

Roll the presses, start the engines

While it has been a longstanding tradition at RSW Investments to include a section in the quarterly newsletter entitled "Fed Watch", we are discontinuing these musings. With the Federal Reserve's Target Rate close to zero its relevance has been greatly diminished.

If there was any doubt about the severity of our economic problems we need only look at the Fed's monetary policy. With interest rates near zero, the Fed is adopting a policy previously utilized in Japan, but new to the United States: namely "Quantitative Easing". In the broadest sense the "TARP", capital infusions, and loan guaranties, are all tentacles of the newly created Fed monetary policy. The usual procedure of reducing a bank's cost of funds to make lending more profitable has been supplemented by direct governmental aid, guaranteeing loans, or buying taxable assets.

The Fed has also announced a plan whereby they will begin to buy up to \$500 billion of longer-maturity Government bonds. The objective is to drive down long-term interest rates to make mortgage borrowing more affordable and increase the number of loans that can be refinanced. By any criteria this is monetary policy on steroids. We believe it is not being overly dramatic to say that the real challenge is not to re-liquify banks, but to help make them solvent. At the risk of making light of a difficult situation, Fed policy is now Ben Bernanke in a helicopter armed with a Treasury printing press, throwing out piles of cash.

Weighing in on Deflation / Hyperinflation

Only months ago market participants squared off to debate whether inflation will moderate or will it surge to produce a 1970's style inflation. While staring down the world financial system's number one enemy (deflation), there is a growing chorus of those who fear that the Fed's "open spigot" monetary policy is highly inflationary. As this debate rages we must be mindful that no matter what the outcome, Hyperinflation is a welcome visitor compared to the dreaded Deflationary result. Inflation in the system is not only normal it is also a sign of a vibrant and growing economy. Deflation, on the other hand, is both a rare occurrence and a sign of an enormous systemic risk.

At RSW, we continue to receive numerous questions about the likelihood of experiencing a period marked by Hyperinflation. To many this is a real concern, although we remain convinced that this fear is an odd lot compared to others that we could conjure up. In pontificating about Deflation versus Hyperinflation, we need to look no further than the billions the Government has doled out to the banks. After all, with all of this new cash being pumped into the system many are concluding that the rate of inflation is poised to skyrocket. The reality of the situation is that the bank bail-outs have actually been deflationary since they have been aimed at propping-up the reserves of the lending institutions. With perfect 20/20 hindsight, we know that this activity has not caused the banks to expand their loans, and their related profit margins. These capital injections may have afforded some banks an opportunity to sustain their credit ratings, but the markets are a zero sum game: for every winner there is a loser. In this case, we are talking about the equity holders who are quickly getting wiped out in this "re-liquification" process.

Predictably, the more than \$1 trillion worth of bailout money and guarantees that have been thrown at the problem so far have caused almost no new lending activity. In fact, another trillion wouldn't change that, as the powerful defla-

tionary mindset has become pervasive. So, can policymakers really cause Hyperinflation in this environment? Yes, definitely, but it should only occur with policies that are different than the one's being implemented. For example, if Congress elected to pay-off everyone's mortgage, effectively bailing out debtors at the expense of savers, this would be highly inflationary. In other words, bail out lenders and you beget deflation; bail out debtors and inflation will soon follow. The course that the Federal Government has charted is indelible and seemingly irreversible. Billions if not trillions will be spent to support the credibility of Fannie Mae and Freddie Mac, but the mortgage obligations of financially distressed homeowners will remain on the books.

Bottom line: here's a tip, it's too early to buy TIPS (Treasury Inflation Protected Securities)

Fast forward: Is the economy's growth potential on a diet?

The only thing more abundant than the problems facing our financial system is the varied remedies being debated and prescribed. At RSW, we believe the damage to the system is so profound that we will need all of the programs mentioned above to be implemented and perhaps more. With that said, we will resist the temptation to add our voice to this debate and instead focus on our view of some economic fundamentals in a post "no leverage too large, no risk too big world".

We are gripped by the belief that once the seeds for a recovery are sown, the U.S. economic engine will likely produce lower levels of GDP growth than we have become accustomed to. If massive amounts of leverage and out-sized risks were at the core of our economic growth in the last two decades, how do we repeat that growth in a world where risk is a four letter word? While Government intervention can provide the stability that the financial system so desperately needs, it too should come at a price. As we "socialize" our system and the appetite to take on risk is squelched, so too may be the ability to generate high returns. For this reason it may take years before the U.S. economy can return to the days when a 3% to 4% GDP growth rate can be achieved.

While lower growth rates are less ominous sounding than imbedded deflation, they carry their own risks for all of us charged with investing and managing assets. In a more risk averse, lower leverage world, the most important thing to manage may be expectations.

Municipal Bond Market

For tax-exempt investors, the fourth quarter was yet another period marked by spectacular turbulence. For example, during the first 15 trading days, prices in the municipal bond market were down approximately 6%¹. True to form and characteristic of other volatile periods during the year, the market recovered from its abysmal start and yields finished the quarter close to where they began. For the quarter the Lehman Bros. Municipal Bond Index posted a return of +0.74%.

This type of volatility drew a lot of attention on the part of the media and concerned municipal investors, and understandably so. The municipal asset class has long been known for its stability and consistent returns. Historically, even during periods of rapidly shifting Treasury bond yields, tax-exempts have long been an asset class known for its relative



stability.

A rare occurrence, and one many market participants had never experienced was a drop in the value of their municipal holdings, even as Treasury yields were declining. Not being armed with the facts, most investors and commentators chalked up the poor performance in tax-exempts to a spike in expectations of the level of municipal bond defaults. In contrast, we felt that forced sellers, surges in new issue supply, and the inability of broker/dealers to position bonds in the trading accounts accounted for the majority of the increase in municipal bond yields. With the benefit of history we know that our prognosis was correct. After all, tax-exempt prices are up sharply in 2009 and if credit concerns were the main driver of return then why would the municipal market be behaving so well? Has the financial health of state and local governments miraculously improved? The answer can once again be found in the market technicals. In mid-December we entered a period known as the January effect. This is a time marked by heavy demand on the back of large coupon payments, maturing bonds, bond calls, and a light new issue calendar. In short, too much cash chasing too few bonds.

Currently, 44 states are facing shortfalls in their budgets for this and/or next year according to the Center on Budget and Policy Priorities (CBPP). Despite challenges in balancing the budgets, most state governments are favoring cuts in expenditures rather than raising taxes. In addition, after considerable debate, we believe a sizable federal package will be put forth to mitigate state deficits. With that said, the steep recession and reduced capital market access for smaller and lower-rated issuers will likely lead to an increase in missed payments. In contrast, the higher quality issuers (RSW's focus) could experience an above average amount of downgrades over the next year.

As always we look forward to keeping you abreast of any market developments in our scheduled quarterly commentaries or in our intra-quarterly communications.

Sincerely,

Robert S. Waas
Managing Member

¹As measured by the Lehman Brothers Municipal Bond Index.

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