

## **Fed Watch**

As Bernanke first embarked on his easing campaign, there was a spirited debate as to whether the effects of the housing debacle would remain contained or spillover into the general economy. There were also arguments about whether the Fed should act in any capacity to ease at all. For example, policy makers were concerned that "John Q Public" may interpret an easing campaign as a means to bring relief to real estate speculators and hedge funds. This reasoning is known as the "moral hazard" argument. Many believe that if you bail out someone who has engaged in overly risky behavior then you are likely to encourage that behavior in the future. The financial markets seem to have grown accustomed to this concept while Greenspan was at the helm. Quite often, traders and investors believed that any severe market dislocations would be met with aggressive interest rate cuts. Now that it is clear that the financial crisis is also an economic event, that debate has ended.

As one debate resolves itself another seems to take its place. Namely, is the Federal Reserve behind the curve? The answer to this question may reside in work previously published by Fed Governor Mishkin. In his analysis, he concluded that interest rate cuts need to be large and front-end loaded before a decline in single family home prices gains momentum. This was due to his belief that declines in home prices could spark a broader deflationary force that may spread into other segments of the economy and possibly cause a severe recession. In fact, history suggests that economic contractions driven by falling asset prices and credit market dislocations seem to linger for quite some time. Some examples of these episodes include the decade long Japanese phenomena and the U.S. recession in the 1990's. That sluggish period was brought about by a bursting real estate bubble and resultant failure of hundreds of Savings and Loan institutions.

## What you don't know can hurt you

For the last year it has been in vogue to use the term sub-prime as it applies to leveraged mortgage backed securities. Although market participants have been busy re-pricing the risk of these securities, RSW has been striving to communicate a broader concept. In a sense, the foundation for the financial crisis that is upon us is about securitization and leverage. It was once thought that the creation of Collateralized Debt Obligations was a clever way of channeling and directing risk to those who were better equipped to manage it. This turned out to be false as the risk seems to have been passed on to those who were the least able to understand it.

Aside from the plain vanilla CDO structures, there does exist another flavor of financial engineering known as credit linked notes. With trillions of dollars outstanding, these structures are not supported by the cash flows from a specified pool of underlying assets. Instead, the return on these "clone" investments is determined by how well a basket of securities or index (known as reference assets) performs. In other words, when Wall Street couldn't obtain loans necessary to package and sell to investors, they created synthetic notes that attempted to mimic the performance of a customized index of bonds. Hence, these off-balance sheet structures serve to mask the scope of the true amount of leverage tied to the destiny of the housing market.

Likewise, it is important to note that off-balance sheet loans weren't limited to just the housing sector. Automobile



loans and credit card payments are other types of cash flows that were securitized, and "tranched" to create different classes of note holders. With the pace of economic activity slowing precipitously, the stability of other types of cash flows that are hinged upon a healthy consumer could soon be called into question. Now that the first domino has fallen, the others may follow. We believe it is prudent to ask ourselves how often you only see one domino fall. Caution dictates that we remain vigilant to see whether the other products of financial engineering (some mentioned above) suffer a similar fate. This is the very contagion that we have been concerned about and have been discussing in our commentaries throughout the past few quarters. We continue to believe that the Fed has been doing what the Fed has always done, fight last year's war, namely, the war against inflation.

## Municipal bond perspective

The fourth quarter proved particularly difficult for Municipal bond investors as the fallout from the single family housing debacle continued to spread. Historically, the higher quality segment of the municipal bond market has been virtually immune to shocks originating in other asset classes. This time has been unique however, as there were several key sources of pressure. First, with a financial system that was starved for liquidity and global markets in turmoil, many brokerage firms were trying to raise their cash positions to strengthen their balance sheet. With many of the markets in disarray, traders capitalized on the opportunity to sell municipal bonds as the tax-exempt market was liquid and able to accommodate the closing of the firms' trading positions.

Secondly, hedge funds also contributed to the "heaviness" of the market. Those that speculated that municipal prices would rise more rapidly than Treasury issues were disappointed. As investors flocked to the Treasury market during the latest flight to quality craze, the price of Government securities advanced rapidly and some hedge funds sought to limit their losses by unwinding their position.

The last culprit was related to the monoline municipal bond insurers. These firms are suffering because they ventured into the world of structured securities and put their "AAA"-rated stamp on more exotic bond offerings such as Collateralized Debt Obligations (CDO's). The news worsened during the quarter as the home prices continued to fall, and the pace of delinquencies and foreclosures escalated. This caused the values of CDO structures linked to the mortgage backed market to fall even further from already distressed levels.

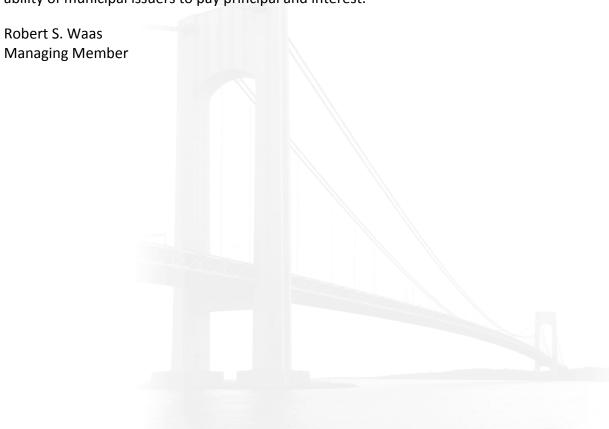
Now with many of these obligations imploding, some of the monoline insurers are experiencing a capital shortfall. With balance sheets in need of repair, the credit rating agencies are threatening to pull their "AAA" rating unless the insurers replenish their capital base. Against this backdrop of inadequate reserves, it has become virtually impossible for these entities to underwrite new business. Furthermore, it has created challenges for investors and traders to value the securities backed by the troubled monoline insurers.

Against this backdrop, the question at hand remains the same. Do the current prices of tax-exempt securities already contain much of the news discussed above? While no one knows with 100% certainty, we tend to believe that as we closed 2007, the tax-exempt market had begun to build in some of the uncertainties mentioned above.



In spite of all of the difficulty that we have been discussing, Warren Buffet, who historically has had a good instinct for value, announced that he is launching a municipal bond insurance company. The insurance arm will be dedicated to guaranteeing the timely payment of interest and principal on debt issued by state and local governments. Buffet is seeking to capitalize on MBIA, AMBAC, and FGIC's (the three largest municipal bond guarantors) self-inflicted financial wounds.

Let us be mindful that what has been damaged is the claims paying ability of the financial guarantors and not the ability of municipal issuers to pay principal and interest.



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