Fed Watch

Watching what the Fed doesn't say is perhaps more revealing and interesting than what they do say! We certainly found it peculiar that during the last FOMC meeting the Fed refrained from commenting on the Bear Stearns debacle. Wouldn't you think that an imploding housing market and the related CMBS/CDO crisis would be worth a mention?

Could it be that the omission stems from the fact that the Fed's take on the housing market has already been wrong?

- Bernanke felt that there would not be a general decline in nationwide single-family home prices
- Greenspan and Bernanke both felt that there were signs of a housing bottom several months ago
- The Fed felt that the bursting of the housing bubble would not affect the overall economy: We consider a +0.8% GDP growth to be proof of a spillover effect

Our point here is not to belittle the Fed since we are all sometimes wrong (Case in point, here at RSW we felt that 10-year Treasury bond yields wouldn't exceed 5% in 2007). But what we are saying is that the Fed has either been incorrect or they have been consistently downplaying the looming crisis, perhaps to instill a sense of calm to the markets.

When is Risk a "four letter word"?

Risk becomes problematic when the term is used to describe instruments that are over-leveraged and overpriced. In our last commentary we asked the rhetorical question: Housing - is it really a market if there isn't a bid? Now that the answer to this seems clear, the same question is being asked of the securities that are used to finance home ownership.

The liquidity and diversity of investors and lenders in the mortgage market have made it possible for virtually anyone to buy a home, even those who could not really afford their mortgage payments. As sub-prime loans were created, many were pooled into mortgage backed bonds; then to diversify the risk, the bonds were packaged into collateralized debt obligations (CDO's). Some of these collateralized debt obligations were carved up into tranches to form other CDO's. Many of these securities were purchased by hedge funds who applied leverage to further enhance their yield. The type of structured product mentioned above is based on the strength in numbers theory and works well until home prices decline and the historic or expected level of default rates are exceeded. When these forces come to bear you have the potential for a mortgage Chernobyl.

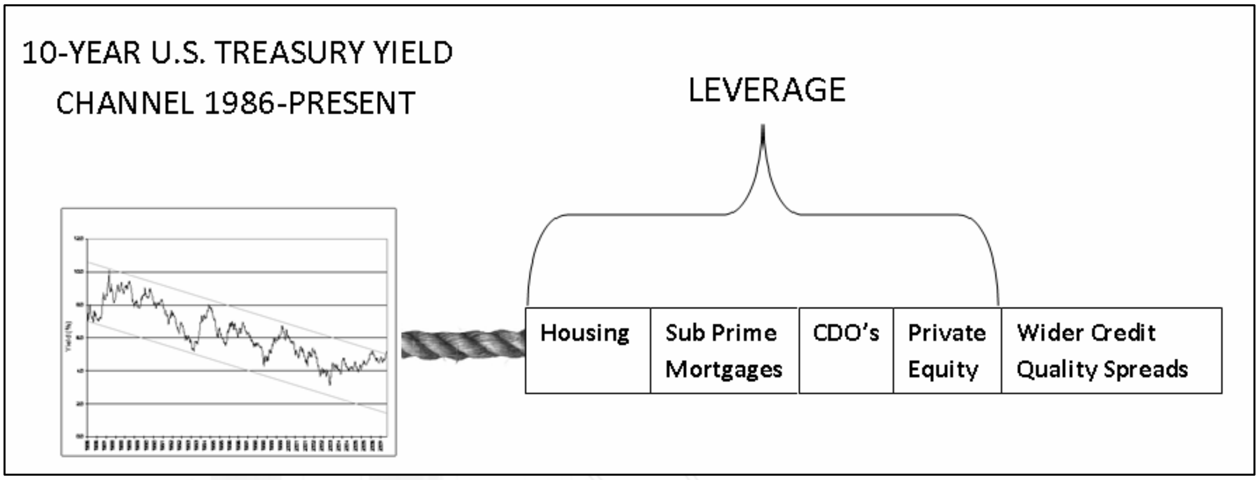
Having watched the Bear Stearns drama unfold, we have learned that these securities may be as illiquid as the homes themselves. Mr. Greenspan spoke quite often about the efficiency of the financial markets. In particular, he commented on the benefit of the derivatives market as well as its role in providing liquidity and diversifying risk. To this end, "Wall Street" has responded creatively as bankers sliced, diced, repacked and transferred the underlying mortgage risk to investors. This has afforded countless investors the opportunity to own a more complex version of the risk on a leveraged basis. The answer that we are now probing for is when does diversification become the source of the problem; that is to say, a contagion?

10-Year Treasury yields touch 5.30%

Aside from a pick-up in economic activity, U.S. Treasury yields are currently being pulled higher as foreign central banks have hiked their short term borrowing costs. As a result, these rate increases have enhanced the relative attractiveness of non-U.S. dollar based debt. Enticed by the additional yield, some investors have sold Treasury bonds thereby raising dollars to fund their purchases of overseas securities. These transactions have in turn driven U.S. yields higher, and thus served to put further downward pressure on the dollar versus a basket of other currencies.

Tug- of -War

From a technical perspective, the threshold of the 20-year trend line for 10-year Treasury rates has been broken. This upper trend line has historically defined the upper boundary for the level of interest rates. With this occurrence, the tug-of-war between those higher rates and the fundamentals of a highly leveraged U.S. economy has now begun.



The illustration above depicts some of the major issues that confront the economy and health of the financial system. We believe that it is unlikely that the overall problem will be contained in only one of the exhibited subgroups. Hence, it has the potential to become not just an episode that only effects financial institutions, but a major economic event. The recent sub-prime experience has served to emphasize how interrelated these topics are; given that any one of these could be the source of some stress in the system exacerbated by rising interest rates.

In the past, we have commented on the self breaking mechanisms that are in place, which theoretically prevent yields from rising precipitously. Now more than ever, our economy is dependent on low interest rates and narrow credit quality spreads for issuers of debt obligations. Although a violation of a long-term trend line should never be minimized, we believe that a confluence of forces (some shown above) obviate the need to be overly concerned.

With the interest rate markets doing some of the work of the Federal Reserve, borrowing is becoming more expensive, and risk is being re-priced. These forces should act as a natural brake on economic activity and could easily intensify the fractures that have already begun to appear.

Tax-Exempt Summary

In response to rising U.S. Treasury and global bond yields, municipal yields climbed higher during the period. Compared to its taxable counterparts, the municipal market has traditionally turned in stronger relative returns during periods of rising interest rates. During the second quarter however, tax-exempt prices experienced additional pressure as new issuance of municipal securities surged. Year-over-year, the supply of bonds increased by 27% and is currently on pace to surpass last year's record levels. Needing to attract investors, prices dropped significantly in order for the market to digest this increased level of issuance. This supply/demand imbalance caused the Lehman Municipal Bond index to under-perform The Lehman U.S. Treasury Index by 24 basis points. While posting a (-0.67%) total return, the Lehman Municipal Bond Index realized vastly different results across each sector of the yield curve. For example, the 1-year segment of the Index rose by 65 basis points while the 15-year segment posted a (-93) basis point decline.

Looking ahead, we are entering the part of the year whereby the technical backdrop for the municipal market should become more favorable. As the level of refunding activity is diminished due to higher interest rates, new issue supply is anticipated to slow. On the demand side of the equation, investors will have roughly $79 billion to potentially re-invest back into the municipal market as they receive payments from maturing securities and bonds being called by issuers. This annual phenomenon serves to explain part of the reason why Municipal bonds tend to out-perform during the summer months.

The Big Picture

Recent events in the sub-prime mortgage market serve as a sobering reminder that sometimes even the most publicized and talked about events can potentially roil the markets. The savings glut worldwide created excesses that contributed to a compression of spreads in the riskiest asset classes versus risk free alternatives. The high tech bubble was just one example where it was believed that liquidity would never dry up (flows from 401K's were perceived to be a bottomless pool of liquidity.) We must be mindful of the fact that gaining exposure to a particular asset class is not the difficult part of investing. The only way to measure the true depth of the market-place (ie. liquidity) is when you are looking for a bid.

In light of recent developments, investors have predictably begun the process of rethinking their risk profile. Is this the beginning of a cycle where individuals commit greater sums of capital to fixed income products or will the latest rise in rates cause investors to panic and go to cash?

History and sound investment practice mandates that we don't chase last year's returns but maintain an "all-weather" approach between various asset classes. The fixed income portion of a portfolio provides the investor with an opportunity to take on some greater risks than he might otherwise have been afforded. When times are turbulent, bonds act as an anchor for a portfolio's total return as they provide a steady stream of income, an opportunity for price appreciation and a hedge against reinvestment risk brought on by Federal Reserve rate cuts.

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***Lehman Brothers Municipal Bond Index, is a broad-based total return index comprising investment grade, fixed-rate, and tax-exempt issues, with a remaining maturity of at least one year, including state and local general obligation, revenue, insured, and pre-refunded bonds that are selected from issues larger than $75 million dated since January 1990. Investors cannot directly purchase an index. The returns of the index are shown for comparative purposes. When comparing the investment returns of the manager to the index, you should know the manager does not necessarily hold the same securities that comprise the index, the index may not reflect the asset allocation and portfolio characteristics of accounts managed by the manager and that the index is unmanaged.