Flashbacks to 2008?

With our thoughts for the New Year freshly outlined in our 2011 Outlook (published December 15, 2010), we have opted to devote this entire Q4 2010 commentary exclusively to the municipal bond market.

For tax-exempt investors, the six weeks ending December 15 marked a period of "spectacular turbulence". Reminiscent of 2008, price declines were virtually unabated from the beginning of November onward. In fact, using 10-year "AAA" rated bonds as a proxy, yields, on average, climbed by approximately 76 basis points through mid-December. This resulted in a (-4.77%) decline in total rate of return (yield and price losses), as measured by the Barclay's Capital Municipal Bond Index over the same period of time.

We entered the fourth quarter with our portfolios defensively positioned in anticipation of some market turbulence. While we underestimated the scope and dimension of the declines, the "rough patch" was not unexpected. The occurrences in the municipal bond market drew a lot of attention from the media, and caused heightened concern and anxiety among some municipal bond investors. It is easy to understand why investors would stress about the speed and severity of the hiccup in municipal bond yields, and the ensuing price losses. Fueling this discomfort was the media's characterization of the situation, which named the impaired ability of state and local governments to pay their principal and interest payments as the catalyst for the decline.

If investors are not armed with facts, it is impossible for them to accurately assess the risks, and potential returns, that may be expected in the future. This causes causal investors to react emotionally rather than with reason and logic. While the press was busy assigning the possibility of a spike in the level of municipal bond defaults and surging inflation expectations as the culprits for the majority of the decline, we have been addressing the market's technical situation. Simply put, too much municipal supply overwhelmed too little demand against a backdrop of rising U.S. Treasury yields.

2010: The year of the BAB

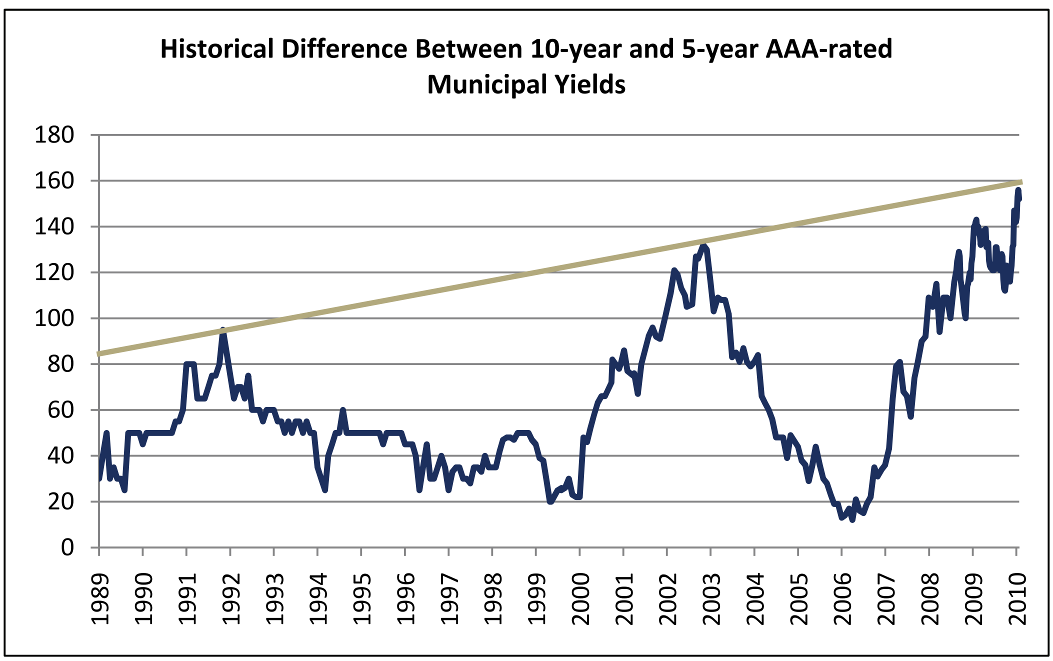
With the renewal of the Build America Bond program (BABs) appearing unlikely, issuers piled in to the late-year marketplace and issued debt before the program expired. This even caused some borrowers to shift their scheduled borrowing to the last weeks of 2010 from the first quarter 2011. While it seems counterintuitive that state and local governments, who are seeking to borrow monies in the taxable market, creates a swell in the level of tax-free issuance, the answer is quite simple. Given the high cost of underwriting new issues, borrowers often combine their offerings of both tax-exempt and taxable bonds. This activity enables the municipality to pay just one underwriting fee. Unfortunately, during late 2010, this issuance was enough to overwhelm buyers, particularly when investor demand is historically light.

Over the past twenty-five years, there have been difficult periods to maneuver client portfolios through.

This time the situation was different, as issuers lined up to bring their bonds to market, irrespective of the elevated yields in the marketplace, because they were trying to beat an arbitrary calendar-imposed issuance deadline. While RSW entered the fourth quarter with a relatively low level of duration (measure of interest rate sensitivity), we elected not to join the herd and sell bonds during the recent decline. Instead we searched for opportunities to enhance our exposure to longer-maturity issues, and bonds with longer call dates. In contrast, if we believed that the long-term prognosis for this market had changed, our game plan would have been materially altered. Please note, there are also other important factors which are embedded in our decision-making process, such as transaction costs (bid/ask spreads), and RSW's estimate of the length of time that the upward pressure on yields is likely to persist.

2011: Where are we now?

The recent rise in tax-free yields was particularly pronounced in longer-maturity bonds, causing the municipal bond yield curve to steepen. This means that the yield gap between short and longer-maturity bonds expanded, and now stands at some of the widest levels seen in the last twenty years. (Please see the chart below). For example, the yield of 5-year "AAA" rated bonds currently stands at 1.73%, a whopping 1.48% less than comparable quality 10 year maturity bonds offered at 3.21%. Said differently, longer-maturity bonds offer extraordinary value, as investors have elected to suffer an outsized penalty for owning shorter-maturity bonds.



We believe that we have entered a period historically known as the "January effect". This time period is marked by outsized investor demand for municipal securities, which tends to outpace new-issue supply. During this period, bond buyers are typically re-investing cash flows received from December's bond calls, maturing securities, and coupon payments. Today's landscape looks familiar, as almost on cue, municipal prices have begun to move higher, since December 15. With history as our guidepost, we believe this dynamic should continue through the end of January, barring a meaningful rise in Treasury yields from today's levels.

While no one should be comfortable with the type of yield spike that we recently witnessed, investors are left with some ongoing questions. In October 2008 we said: "Do you judge an asset class during times of nearly unprecedented price volatility or remain committed to an asset class that over time has produced solid returns relative to the taxable bond market? If you analyzed the municipal asset class in 1994 (weak returns), instead of 1995 (strong returns) your opinion would be vastly different. Here, yields plummeted by approximately the same amount that they rose in 1994".

- Will the outcome of this 2010 be the same as in 1995 and 2009?
- Should investors buy, sell, or hold a bond maturing ten years and beyond, when the yield difference compared to shorter maturity bonds is approaching the widest levels in over twenty years?
- Should investors buy, sell, or hold a tax-free bond whose yield is close to 100% of U.S. Treasury obligations?
- Should investors buy, sell, or hold a 3.50% to 4% tax-exempt yield? (5.39% to 6.15%% taxable equivalent yield, without the consideration of state income taxes)?

While we do believe that tax-exempt bonds afford a solid risk-to-reward opportunity at this time, investors should understand that the marketplace may continue to experience periods of volatility (rising and declining prices). After all, the ability to collect relatively high levels of after-tax return should come at a price.

The silly season may have passed

Many of the events and news stories that recently emerged were predictable and expected. While the media has done a remarkable job of creating hype and hysteria, the headlines are in synch with those we projected roughly two years ago. In RSW's Q1 2009 commentary, we suggested headlines that may be in the offering, included:

- "Every state is on the verge of collapse as budget deficits swell"
- "Pension benefit and health care costs are strangling cities and states"
- "Lurking beneath the surface are great risks that Municipal Investors don't know"

As we all know, many municipalities are experiencing financial stress, and are in the process of correcting their irresponsible behavior. With that said, a plethora of stories reported in the media continue to highlight those rare instances of chapter 9 filings or those public entities staving off bankruptcy protection. Examples include: Vallejo County CA, Jefferson County AL, and Harrisburg County PA. (Please visit our website, and click on the "Crossing the Bridge section" to read about these specific issuers). In a relentless manner, the media portrays the problems facing these issuers as "mainstream," and holds out these examples as predictors of imminent doom for many public entities. At RSW, we would not characterize these municipalities as entities that experienced "normal" stresses. Rather, these are one-off situations where there may have been an abnormal concentration of individuals making foolish decisions.

Yes, it's probable that the silly season is behind us, at least for a while. The era of gold-plated pay, pension, and health care packages may be going the way of the Ford Pinto. There is no longer any tolerance for funding projects that are not imperative (bridges to nowhere, no more!), promises made by municipalities without respect for the cost, or the irresponsible use of financial derivative products by unsophisticated bureaucrats (Orange County CA, Jefferson County AL).

For all of the recent media scrutiny, it is interesting to note that the incidence of default actually declined in 2010, compared to 2009. While we maintain that the incidences of municipal default are over-blown by the media, we do expect to see an increase in the level of default rates among certain types of issuers. Namely, smaller issuers from economically challenged areas, where the cash flows are not supported by taxes. In fact, the overwhelming majority of municipal defaults that occurred to-date since 1970, were confined to the healthcare and housing sectors – sectors we assiduously avoid.

Nevertheless, the opening weeks of 2011 will see new headlines as budget season opens and governors deliver their respective "state of the state" addresses. We expect that the resounding theme will be that of the need to start putting "our fiscal house in order". While we do not expect to see overnight change, they are in the offing, and should lead to recurring solutions that should result in the enhancement of security for existing bondholders.

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