current inflation sow the seeds of the next deflation, as too many people spend ever-increasing sums of money on necessities with nothing left for discretionary spending.

When considering all of Bernanke's policy decisions, do his actions make him sound like a man who is more concerned about Deflation or Inflation?

Parting Thoughts:

- Infinity and a day is an oxymoron, and so are liquidity and a solution.
- Is Chairman Bernanke operating by Abraham Maslow's maxim that "if the only tool you have is a hammer, every problem looks like a nail"?
- Although the risk of a left-tailed event has been substantially reduced, if one should occur, our ability to respond has likewise been substantially reduced. How do you present a plan that goes beyond infinity? **Infinity plus a day?** We, and Bernanke, are now truly all in!

Municipal Commentary

Despite Volume Surges, a Lid Has Capped a Rise in Muni Yields

Year to date (through September), municipal new issue volume of roughly $279 billion is significantly (44%) higher than during the same period one year earlier. Despite the surge in borrowing, tax-exempt yields are dramatically lower than a year ago. Likewise, credit quality spreads have continued to narrow as the "grab" for yield by investors continues.

The municipal bond market posted solid returns during the third quarter amidst "negative net municipal supply" (see below), and relative calm in the Treasury bond market. Using the ten-year maturity "AAA" rated tax-exempt bond as a proxy, yields *declined* by 16 basis points, versus a 2 basis point *rise* in like-maturity Treasury bond yields. Furthermore, returns in the marketplace were uneven, as the yields (and hence return) of longer maturity bonds significantly outpaced shorter-dated maturities.

Negative Net Supply

During the summer months the amount of cash invested in the municipal bond market outpaced the level of new issue supply. Investors busily invested the out-sized proceeds they received from coupon income, bond calls, and maturing securities. Additionally, as interest rates declined, issuers seized the opportunity to reduce their interest rate expense by refinancing their existing debt. In fact, approximately 50% of this year's new issue volume was due to refunding older, higher interest-rate bonds.

When old bonds are "called' and refunded before their maturity dates, the cash is returned to bondholders who frequently re-deploy the cash in the newly issued bonds that replace the refunded bonds. Notwithstanding a 2012 new issue volume which is 10% to 12% higher than previous YTD issuance, there is insufficient inventory currently available to replace bonds that are maturing or being subject to redemption.

Looking ahead, municipal yields typically experience an upward drift during the fall season as the height of the summer redemption period fades away and new issue activity tends to rise. For these reasons, we have been "shading" the average maturity and duration (measure of interest rate sensitivity) of our client portfolios shorter. Furthermore, the upcoming elections and meaningful yield declines that have already unfolded mandate that a more cautious approach is warranted in the coming months. Our focus over the near term will therefore be tilted in favor of capital preservation, as we move through a period that we expect to be marked with a greater level of uncertainty and volatility.

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**