Fed watch

Against the backdrop of a slowing economy and rising inflation, Federal Reserve members find themselves in the precarious position of trying to balance an inflation fighting credibility while avoiding a recession caused by "overshooting" on their interest rate policy. While underscoring their first priority, the FOMC (Federal Open Market Committee) yet again, and for the 17th meeting in a row, raised the Federal Funds rate by 25 basis points to 5.25%. The text of the overhauled statement from the June 29 FOMC meeting deftly outlined the risks of higher inflation against factors that should limit price gains. High productivity, the housing slowdown, and the lagged effects of past rate hikes are some examples. They also stated that the need and timing of any additional monetary firming will depend on incoming information.

The Fed's "data dependent" mode in determining future policy changes is a major catalyst to the increased levels of volatility in the fixed income markets. From our vantage point the Fed has always been "data dependent." Nevertheless, the implication of Bernanke's comments was that the Fed would essentially make decisions on the fly, based only on the latest economic headlines. Therefore, every time a new piece of information is released, investors try to ascertain what it means about future Fed decisions. The contradictory nature of the economic data is another source of volatility and overall investor confusion. In theory, this type of transparency and disclosure was precisely what the market wanted from the new Federal Reserve Chairman. For years investors have complained that Greenspan's Fed was too opaque and too hard to read. But now investors are finding out that trying to interpret public data is even trickier than deciphering Greenspan's cryptic statements as they grew accustomed to his language and were comforted by it. Another significant source for the increased spike in volatility is the disturbing geopolitical environment.

Bottom line: the full economic impact of the Fed's heavy lifting has yet to be felt by consumers and businesses. Many pundits classify Bernanke as more moderate and balanced in his approach compared to his predecessor. As a result, they feel that he is less likely to tip the economy into a recession. While this is a possibility, it is not a slam dunk. The combination of using a lagging indicator such as inflation (inflation is typically peaking coincident with an economy that is weakening), and a Chairman who is a proponent of inflation targeting is a formula for a Committee that needs to maintain a hawkish position or risk losing credibility.

Is the consumer impervious to gas pains?

When entering 2006 our base case forecast was for the consumer, representing roughly 2/3 of the economy, to react to the wealth drain which was triggered by a number of financial events. Recent economic data is beginning to expose the impact of skyrocketing gas prices as the event is bleeding through into consumer sentiment and impacting their spending habits. As oil prices rise, dollars which could be better spent elsewhere in the economy become unavailable. Rising energy prices are therefore an expense, a cost, and a drag on the economy. This can be seen from a slowing in existing home sales (See chart 1) and the latest reading on Michigan Consumer Confidence Survey (See chart 2) which is now approaching the lowest levels seen since September 2001. Higher interest rates, housing price gains becoming a thing of the past, and negative savings rates are further constricting the spending might of individuals.

Chart 1

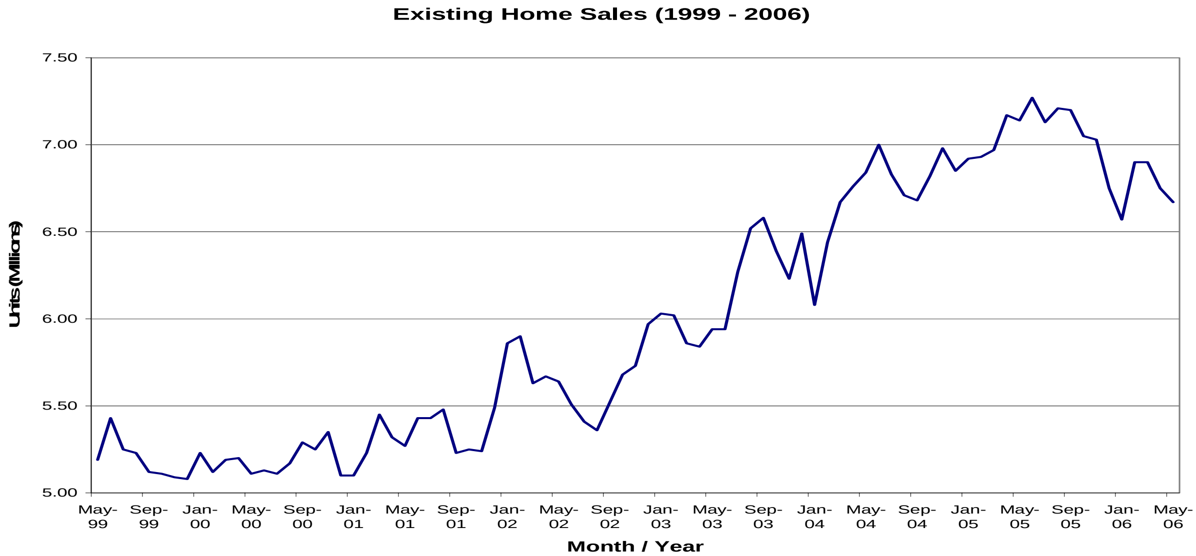
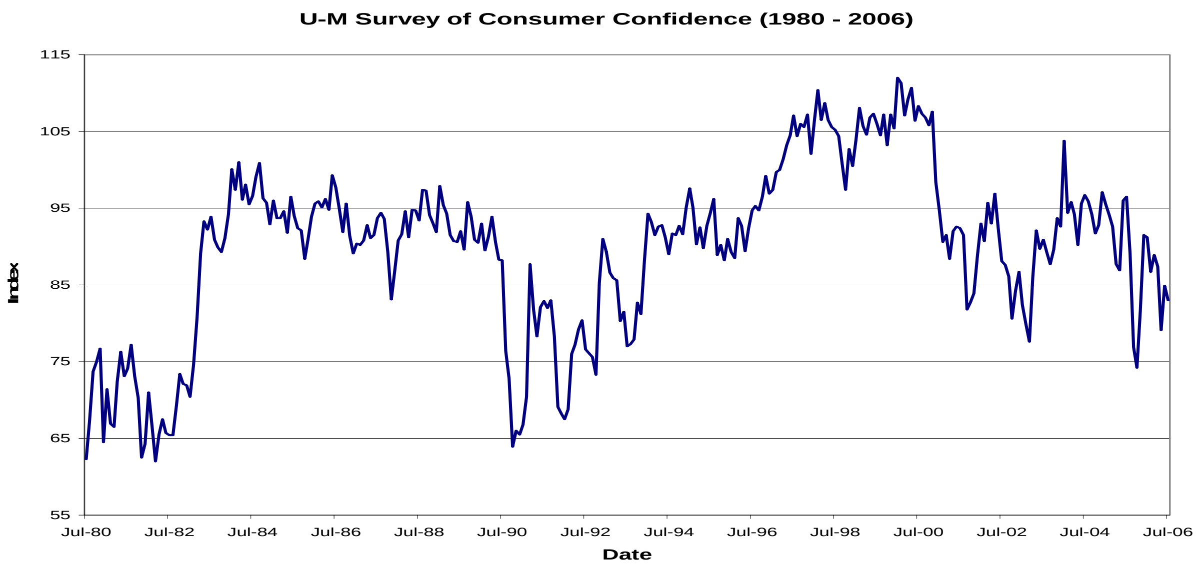


Chart 2



What does this mean to fixed income investors?

We entered the year believing that the secular bond bull market will remain in tact. However, we left open the possibility that interest rates might experience a cyclical spike as any number of forces could emerge and cause 10 year bond yields to sail higher and reach a 5.10%. Even though our upper threshold band has been violated (10 year bond yields reached a 5.25% on June 28), the long awaited economic slowdown appears to be underway. Although all eyes are on the next release of the Consumer Price Index due to investor concerns for elevated readings, we are a little more dismissive of the data. We have contended that there is a self-breaking mechanism in place that will ultimately forestall any lasting inflationary shocks. Extreme market volatility, which has rocked the equity markets, supports our view that higher interest rates are a double edged sword. As monetary policy becomes restrictive there is often a flight from risky assets as corporate profitability slows. The silver lining is that as global growth decelerates inflationary pressures should abate; thereby calming fears of excessive monetary tightening which should cause bond prices to rise.

Municipal Bond Market Environment and Outlook

On the back of rising treasury bond yields, the municipal bond market posted a virtually flat total rate of return as the Lehman Bros. Municipal Bond Index was up just three basis points. This return for the entire index bested the score for bonds maturing in the fifteen year sector, one of the worst performing segments, as these securities fell by 17 basis points on average. Although issuing authorities were reasonably quiet with new issue supply down 15% year over year, the secondary market was exceedingly active. Through much of the first half of the year tax-exempt yields remained relatively “sticky” compared to the rise in treasury bond yields. This out-performance provided arbitrage players with an opportunity to take profits by selling tax-exempt securities at relatively high prices and buy the more depreciated fixed income asset: treasury bonds. This dynamic created a “shadow” calendar as secondary supply escalated to relatively high levels. Coincident with the elevated secondary volume, demand for municipal bonds was mixed during the period as institutional involvement was weak and retail demand was subdued.

The balance between slower economic growth and still high inflation readings remains unresolved. In this environment the municipal market will not be immune from this volatility but prices should be relatively well behaved. At current interest rate levels, with yields having risen throughout the first half of the year, there are signs that interest from the retail investor is returning. This is a typical occurrence in the tax-exempt arena particularly when 20 year yields move closer to 5%.

Portfolio Strategy

During the quarter we increased our concentration of investments maturing in 10 to 15 years. In addition, a cornerstone of RSW's approach stresses the use of pre-determined exit strategies. To this end, the rise in bond yields exhibited during the period "touched off" a number of transactions. As bond yields rose, the move was not sharp enough to cause our premium coupon callable bond holdings to fall near par (100) on debt maturing inside of 15 years. However, this was not the case for securities with a final maturity of approximately 20 years. Here, as prices drew closer to par we sought the opportunity to exchange these securities for higher coupon and/or shorter dated bonds. This afforded us with the potential to stabilize the interest rate sensitivity of the portfolios while locking in a capital loss for our clients. Lastly, with credit quality spreads historically narrow and the economy slowing we continued to concentrate our investments in securities carrying the highest rating.