Fed Watch

On January 31st, Alan Greenspan capped his 18 ½ year career by lifting the Federal Funds Target Rate to 4.50%. Widely expected, this move brought the cumulative increase since the hikes began in June 2004 to 350 basis points. In a remark from the former Chairman's last testimony, Greenspan stated that "although the stance of policy seemed close to where it needed to be given the current outlook, some further policy firming may be needed." Most noteworthy however, was the fact that Fed officials finally withdrew the "measured pace" rhetoric, which in the past had alluded to the inevitability of regular future rate hikes.

Unlike the last time a new boss slid behind the wheel of the Federal Reserve, this occasion was heralded by a muted market reaction. Thus far, Chairman Bernanke seems to be on automatic pilot, maintaining the same course that Greenspan had charted throughout the current tightening cycle. On March 28th, with the same heavy foot, Bernanke continued to lean on future economic growth by opting to raise the Fed Funds Target Rate by 25 basis points to 4.75%. As expected, his prepared remarks contained much of the same balanced language employed by his predecessor in past commentaries. In particular, the new Chairman stated that steeply rising energy prices pushed up overall inflation, raised business costs, and squeezed household budgets. Nevertheless, he believes that "longer-term inflation expectations appear to have been contained."

The Federal Reserve policy members have stated that they will push rates higher until they are confident that the pace of economic activity has slowed down to a trend rate of growth. However, since there is a lag between their actions and the time it takes for the effects of the rate hikes to appear, we believe that they will "overshoot" on the degree of their tightening campaign. Looking back on the Fed's long-term track record, we have endured eight Fed tightening cycles in the past three decades. The Fed has inverted the yield curve on five of those occasions, and out of those five rate-hike induced inversions, the economy has skidded into a recession one year later all five times.

Cyclical or Secular rise in longer term yields?

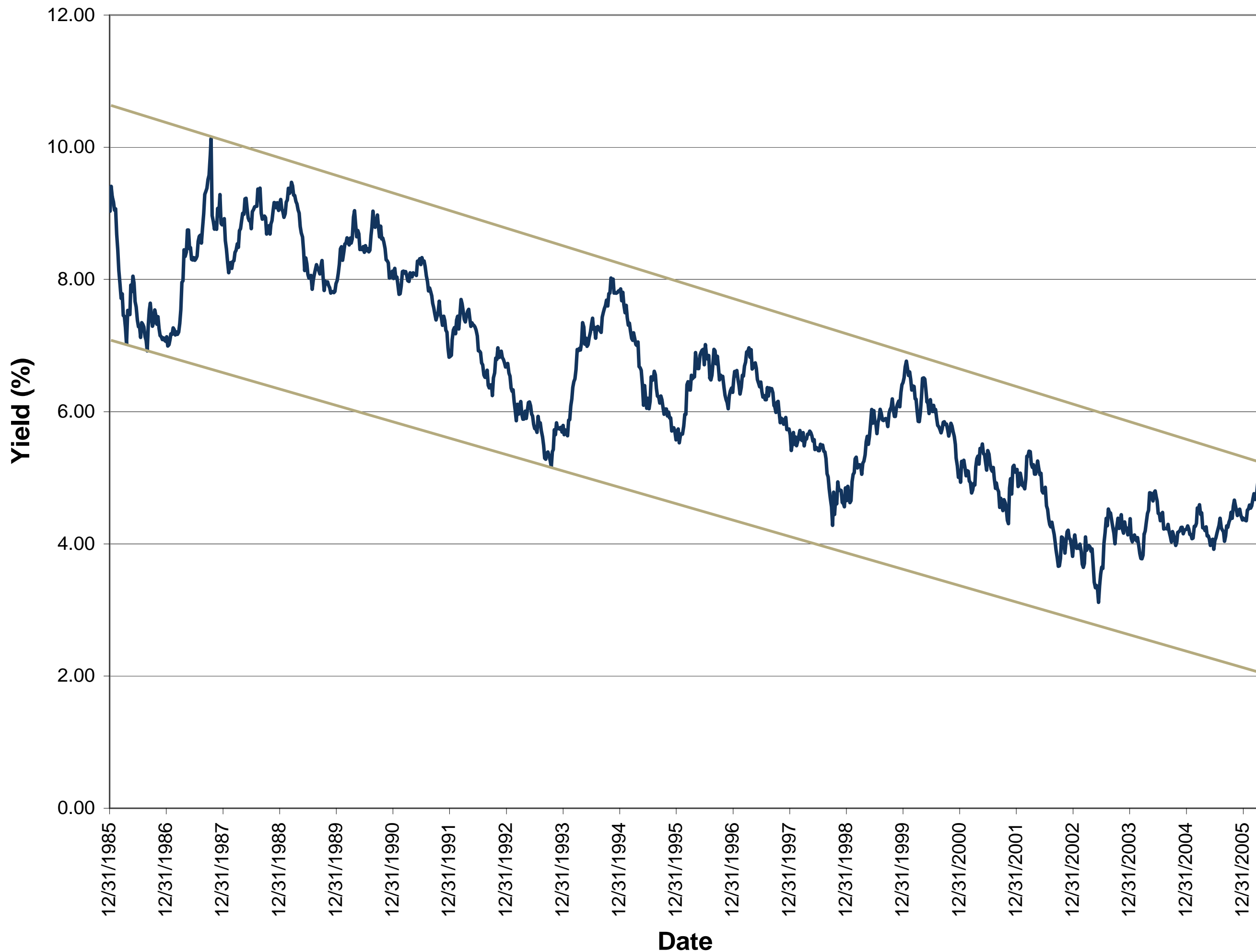
As this commentary is published, the 10-Year Treasury Note is trading slightly higher than a 5% yield. The question on most investor's minds is whether the recent bond market correction is a secular change toward higher interest rates or a cyclical aberration in a 20 year bull market. Although this correction has been impressive, we remain steadfast in our view that a meaningful rise in long term interest rates such as the one currently exhibited, should be relatively short lived; i.e. a cyclical shift.

During his State of the Union Address, President Bush asserted that the United States is "addicted to oil". Surely, we agree with this statement, however, the same could also be said with regard to America's use of leverage, and particularly to its application within the domestic housing market. There is mounting evidence that

growth in the housing sector is faltering. The latest release from the MBA Mortgage Applications Index, supports this belief, as the Index slumped by 1.7% for the week ending April 14th, preceded by a 5.5% decline for the week ending April 7th. This index is considered a key indicator, as the trend in mortgage applications typically leads existing home sales. Therefore, a weakness implies that there may be more downside to follow. Weaker housing activity increases the time it takes to sell a home and invariably leads to lower prices. Further verification of a consumer-led slowdown can be found in the negative growth rate of personal bank loans, revolving home equity, and revolving consumer credit. In fact, this is the first time that those data have turned negative since their respective inception dates. It appears that soaring energy costs, escalating property taxes, and higher interest rates are taking a toll on the consumer.

Bottom line: We feel that the rise in long-term interest rates that we have witnessed over the last several months is cyclical in nature. We continue to believe that an upward correction in interest rates is, in and of itself, a self-breaking mechanism. Higher interest rates should cause a retreat in the price of real estate, a stock market correction, and provide the impetus for a consumer led spending retrenchment. Lastly, in our 2006 Market Outlook, we commented about the 20-Year Long Bond bull market. Specifically, we outlined that an upward adjustment in the 10-Year Treasury Note yield to a 5.10% level was possible for this year. With yield levels now approaching this target, we remain confident that this latest bond market rout will be capped by this upper yield trend line. Please see below.

10 Year Treasury Note Yield Channels: 12/31/85 – 4/20/06



Municipal Bond Market Overview

As is often the case, the first quarter proved to be a difficult period for tax-exempt investors. This can be quantified by the market's yardstick; the Lehman Bros. Municipal Bond Index, which scored an anemic 25 basis point total rate of return. Over the last 15 calendar years, the first quarter has, on average, provided the weakest level of returns to municipal bond holders versus any of the subsequent three quarters. In fact, since 1991 the tax-exempt bond market has only registered positive performance for March on three occasions. Although it was a tough quarter, the municipal bond market faired comparably well against their treasury brethren. Amidst a 29.2 % collapse in the volume of new municipal bond issuance, securities in the marketplace were relatively scarce and served to soften the rise in tax-exempt yields. For example, "AAA" –rated General Obligation bonds maturing in ten years saw their yields rise by 23 basis points, compared to a 46 basis point increase for

like maturity treasury bonds. This strong tax-exempt market out-performance drove the 10-year municipal to treasury ratio down by 4 full percentage points, to stand at 82%, as of March 31, 2006.

Looking ahead, the municipal market should continue to be in excellent technical condition. Even if a heavier new issue calendar were to emerge, the demand side of the equation ought to remain quite robust. Roughly $87.6 billion is expected to be put back into investors hands during the May through July period due to bond calls, maturing securities, and coupon payments. Given the recent back-up in yields, we would expect the retail investor to re-invest the preponderance of this cash flow in municipal securities. Thus far in 2006, the most impressive performance has been exhibited by the longest maturities, which have continued to outperform by a wide margin, putting downward pressure on the "ratio curve" of municipal yields vs. taxable yields. Since there is only a modest pick up in yield by extending beyond 10 years, we are expecting much of those proceeds to be reinvested in the one to ten year maturity range. As is quite common, the retail buyer is lured into the shorter maturity range at precisely the time when they should be seizing the opportunity to extend their average maturity and "lock-in" these higher interest rate levels. This view also coincides with our economic and market outlook. As the economy cools and it becomes apparent that the Federal Reserve has completed their tightening phase, it is quite likely that the treasury curve will begin to steepen and return to its normally positive slope.

Strategy

Given the sharp rise in municipal bond yields during the quarter, we are seizing the opportunity to re-allocate our shorter term holdings into bonds maturing in 10 to 15 years. By concentrating our investments in longer-dated bonds, we are afforded an opportunity to maximize tax exempt cash flow relative to that offered by shorter term issues. On the surface, it could appear that these transactions serve to aggressively increase the interest rate sensitivity of the portfolio. However, in reality this is not the case, as we seek to target a premium coupon callable bond structure. This is important because the interest rate sensitivity of this bond structure is more closely correlated to that of the shorter call date as opposed to its longer final maturity date. Since we believe that interest rates will begin to ratchet their way lower during the second half of the year, we are pursuing low risk strategies in order to maximize price appreciation. Acquiring bonds with an advance refunding option is essential to the strategies employed. It's all very predictable. As interest rates rise dramatically, market participants begin to forecast that the rise in yields will continue for a protracted period of time. At these moments, we are afforded the ability to purchase bonds that have the potential to be advance refunded, at close to the same price levels as issues that are precluded from this option.

Why do we bother making this distinction? To begin, Issuers generally seek to refinance debt that carries an above market coupon rate as interest rate levels decline. This is similar to the way a homeowner seeks to re-finance their mortgage

at lower rates. When this occurs, the price of an advanced refunded bond increases sharply because the bond being refunded is now secured by an escrow account, generally funded by U.S. Government securities. Furthermore, the final payout of the bonds is no longer occurs at the original maturity date, but occurs over a much shorter time period, or typically at the first optional call date.

Past performance is no guarantee of future results. The opinions and forecasts expressed above are those of RSW Investments as of December 31, 2005 and may not be realized. This report should not be construed as investment advice and contains no recommendations to buy or sell specific securities. This information may change as a result of changing market conditions and is not a recommendation to buy or sell any specific security. The information provided is of generic nature. Information was obtained from third party sources, which we believe to be reliable, but are not guaranteed. An investment in any municipal bond portfolio should be made with an understanding of the risks involved in investing in municipal bonds, such as interest rate risk, credit risk and market risk, including the possible loss of principal. The value of the portfolio will fluctuate based on the value of the underlying securities. Please contact your tax advisor regarding the suitability of tax-exempt investments in your portfolio. If sold prior to maturity, municipal securities are subject to gain/losses based on the level of interest rates, market conditions and the credit quality of the issuer. Income may be subject to the alternative minimum tax (AMT) and/or state and local taxes, based on your state of residence.