Is the Yield Rise Getting "Overdone"? (6/4/13)

Prices of tax-exempt bonds dropped sharply during the month. As outlined in our 2013 forecast, we believe that yields at these adjusted levels are attractive and as such, where appropriate, we are seeking to extend the average maturity/duration of our client accounts.

Yields on virtually all fixed income securities rose rapidly during the month of May as investors were unnerved by the possibility that Federal Reserve Chairman, Ben Bernanke, may soon reduce the pace of the quantitative easing program (QE). Ten year Treasury bond yields jumped 46 basis points, rising quickly from 1.67% to 2.13%. These are the highest levels recorded over the last 13 months. Taking their cue from the Treasury bond market, municipal bond yields also rose steadily throughout the month of May, pressuring bond prices. The weakness is reflected in the total rate of return of the market's "yardstick", the Barclays Municipal Bond index, which was down 1.22%.

Should market participants be concerned about a tighter Federal Reserve policy due to a resurgence of inflation?

- On May 16, 2013 the Consumer Price Index (CPI) report showed that prices had fallen by 0.4%, the second consecutive monthly decline. This brings the annual rate of inflation down to a two-year low of 1.7%.

- Additionally, the Fed's preferred "yardstick" to gauge the pace of inflation is also falling. Personal Consumption Expenditures Index (PCE), which takes into account consumers' changing consumption patterns due to price changes, likewise fell during April to a 1.05% annualized rate. The Core PCE rate (excludes volatile components such as food and energy) however, fell to a 50 year low of 0.74%, a level not seen since March 1963.

Could the weaker inflation data be a sign of weakening income levels?

- In the first quarter of 2013, real personal disposable income (the amount of money the average American has left after paying taxes) in the U.S. economy decreased 5.3%, compared to the same period of 2012.

- Disposable income in America is still hovering below 2006 levels.

For consumer spending to continue increasing, consumer income needs to increase. Or it may be that many individuals need to draw down their savings to fund their commitments/lifestyles:

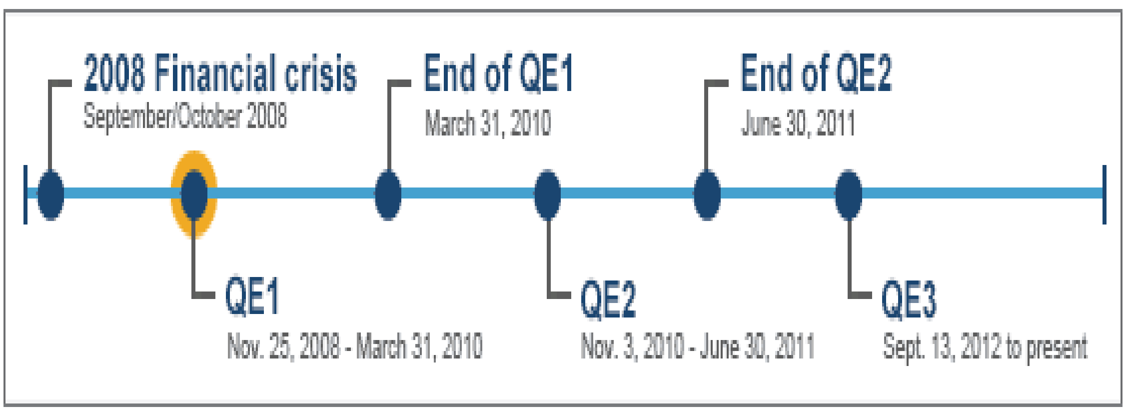
➢ It is very important to note that since November 2008, the personal savings rate declined 62% from a high of 6.50% to April 2013's reading of 2.50%. This should restrict second-half growth in personal consumption expenditures, a deviation from the average pundit who is forecasting an accelerating growth rate.

With the economy "stuck in the mud" and the rate of inflation falling, why would Bernanke hint at the possibility that the pace of QE may slow?

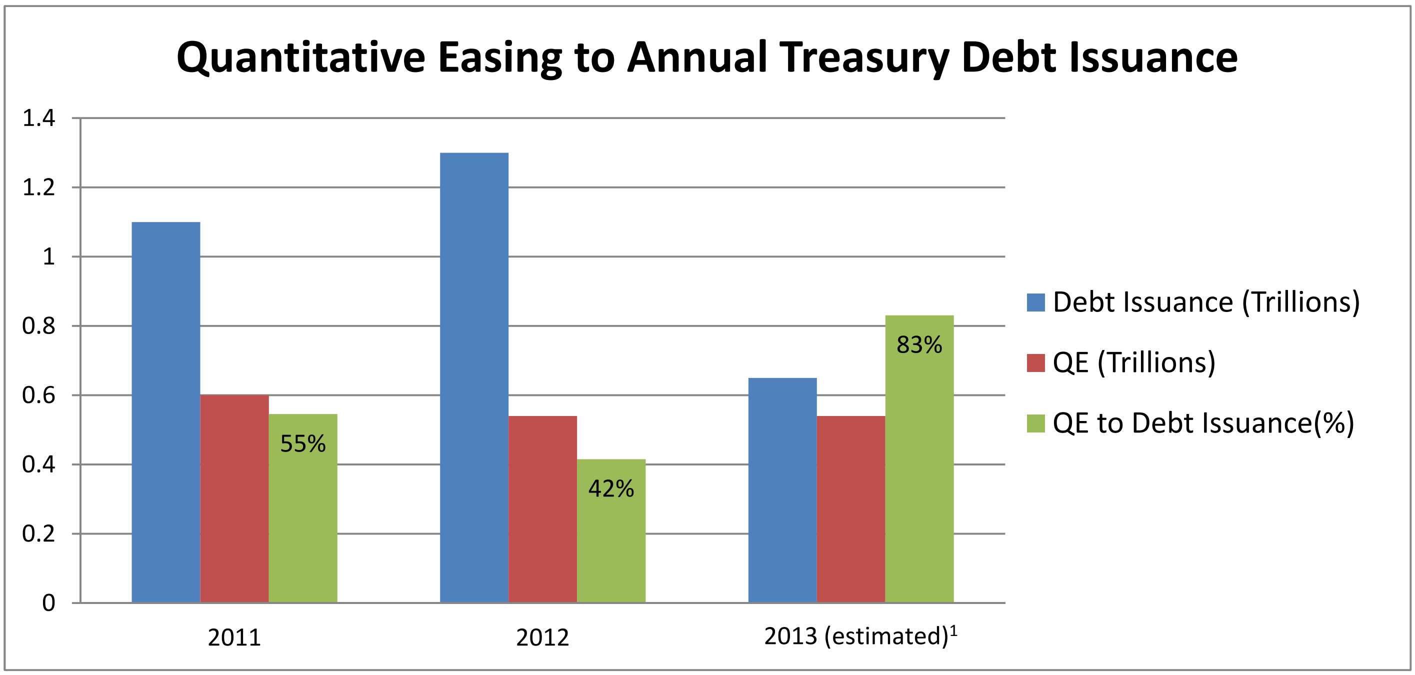
First, what is Quantitative Easing?

Quantitative easing (QE) is an uncommon process implemented by Chairman Bernanke and the Federal Reserve to offset the financial crisis, in which the government purchases outstanding government bonds or other securities in the marketplace. In theory, this monetary policy works to increase the monetary base, thus increasing liquidity and hopefully enticing more people to lend.

In 2008, the first round of QE's began in the United States as Bernanke and the Fed effectively bought $300 billion worth of US Treasury securities. In November 2010, the Federal Reserve continued to add liquidity with QE2. Here, they purchased an additional $600 billion from November 2010 to June 2011. QE3 started in September of 2012, when Bernanke announced the Federal Reserve was going to spend $45 billion a month purchasing government securities.



At RSW, we believe that aside from the health of the economy, there is another reason why the Fed Chairman may now want to reel in the pace of quantitative easing. As you will note from the chart below, Ben Bernanke, in implementing QE2 and QE3, purchased approximately half of the annual US Treasury debt issuance. Specifically, Bernanke purchased roughly 55% of the Treasury's issuance in 2011, and approximately 42% in 2012.



[1]Assuming an estimated total U.S. Treasury debt issuance of $650 billion, and total Federal Reserve (FED) "quantitative easing" (Treasury bond purchases of $540 billion).

Now for the twist! *It is expected that our nation will "run" a smaller budget deficit this year compared to the last several years. With less debt needed to cover the budget gap, the U.S. Treasury could issue far less debt this year than prior years ($650 billion versus $1+ trillion). Therefore, if Bernanke maintains the current QE3 policy and purchases $540 billion Treasury bonds a year, and the expected debt issuance declines to $650 billion, the QE to debt ratio will reach 83%. In essence, if Bernanke continues to buy Treasury bonds at the current pace, as the level of new issuance is shrinking, he is "de facto" doubling down on his QE policy. Therefore, we believe that a reduction of treasury purchases is likely, but should not be misconstrued as a tightening of liquidity. A reduction in the annual debt issuance could provide the catalyst for the Fed's next move, not economic strength.*

As stated in RSW's 2013 Outlook: "U.S. Treasury 10-year bond yields could reach 2.25%, should a spike occur". Moreover:

- Yields, and their corresponding prices, will fluctuate just like any other market, moving from "overbought" to "oversold" and back again. These changes do not necessarily reflect any "sea change" in the underpinnings of fundamental economic data or Federal Reserve policy. As we witnessed in the past, these current variations in yield may represent an opportunity.

- Akin to the tax-exempt bond market performance of 2006 and 2007, the first six months of 2013 provided a relatively flat total rate of return (12/31/05 – 06/30/06: +0.28%, 12/31/06 – 06/30/07: +0.14%). However, in the last six months of these years, yields declined from their elevated levels producing reasonable total rates of return (+4.55%, and +3.21% respectively).

- We believe this period should be similar. Therefore, where suitable, we are seeking to extend the average maturity and/or duration of client accounts.

- These transactions are not meant to time the market to the nearest basis point, (we deem the entire 10-year Treasury zone of 2.25% to 2.40% to be attractive) but believe that we are now being more appropriately rewarded for assuming a modest amount of additional risk.

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