**Is Perception Reality?** **January 19th, 2011**

Over the weekend, there were several articles that characterized the fear of municipal defaults, and resultant plunge in municipal bond prices as being “overdone”. While these editorials are thoughtful, and seem sensible, it is nearly impossible to pin-point the bottom of a market that currently is being driven by fear and a lack of liquidity. More important than opinions on price, and the future level of default rates however, is the transformation that is taking place within state and local governments. This “sea change” is being fueled by necessity in order to maintain the fiscal health of municipalities, and was captured in a Monday *New York Times* article entitled “Budget Worries Push Governors to same mind-set.”

This article examined the tone of approximately two dozen opening speeches of incoming governors. After dissecting these gubernatorial addresses, it is plainly evident that the business as usual rhetoric has been replaced by the new harsh realities facing state and local governments, namely, budget deficits and job losses. The new way forward, and mind-set described in this article, speaks to frugality, shared sacrifice, and “right-sizing government”. In fact, with the exception of only two states, the mantra of “living within our means” seems to be the consensus view of the medicine needed to treat the nation’s ailments. With that said, the politicians of Illinois and Minnesota are tackling the issues differently, as they seem to be relying currently more on an increased rate of taxation, rather than frugality and sacrifice. The vast majority of the states, however, seem to be blurring the line of demarcation between Democrat and Republican. For example, in New York, Gov. Andrew Cuomo, recently said: “We must right-size the state government for today,” and added that New York had no future if it intended to be “the tax capital of the nation.”

In our 3rd Quarter 2010 Commentary, we mentioned that: “While politicians are famous for kicking the can down the road, we are running out of road. As a result, real solutions may not be far behind.” We believe that time is now. While we have steadfastly believed that the fiscal health of many municipalities is under pressure, we have believed that responsible state and local governments will do what they need to do to survive. To this end, since 2007, we have been predicting an increase in the volume of municipal credit rating downgrades, while believing the event of actual default will remain relatively low for higher-quality issuers.

**Selling Begot Selling**

Over the last several months, we have read countless articles talking about the state of the states, and the impending apocalypse. This barrage of attention was capped by the “60 Minutes” segment, which included Meredith Whitney’s call for 50 to 100 municipalities to default within the next 12 months. These calls for doom, and resultant fear, rocked an already illiquid market.

Perception became reality as “selling begot selling” and investors, fearing a surge in the level of municipal defaults, felt compelled to exit their mutual fund holdings at an historic pace, as their value dropped precipitously. In order to meet investor~~s~~ demand for liquidity, mutual fund managers were forced to sell bonds in the open market. Unfortunately, the broker/dealer community had little appetite to add to current positions, as their inventory levels were already elevated, as traders prepared to capitalize on the "January effect". During this period the "Street" seizes the opportunity to sell bonds to individuals, as they typically seek to reinvest the proceeds of coupon income, maturing securities and bond calls. The large size of monies leaving the market by way of mutual fund redemptions effectively served to "cancel-out" any anticipated positive impact of increased investor demand typically experienced during January. With the risk appetite, and liquidity position of the broker/dealers challenged, the price that they will pay (bid) for the next eager seller has been dropping. This caused prices to cascade lower, with the result being a (-2.04%) drop in the value of the Barclay's Capital Municipal Bond Index for 2011 Y-T-D (Benchmark for RSW's Market Duration strategy).

While no one has a crystal ball to know when the selling pressure will abate, some investors may be giving the headlines or the market too much credit at predicting future events. Sometimes price volatility is just what it seems, namely, too many motivated sellers trying to fit through a tiny door at the same time. At some point history tells us the "smart" money will attempt to seize an opportunity that once began as an imbalance of new issue supply versus demand, and has now morphed in to a market driven by fear of defaults on the back of media hysteria. In fact, this may be happening already.

Institutional investors have recently begun purchasing Build America Bonds (taxable municipal bonds: BABs) at a quickened pace, narrowing the yield differential between taxable municipal debt and U.S. Treasury Bonds. In contrast, yields of tax-free bonds are rising at a faster pace than those of U.S. Treasury Obligations, and in some instances, forcing Muni yields to be equal or in excess of Treasury bonds. Historically, tax-free yields in excess of UST yields, has proven to provide long-term opportunity for savvy municipal investors. For additional perspective, over the last six months, the absolute yield differential between 10 to 20-year AAA-rated taxable and tax-exempt municipal bonds has been as wide as 1.65%, and currently stands at approximately 0.55%.

For the last couple of weeks, Financial Advisors have been using us as a "sounding board" to gain another perspective on the relative attractiveness of the tax-exempt asset class. To this end, Saturday's *Barron's* article answered this matter rather succinctly: "Friday long-term Muni (general obligation) bonds are yielding 8.30% [on a taxable equivalent basis]. This compares with high-yield bond rates of 7.15%, Baa corporate bond yields of 6.08%, and a forward earnings yield on the S&P of 7.40%. Thus, the risk-to-reward in Munis looks increasingly compelling in our view."

Lastly, with respect to the State of Illinois, we can agree or disagree on the long-term impact of their decision to increase their personal income taxes (raised to 5.00% from 3.00%) by 67%, but one fact remains. With the stroke of a pen, state representatives were in a position to raise considerable revenues. This is one of the primary reasons why high-quality municipal bonds remain among the safest and strongest fixed-income asset classes, second only to the U.S. Treasuries.


| Robert S. Waas<br>Managing Member | Robert K. Coates<br>Senior Portfolio Manager | Matthew T. Werner<br>Portfolio Manager | Mark J. Tenenhaus<br>Director of Municipal Research | John A. Carlson<br>Director of Business Development | Marites A. Vidal<br>Data Analyst | Randy J. Fox<br>Operations Associate | Jon P. Skoog<br>Operations Associate |
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