The Games People Play (1/18/12)

Before the advent of Pac Man, computers, cell phones, iPads, and XBOX, kids had to amuse themselves with homemade games. One of the more popular games was called "kick the can". Maybe we have been watching too many financial and political television programs, but it seems that lately the game has returned with a vengeance, and a new twist. What used to be an aimless kicking the can to and fro has become a more purposeful "kicking the can down the road". Along with being modernized, the new game has spread from our shores to Europe, where endless variations of the game are now daily sport. The game, and its second and third derivatives, has become such a big part of the financial world, we thought RSW should offer a view of who was playing and which form of the game was being played. To accomplish this, we have chosen the form of matching Column A with column B. While we have made the matches that we feel are the most appropriate, there certainly can be more than one correct answer or even multiple answers. No need to approach this exercise with trepidation, just like in our children's schools, we grade on a curve and everyone gets a trophy.

Column A	Column B
Kicking the can down the road:	Portugal, Spain, France, the Congressional Joint Select Committee on Deficit Reduction
They got kicked in the can:	George Papandreau (Former Greek Prime Minister), The Bowles Simpson Commission (Fiscal commission's co-chairs, Erskine Bowles and former-Sen. Alan Simpson)
They ran out of road:	Greece
They had one for the road:	Ireland
Opening up a can of worms:	European Banks, and Bank of America
They make the can:	Alcoa (we wanted to make certain everyone got one right)

Column A	Column B
Hit the road Jack and don't come back…:	Silvio Berlusconi (Italy's longest-serving post-war prime minister who resigned) and the Bowles Simpson Commission (thought they deserved two)
The road to hell is paved with good intentions:	The ECB (European Central Bank), Ben Bernanke
They could run out of road:	Germany, and the USA
Road-kill:	Most of the above, and Jon Corzine

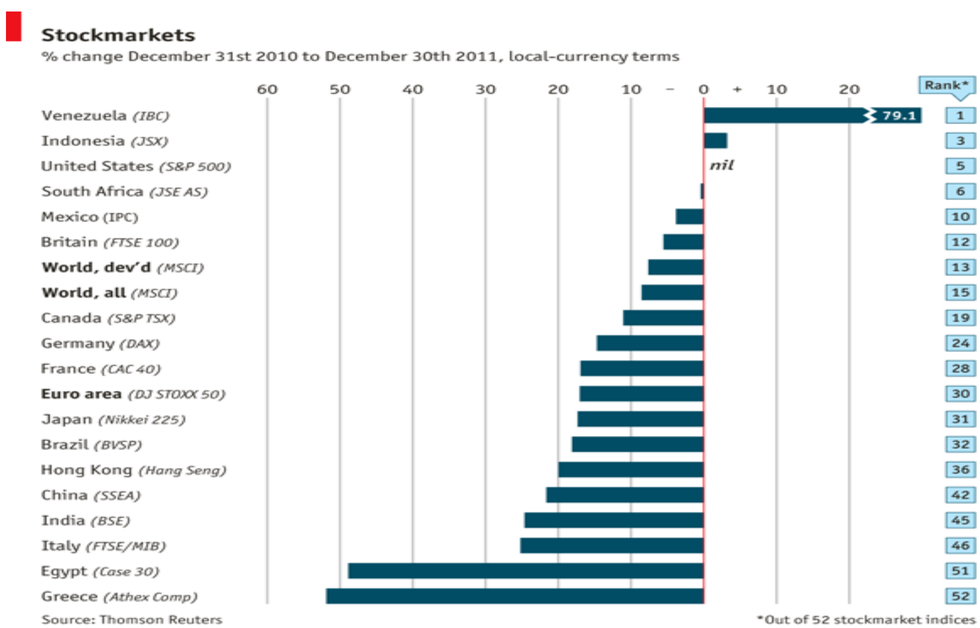
In RSW's December 2012 Investment Outlook, we cautioned our readers not to keep an eye focused solely on developments in Europe. It remains our central premise that there are so many fissures in the world's economic landscape that the most probable outcome is some kind of fracture, the severity of which will ultimately be determined by how the events are dealt with by elected and non-elected policy makers. We certainly do not eliminate the chance for better than expected outcomes, we simply assign them a lower probability. As we implied in December, you can be hurt by looking in the wrong direction, but there is also danger in looking at the wrong variables. Bottom line: Don't just focus solely on the headlines!

The financial markets, on the other hand, seem to focus solely on one announcement at a time. Traders salivate over the thought of the ECB becoming "the buyer of last resort" of troubled European sovereign debt, or the announcement that another European Summit is scheduled. The yield on the 10-year Italian bond is a headline, and the unlimited 3-year 1% loans provided by the European Central bank (ECB) to European banks become the latest "bazooka". If problems and challenges are a cancer in the economic bloodstream, then providing liquidity becomes the Oxycodone. While it may be great for pain relief, it does not slow the spread of the disease. In the United States, we have continued with the same prescription through our quantitative easing programs (QE 1+2) and "Operation Twist" (the Fed sells short maturity Treasury bonds previously purchased during the Fed's Quantitative easing program using the proceeds to acquire longer maturity Treasury bonds). Liquidity seems to be the addictive and perfect policy prescription placebo.

We at RSW don't argue that the various steps taken in the Eurozone aren't necessary; only that they aren't necessarily game changing. All of the "silver bullets" often discussed and considered could be implemented, and some European countries could still fall hard into a recession. For us, the true storyline is how developed economies resolve their burdensome debt loads, their lack of competitiveness, declining incomes, structural unemployment, disparity of incomes, and bank solvency. These issues are unleashing a tidal wave of deflationary headwinds. Solving these larger problems does not lend itself to magic bullets or pronouncements from summits. They involve unpleasant socioeconomic decisions and political courage that is as difficult to find as rare earth minerals. It seems that most of the world is overweight politicians and underweight statesmen.

While Europe gets and deserves much of the attention, there is something strange going on in some important BRIC (Brazil, Russia, India, and China) countries. We previously mentioned their noticeably decelerating economic growth rates, but of even greater note, of late, is the performance of their equity markets. Whether it is the realization of a housing bubble, or steps to curb inflation, or the contagion from the weakness in Europe, there has been a persistent and long term decline in the equity markets of the BRIC countries.

Here again, we claim no expertise on developing economies. We simply believe we should be asking why, with different internal dynamics, the stock markets of countries with such high growth rates can either be experiencing "bear markets", or something close to it. We could argue that one cause has been China's Central Bank which, until recently, was steadily raising short term interest rates. However, even after the Chinese Central Bank reversed course and began to ease, their broad stock market indices continued to deteriorate. Please see the chart below which depicts the 2011 returns for 20 of the 52 world equity indices.



We bring all this up because it has become conventional wisdom that developing economies are insulated from the ills of the developed world. It has also been said that the economic might of these countries will serve as the world's "growth engine", thereby ensuring that the global economic system has a built-in "shock absorber". It seems unlikely that 8-9% growth can produce (-25%) equity returns without other outside forces contributing! We fully recognize that there are endless voices telling us what the problems are, and even more voices offering remedies. Our view is well documented: an array of structural, economic and socioeconomic woes created a treacherous deflationary force. Since the Lehman crisis, the US equity market took great solace from short term interest rates being pegged at near zero percent, QE1, QE2, and we danced when the Fed did the "Twist". We ask for your indulgence in advance if we sound like party poopers. We believe that financial markets should soon begin to figure out that each time the Federal Reserve spoons out another dose of QE, more modest results should be realized. After all, doesn't logic tell us that a QE3, in and of itself, clearly indicates that QE 1 and 2 didn't work?

All through the recent period of fiscal and monetary stimulus, we experienced declining bursts of growth, followed by set-backs. Reminiscent of January 2011, the pundits, once again, are raising their forecasts for 2012 as the recent economic data continues to improve. However, the same forces that served to squelch the level of activity in the US during 2011 are still raging (falling real wages, sinking home prices etc). This time around however, the headwinds from Europe are gaining momentum as the PIIGS (Portugal, Italy, Ireland, Greece, and Spain) are all but a slam dunk to roll back into a recession in the near-term.

Furthermore, while it is true that holiday retail sales increased the level of retail price discounting was aggressive. With the level of consumer credit increasing from $14 billion to $20 billion, it is obvious that individuals are once again picking up their previous bad habits by spending more than they are taking in. This probably served to inflate the level of recent business activity temporarily, but should subside again as many individuals assess the damage when the final tally from the Holidays comes in from the credit card companies. Bottom line: akin to 2011, growth in 2012 is poised to disappoint yet again, as the strongest period of economic activity should soon be behind us.

Our skepticism arises out of our belief that the world's economic ills will not be cured by silver bullets, or bazookas, the ECB, or the Federal Reserve being "all in". And above all, we believe that nothing good can come from kicking the…

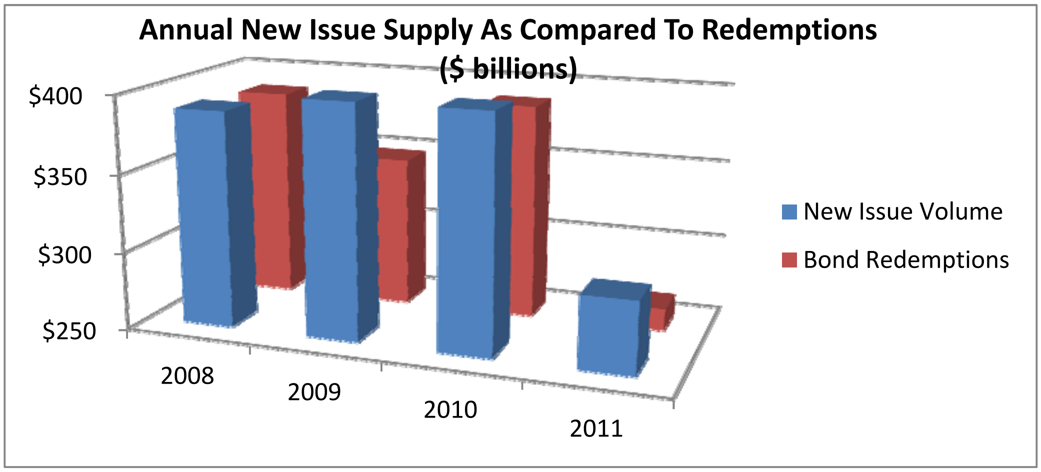
Waiting For Higher Yields?

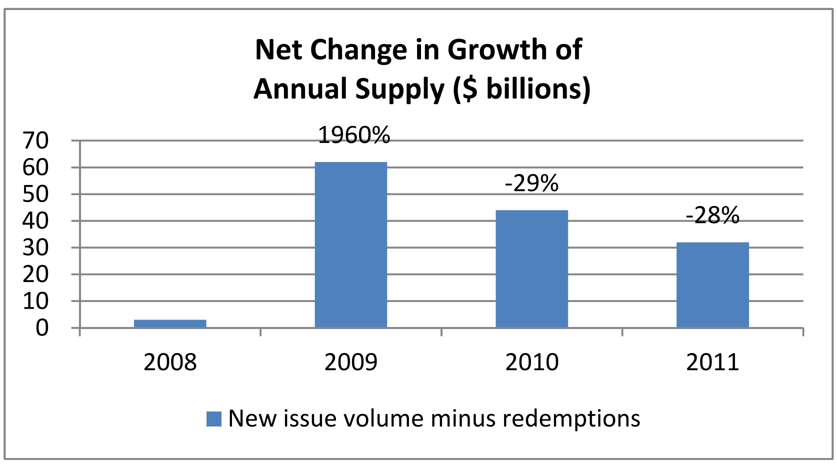
The municipal bond market entered the fourth quarter 2011 with a 180 degree different tone than one year ago. During the fourth quarter of 2010, many investors were panicking as the fear of widespread municipal bond defaults raged. Numerous negative headlines, and an exaggerated call by Meredith Whitney forecasting the imminent prospect of billions ($) of municipal defaults led to wide-spread selling of municipal holdings.

In contrast, this past year, investors were busily snapping up tax-exempt bond issues at a rapid pace propelling yields to historically low levels. As 2012 unfolds, interest rates, especially municipal yields, remain at new historic lows. Currently, the market yield for 10-Year "AAA" General Obligation (GO's) bond yields stands at 1.69% or approximately 177 basis points lower than the same time last year. The rapid pace of investment occurred despite the fanfare generated by isolated challenges: the insolvency of Harrisburg, Pennsylvania and the bankruptcy filing of Jefferson County, Alabama. Investors rightfully viewed these issues as "one-offs", as the level of municipal defaults actually subsided to levels not seen in over 10 years. This strength in issuer credit quality provided a healthy backdrop for the marketplace, helping to propel the total rate of return of the municipal bond asset class toward the top of the pack in 2011.

Technical forces (robust demand and limited new-issue supply) in the municipal bond market, created an additional tail wind for yields to drop. With that said, as the fourth quarter of 2011 unfolded, the "January Effect" took hold early, as the new-issue market came to a holiday halt, while demand continued to be strong for a paltry supply of available quality bonds. As you may recall from our previous missives, investors are typically quite active around the "turn" of the year, as they are flush with cash from coupon payments, bond calls, and maturing securities.

The following two charts illustrate the virtually unprecedented year-over- year decline in new municipal bond issuance in 2011, and the miniscule net change in outstanding supply, as the estimated par value of maturing and called bonds in 2011 was 99% of the new issue bond volume (excluding short term notes).





- 2010 record issuance of $433 billion was bolstered by the expiring (at year-end) Build America Bond program which "robbed" from 2011 issuance.
- 2011 new issue volume of approximately $297 million fell by 32% from the previous year.
- While the 2011 outstanding supply increased by a net $32 billion, this was a negligible amount as bond redemptions and maturities totaled $265 billion.

- Year-over- year declines in the amount of net new supply occurred at the same time as demand for quality municipal bonds surged, as investors focused on capital preservation and income in a weakening economy.

Where We Stand Today

The favorable supply-demand balance that benefited municipal bonds in 2011 remains intact as we begin 2012. Although the trend is likely to persist, there is the potential for the level of new-issuance to increase from the pace experienced in 2011. In fact, the consensus forecast for supply targets a range of $300 to $350 billion, an increase over the 2011's paltry total but still modest compared to prior years.

The tax-exempt asset class still appears to be priced at attractive levels versus its taxable brethren. This favorable valuation should provide a buffer against price declines should interest rates rise to any meaningful degree during 2012. Given our forecast this year for the number of issuers being downgraded versus upgraded, we still find high-quality bonds to be an attractive consideration -- but the lower overall level of yields should imply lower returns in 2012 versus 2011.

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