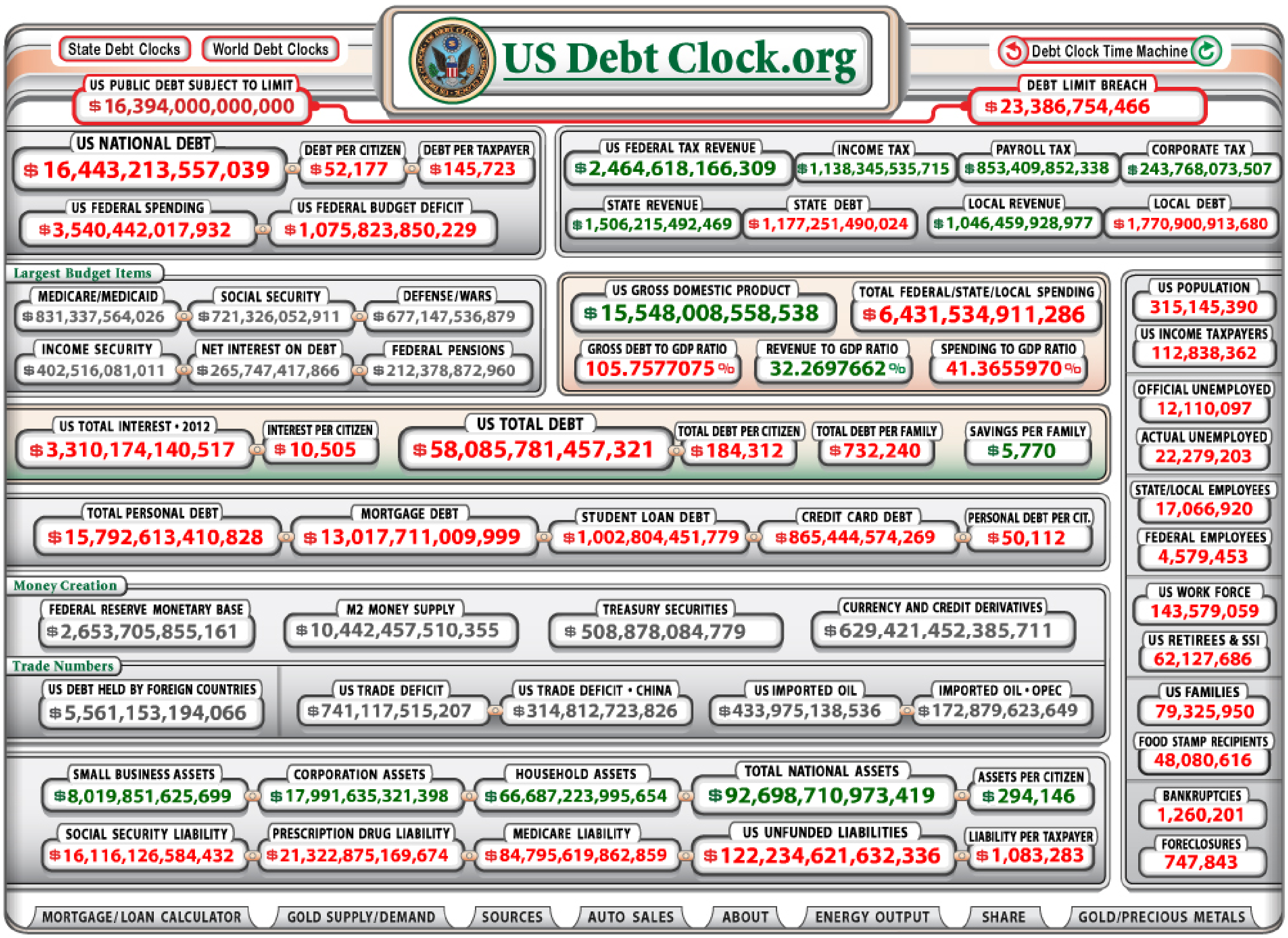
“You Can’t Handle the Truth” (1/14/13)



In RSW's 2013 Outlook entitled "If We Don't Build It They Can't Come", we talked at length about the demise of America's manufacturing base. While there can be no doubt that our nation manufactures fewer goods today, our country's ability to "manufacture" a crisis still remains second to none. The latest fabrication named the "Fiscal Cliff" certainly didn't disappoint.

In the words of William Shakespeare: "it's a tale told by an idiot, full of sound and fury, signifying nothing". To our way of thinking, this latest "emergency" provided Congress with an opportunity to score political points through their posturing about a self-made "cliff" (expiration of Bush tax cuts, automatic spending cuts, etc.), while ignoring fiscal and governance issues resulting in a debt crisis.

It seems that just when "Washington" mastered the international sport of "kicking the can", a brand new challenge is thrust upon the country. It takes the form of the daredevil sport of "cliff diving". Never one to shy away from anything death defying, we are ready and able to try our hand -- after we have put in some ground rules. Since the cliff is manmade the rules should be as well. Let's stipulate that:

- ✓ The rate of growth in our level of debt is not sustainable.
- ✓ In 4 years the $16 trillion U.S. National Debt will be $20 trillion (Congressional Budget Office, CBO estimate).
- ✓ The height of the cliff is approximately $138.5 trillion (including unfunded entitlements) as of this writing, and roughly $139 trillion when you receive this commentary.
- ✓ These guesstimates are partially derived from GDP growth projections from the CBO: 4% in 2013; 4.30% in 2014-2017; 2.40% 2018-2022.
- ✓ If spending and entitlements slow to a growth level of 5-7%, and economic growth increases to 2-3%, the debt clock still ticks faster.
- ✓ Spending and entitlement spending continues to grow at 9.5% annually (American Enterprise Institute), and economic growth continues in the range of 1.50% to 2%. In this case, in the words of Jack Nicholson (*A Few Good Men*): "I don't give a damn what you think you are entitled to", you may not get what you would expect to get.
- ✓ Lastly, if the growth of debt and unfunded liabilities slows to a rate of 5% (one-half of its historical growth rate), in 10 years our $139 trillion becomes $210 trillion.

Let the games begin:

- ✓ We just agreed to raise taxes $650 billion over 10 years.
- ✓ We may raise another $800 billion in taxes (reduce exemptions, etc.) over 10 years.
- ✓ We may agree to reduce spending by $1.5 trillion over 10 years.
- ✓ Total revenue and "cuts" over 10 years will then equal $2.95 trillion.

Now let's compare this hypothetical resolution to the Debt Clock on the first page (or visit at http://www.usdebtclock.org). Using our $2.95 trillion calculation (above), we will have reduced total liabilities by roughly 2% using today's debt clock, and 1.5% using a conservative assumption on what the debt clock looks like in 10 years. The "game" can begin when you plug in your own estimates of how high the debt might grow at the end of the 10-year period. Upon further reflection, we decided not to participate in this event, as the "cliff" appears to be unambiguously too high for us to contemplate. We understand we are missing out on a great deal of fun, but on a more sober reflection, our intestinal fortitude only goes to the high diving board at the beach club, and the cliff surpassed that way back in 2002.

The game described above was intentionally tongue-in-cheek. However, the coverage by the media regarding our nation's debt crisis, and the "solutions" that are being cobbled together by our elected officials in Washington are unintentionally silly. While we are on the topic of ludicrous, please note these quotes below:

"In the case of United States, default is absolutely impossible. All U.S. government debt is denominated in U.S. dollar assets." *Business Insider*

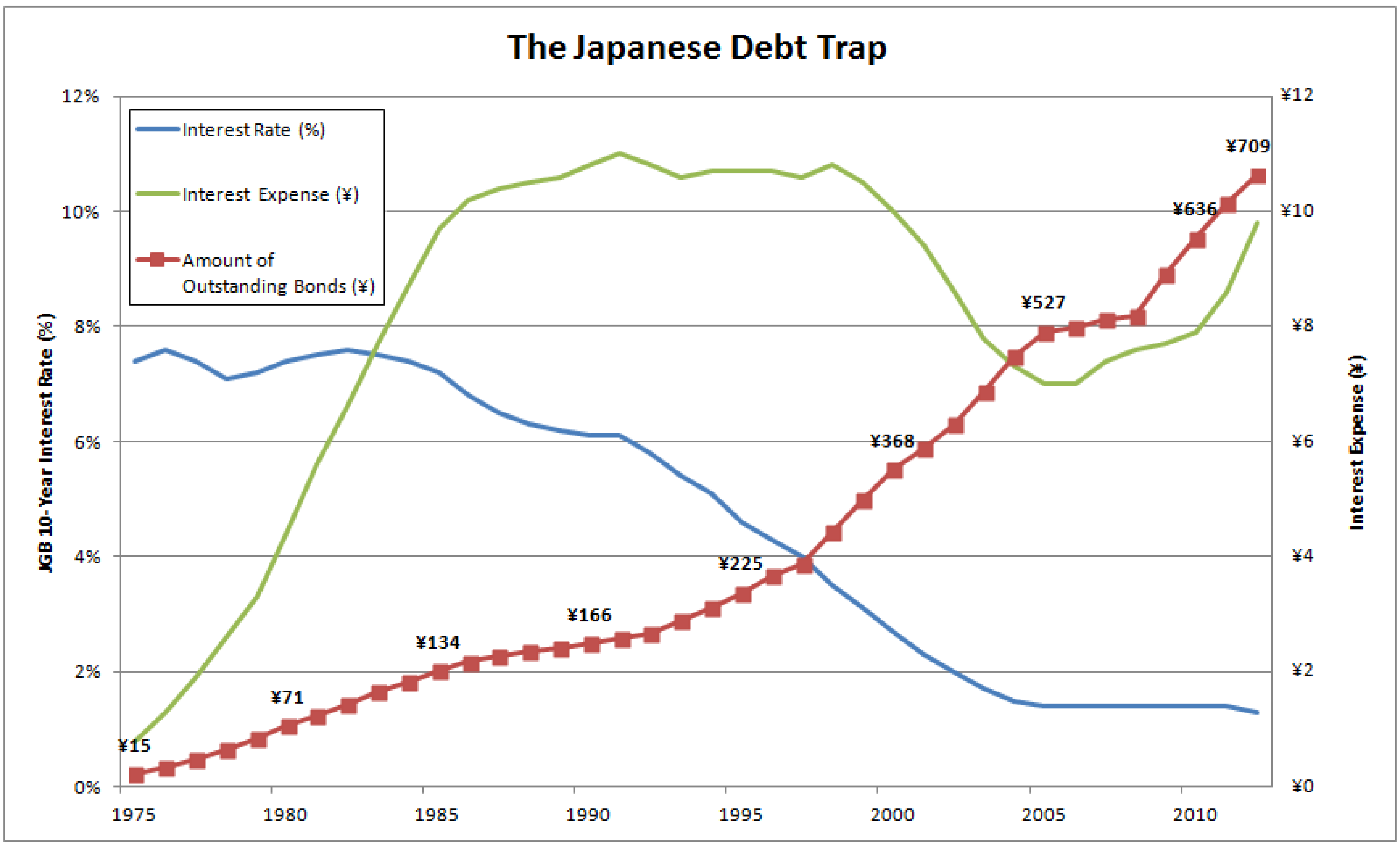
"The United States can pay any debt it has because we can always print money to do that. So there is zero probability of default." *Alan Greenspan*

"As the sole manufacturer of dollars, whose debt is denominated in dollars, the U.S. government can never become insolvent, i.e., unable to pay its bills. In this sense, the government is not dependent on credit markets to remain operational." *Federal Reserve Bank of St. Louis"*

Does Debt Really Matter?

With all due respect to the astute folks quoted on the previous page, there is a level of debt that becomes unsustainable even for those countries that have a printing press and lots of ink. As an example, let's look at the Japanese experiment. Aside from lowering their benchmark rate to zero in 1999, two years later the Bank of Japan (BOJ) engaged in a quantitative easing (QE) strategy (and you thought this strategy was original to Ben Bernanke). In fact, the BOJ recently announced QE 8, bringing the total easing accumulated in its battle against deflation to approximately ¥80 trillion.

Could this "game" go on in perpetuity? Does Debt Matter? No and Yes. Please see below.



The purpose of the preceding chart above is to illustrate the theme that there is a point of diminishing return from a zero interest rate policy. From 1998 to 2005, even as the amount of debt grew, Japan's net interest expense declined as they replaced maturing higher yielding debt at the current lower levels of rates. Despite Japan's continued low interest rate policy, the current volume of debt being amassed is so large that annual interest expense is mounting. Eventually, you do get to a place where there is a mathematical "Keynesian Endpoint" to the amount of debt that you can layer on. Today, Japan's interest expense represents approximately 25% of Government revenues (roughly ¥10 trillion in interest expense versus ¥42 trillion in revenues).

Be Careful What You Wish For…

Policymakers in Japan are exploring new methods to reflate by diminishing the value of the Yen, coupled with a fiscal stimulus to promote growth. If Prime Minister Shinzo Abe is successful, both economic activity and the pace of inflation would rise. The unintended consequences of this desired result is that while current bond investors in Japan are willing to accept interest rates that vary between 0% and 1.50% during today's declining inflation environment, they ultimately will begin to demand higher interest rates as inflation rises.

Success, in this case, means that the markets will increase Japan's cost of capital to levels that are unsustainable, sooner rather than later. Should market rates rise by 1%, Japan's annual cost of capital will increase by approximately ¥10.5 trillion, or to 50% of projected revenue. Think of the implications if rates were to rise by 2% or more…visualize a debt load of one quadrillion (one thousand trillion)…

Fiscal Cliff negotiations, zero percent interest rates, QE's, "Twists", and the Debt Clock continue to tick.

Municipal Commentary

Municipal bond yields continued their descent throughout much of the 4th quarter, capping off another solid year of returns. Despite widespread concern that 2012 would bring higher market rates, tax-exempt yields declined to generational lows. Fourth quarter 2012 can best be described by visualizing a "seesaw". Using 10 year "AAA"-rated municipal bonds as a proxy, yields declined by approximately 23 basis points during the months of October and November, while rising abruptly in December by roughly the same amount. Several forces "ganged-up" on the market in December including:

- ✓ A reversal of mutual fund flows from positive to negative.
- ✓ Concerns regarding the fiscal cliff.
- ✓ The possibility that legislation may be enacted capping the value of municipal tax-exemption at 28% for highest wage earners.

- ✓ Concerns about the financial health of Puerto Rico (downgraded by Moody's to one notch above junk).
- ✓ The general low level of interest rates.

State Government – Different from the Federal Government?

With the exception of Vermont, states are required by statute, and in some cases by constitutional mandate, to produce balanced budgets. When deficits occur, states take various corrective actions. Unlike the U.S. Treasury, state and local governments do not "print money". While budgets need to be balanced, they do not necessarily have to be "structurally balanced". That is, the use of non-recurring revenues, one shot items and deficit financing can be used to produce a so-called "balanced budget" that mask structural deficiencies, as in Illinois and California (the lowest rated states). Currently, only 4 states (Standard &Poor's) have negative credit outlooks -- on the heels of the worst recession since 1929. Unlike the federal government, states do not have a "debt problem". The stable outlooks, for the most part, reflect the various actions that the states have implemented in response to both cyclical and non-cyclical budgetary issues. **S&P calculates aggregate state median total debt service as a percent of general government spending to be only 5.15%.**

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	Irina R. Brooklier Client Service Assistant