In Like a Lion, Out Like…? **(3/16/12)**

Right on cue, like so many times over the past decades, tax-exempt yields declined during the month of January and into February. As you may recall from many of our earlier missives, this period is known by market participants as the "January Effect" in which investors redeploy the relatively large level of cash they received from bond calls, coupon payments, and maturing securities at year-end. Given the hiatus of municipal issuers that usually occurs during this period, historically, prices tend to rise as demand exceeds the available supply of bonds.

During March the pattern tends to "flip" as the pace of new issue supply rises and the level of investor demand shrinks. Quite often, this phenomenon serves to explain why tax-free bonds have scored the weakest total rates of return during the March through April period. Thus far in 2012, and true to form, interest rates have "marched" higher, and are in some parts of the yield curve, higher than when the year began.

In addition, rising U.S. Treasury bond yields have put further pressure on tax-exempt rates, as both markets tend to move in similar direction. Aside from the "seasonals", Treasury yields have recently jumped as investors are encouraged by the stronger economic data released over the last several weeks. Notwithstanding a moderate (Federal Reserve's description) uptick in economic activity, we believe that the financial markets may be in the process of pricing in a higher level of growth and higher level of inflation rate than may actually materialize.

Notwithstanding the "feel good mood" of market participants, at RSW we continue to believe that this year's GDP growth rate will fall within the range we outlined in our 2012 forecast, not to exceed 2%. Likewise, this sub-par level of activity should not cause the inflation rate to be elevated for extended periods of time, while brief upticks are always possible. On many occasions we have written about the self-breaking mechanisms that we believe are in place to keep a lid on just how high market yields can rise. For the sake of brevity we will touch on two: interest rates, and fuel costs.

Given the fragile economic recovery now occurring, it remains our view that a sustained period of higher interest rates will serve as a meaningful impediment to a more normalized growth rate. Whether the market raises rates, or is led by the Federal Reserve, economic activity doesn't know the difference. Rising rates would hurt either way. Put another way, the Federal Reserve has been keeping interest rates at historic lows for the last two years because they are "afraid" of something. Perhaps, they understand that because of a climbing debt burden, interest rates must remain low. Therefore, it should become a self-fulfilling prophecy that those higher rates will ultimately undermine the rate of growth, thereby ushering in the next cycle of lower interest rates.

Next, fuel costs. Approximately one year ago today, the bond market was then disturbed by rising inflation expectations as the price of gasoline surged. Today, the average price at the pump is $0.26 higher. We have consistently argued that fuel should be viewed as a tax that ultimately serves to slow economic activity. Remember, for the vast majority of the population whose major asset is their home, the price of the "stuff" they own is declining while the price of the "stuff" they need is increasing. As fuel and the price of other commodities such as food rise, we believe that ultimately these movements destabilize the pace of inflation. As a growing share of disposable income is spent on necessities, consumers have a shrinking amount that can be allocated towards discretionary spending. This, in our opinion, will ultimately impede the growth rate in the future.

Bottom line: We believe that the markets will continue to have substantial sentiment swings based on many factors, but one force will predominate. The markets will feel optimistic when they focus on the *fact* that central banks around the world are printing money at an unprecedented rate, and pessimism will return when they focus on *why* the Central Bank must provide such extraordinary liquidity.

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