Fed Watch

For the eighth time in 2005, the Fed raised its target for the overnight lending rate between banks by 25 basis points to 4.25%, making it the 13th consecutive increase since initiating their tightening campaign back in mid 2004 at 1%.

While the markets had already anticipated the most recent rise in the level of the Federal Funds rate, traders and investors remain focused on the statement that accompanies the Federal Open Market Committee's interest rate decision. The release of the minutes from the November 1st FOMC Policy Meeting showed that some decision makers were concerned about a hard economic landing, stating that there were "risks of going too far with the tightening process". In addition, for the first time in nearly two years, the Central Bank removed the phrase claiming that their interest rate policy remained "accommodative". Lastly, the Fed further qualified its "measured pace" language.

The revised Fed speak states that "the committee judges some further measured policy firming is likely to be needed to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance". As outlined in our 2006 Outlook, we believe that the Fed will conclude their rate hike campaign only after they are confident that the economy is headed on a downward trajectory and that the pace of inflation is back within their comfort zone. Since monetary policy seems to work with a lag of six to nine months, the Fed typically "overshoots" and tightens more than is usually necessary. Using history as our compass, we hold the belief that the Federal Reserve will not relent until it sees concrete signs of slowing in key components of the economy, such as housing and consumer credit.

Upside down Yield Curve

On December 27, 2005 the yield curve briefly inverted for the first time in 5 years, with the yield of two year treasury notes rising above those maturing in ten years. While this event does occur with a greater frequency than the sighting of Haley's comet, it is just as noteworthy in the business community. For those who see the yield curve as a crystal ball for the economy, the inversion in the Treasury market could be seen as a bad omen. This is certainly not the end of the world as we know it, but it is a time to be thoughtful about the economy and the markets.

At first glance, an inverted yield curve seems illogical. Why would long-term investors settle for lower yields than short-term investors, while the short-term investors take so much less risk? The answer is that long-term investors will settle for lower yields now if they think interest rates will be even lower in the future. In essence, they are speculating that this is their last opportunity to lock in longer term interest rates before yields begin to decline.

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Looming recession?

Although each of the previous recessions were always accompanied by an inverted yield curve, there have been rare instances where the yield curve has inverted and a recession did not occur. The Fed has stated that they believe this time to be different and have publicly discounted the yield curve's predictive ability as an economic indicator. Instead, the Fed has stated that other factors, such as a heavy flow of overseas capital into the U.S., have depressed the yield on 10-year notes to abnormally low levels. Certainly, we also agree that the technical position of the fixed income markets has been enhanced by the surplus of foreign assets that have been "chasing" a relatively scarce amount of domestic securities. However, we sense that there is more substance to the inverted yield curve and that its significance should not be completely discounted.

Given the rise in 2-year treasury yields above 10-year maturity treasury bonds, the bond market seems to be signaling that the Fed has gone far enough in their tightening campaign. The conventional wisdom that had expected a return to a 1970's style of inflation has been wrong. Despite a parabolic move in commodity prices, including oil which has risen roughly 75% over the last year and a half, robust economic activity and ballooning deficits, the core CPI, as of late, remains contained. The year over year rate of the CPI now stands at 3.4%. Ironically, 5 years ago (the last time the curve inverted) the CPI advanced at the same rate: 3.4%. Let us also reflect and recall that the NASDAQ was presumably going to 10,000, Y2K monies would continue to be spent and that the rate of GDP was roughly expanding at an annualized rate of 4.75% in 1999.

Bottom line: The strong economic activity that we are currently witnessing may not be a realistic gauge for strong growth in the future, as we believe a slow down is under way. Inverted yield curves are atypical. Never ignore them. They are usually followed by an economic slowdown and often accompanied by lower interest rates across the board.

Municipal Bond Overview

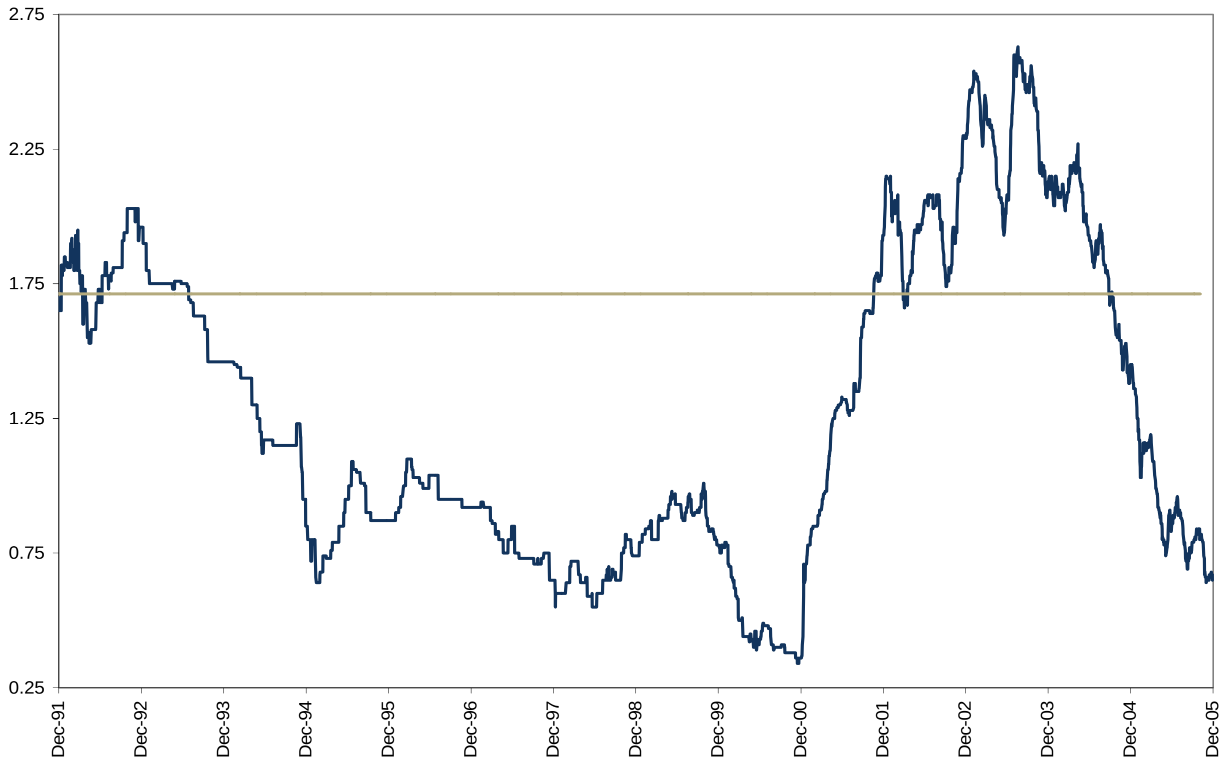
Prices of Municipal securities continued to hold up quite well against a myriad of headwinds in the fourth quarter, which included: record new issue tax-exempt supply, repeated Fed rate hikes, continued strong economic data, and surging energy costs. In maneuvering through this difficult environment during the quarter, maturity selection remained crucial. Rates on short and intermediate term maturity issues rose, while rates offered on longer maturity issues declined, which resulted in some further "flattening" in the slope of the curve. Thus far, and in line with our expectations, the municipal yield curve remains upward sloping. Unlike the Treasury bond market, investors who commit capital in the tax-exempt market should continue to receive a greater income stream by investing in longer-dated maturity bonds compared to shorter-dated bonds. In fact, an inverted yield curve has not occurred in the municipal bond market due to its unique supply/demand dynamics.

Strategy

We entered the period with the majority of our assets concentrated in bonds that mature in the 10 to 15 year range, while maintaining a foothold in bonds maturing in 2 to 3 years. The shorter maturity portion of our holdings is a tactical position, as the municipal yield curve is already flat on a historical basis. We are therefore, awaiting a better entry point to lighten our position of shorter-dated bonds in exchange for securities maturing beyond 10 years.

The rationale for this strategy can best be seen by referring to the chart below.

2 Year / 10 Year AAA Municipal Bond Spreads



Source: Bloomberg, RSW Investments

In reviewing the composite portfolio performance attribution, we observed that premium coupon bonds callable within 7 years underperformed both current coupon and discount securities during the fourth quarter. This bond structure lagged as interest rates rose on the front end of the yield curve, detracting from the bonds total rate of return. As a refresher, we predominately invest in longer final maturity, premium coupon callable bonds that have not yet been pre-refunded. An investment in this type of bond affords us the opportunity to capture an attractive combination of yield and market risk. This stems from the fact that the interest rate sensitivity (volatility) of high coupon securities is more closely correlated to that of its shorter call date, relative to its longer stated final maturity.

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Again, we sense that the majority of the Federal Reserve tightening campaign is behind us. Once their work is completed, short-term and long-term yields have historically declined. In this environment, our investors should reap the reward of the higher tax-exempt cash flow associated with the premium coupon structure coupled with price appreciation.

On another note, we are concerned that fixed income investors enticed by higher rates on shorter-term notes and bonds may abandon their plan of buying long-term bonds and expose themselves to income risk.

What do we mean by this? The most glaring example of income risk occurred in the early 1980's, immediately after Paul Volker had been appointed Fed chairman. He began to push up short-term rates in an effort to squash inflation. On the back of that aggressive tightening came a dramatically inverted yield curve. Short-term bank CD's returned more than 20%, while long-term Treasuries were yielding 14%.

With hindsight being 20/20, we can now clearly see that investors who were lured by these 20%+ short term yields failed to lock in those higher long term rates.

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