Fed Watch

The Fed seems to be stuck between a rock and a hard place, and the dilemma appears to be self-inflicted. In a recent Fed statement, they admitted that persistent inflation was an immediate concern and yet they began to transition to a "neutral stance". We still cannot fathom why the Fed would declare inflation "public enemy #1" and then remove their tightening bias. The lack of clarity became cloudier yet again as the minutes from the March FOMC meeting revealed that officials hadn't yet ruled out future rate increases. This has caused the inflation statistics to take on a heightened level of importance. Any upside surprise in the data occurring while the Fed is sitting on its hands could cause a temporary spike in rates, especially long rates.

While pain is never welcome, even of a temporary nature, we believe that higher rates could be the knockout blow to this sputtering enemy and eventually help all rates to go lower than they otherwise would have. We believe the Fed knows the economy is in trouble but they remain hamstrung by their own hawkish inflation jawboning. Their own rhetoric keeps them from easing which increases the chances for the dreaded "R" word to happen.

Were 17 Fed rate hikes too much, too little, or of the Goldilocks scenario and just right? The history books seem to be a little thin with examples of the Fed doing too little or doing it just right. Let us also be mindful that the last 150 Bp's of tightening have not yet fully worked their way into the market. To our way of thinking, it looks like Goldilocks has been mugged by the three bears: a single family housing market that is "off the hinges", weak business spending, and an elevated rate of inflation.

Housing - is it really a "market" if there isn't a bid?

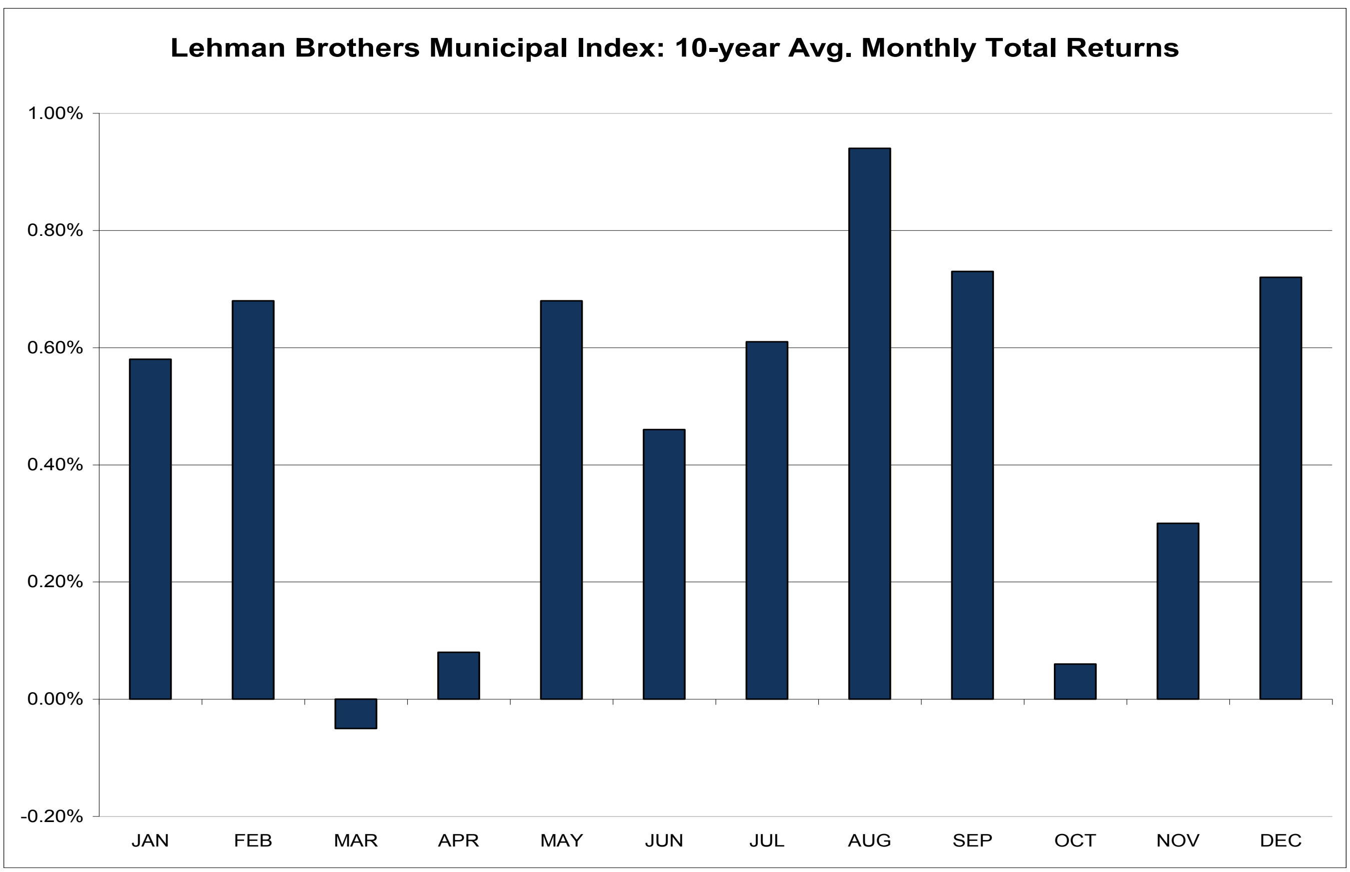
It would be nearly impossible to discuss the state of the U.S. economy without mentioning the current condition of the single family housing sector. We note with interest that the chatter in the marketplace about housing has almost come full circle. Six months ago the airwaves were filled with building company CEO's and industry economists who denied the "bubble" theory saying that this was just merely a "pause" and even a great buying opportunity. Then there was a mention about traffic improving, increased housing starts, building company stocks "bottoming", and finally a free vehicle for your 3 car garage. Our guess is this bottom was the same mirage as water in the desert since it was followed by an enormous write down of the land owned by builders. The next thing we knew, DH Horton's CEO was telling us the housing market "sucks".

More recently however, we have begun to see the unraveling of the "sub prime market," but we are being told that this problem will stay "well contained." The point of this chronology is that the market has consistently ignored this growing problem or at least badly underestimated its impact. It is our belief that the economy has not yet experienced the full impact of falling single family home prices and spreading foreclosures. As the situation worsens, it should have a serious impact on the psyche of the American consumer. It is no longer out of place to fear both a financial event where securities and institutions of all kinds are affected and an economic contraction caused by a severely damaged consumer.

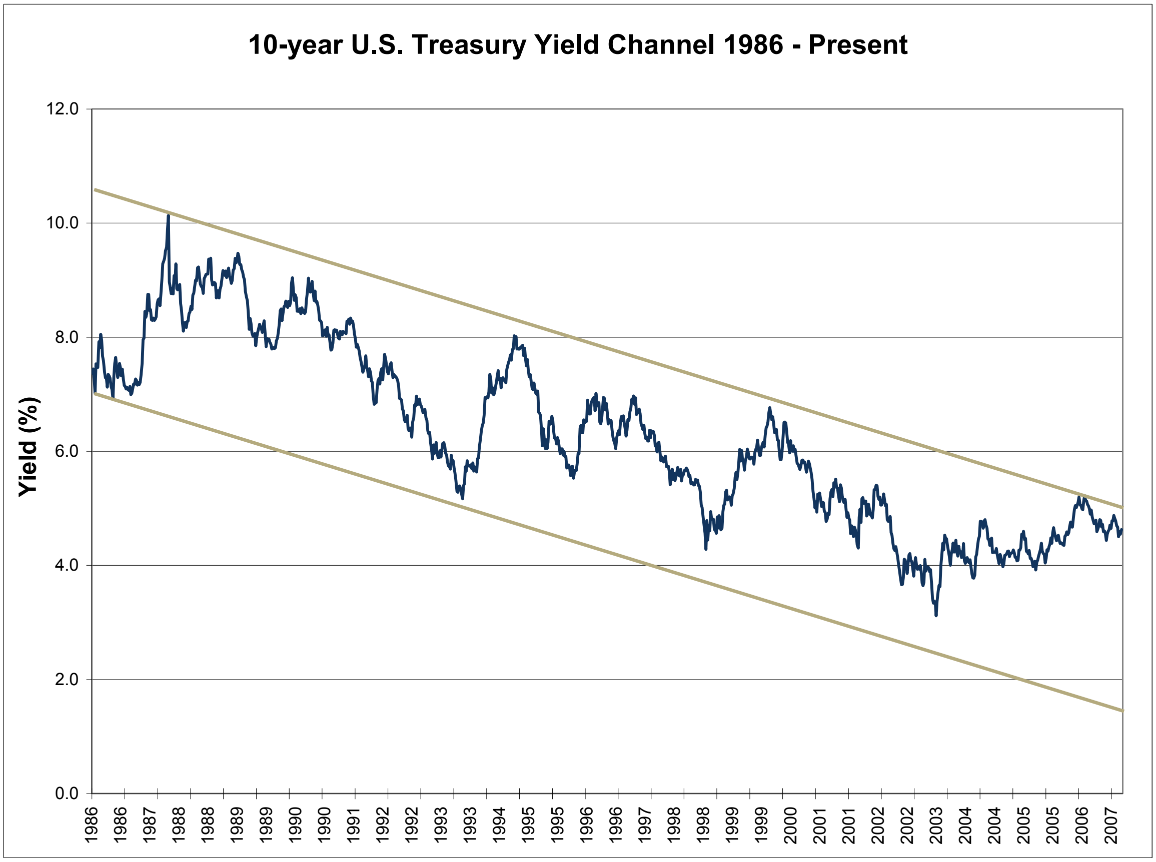
Municentric View

Surging tax-exempt new-issue supply and a schizophrenic Treasury Bond Market helped to create a choppy environment for fixed income securities. Municipal new issue supply for the first quarter of 2007 spiked as a record $104 billion was priced. This represented an increase of 6% over the amount issued the same period last year. Municipals, which tend to outperform taxable bonds in a rising interest rate environment, this time around scored poorer returns. Tax-exempt bond yields experienced upward pressure as a supply-to-demand imbalance bounced yields around during the 1st quarter, finishing slightly higher then where they started. While this caused bond prices to fall modestly, the coupon income pushed total returns into positive territory. For the quarter the Lehman Bros. Municipal Bond Index posted a total return of 81 basis points. This puts the results scored thus far in 2007 in-line with the quarterly market returns of the prior two years.

The long-term trend of a flattening tax-exempt yield curve was snapped during the period as long-term bond yields increased slightly more than short-term bond yields. While it is too early to call this reversal a trend, it is noteworthy as it may be signaling an inflection point. Overall, the bond market is still anticipating an easing move by the Federal Reserve some time in 2007, but it seems to be pushing off the timing of any rate cuts. The recent weakness in bond prices may also be explained by the strong seasonal forces that are at work. Upon reviewing the historical returns of the Municipal Bond Market you can certainly see a definitive pattern. Previously, the months of March and April have been challenging for investors. The chart below highlights this occurrence as we analyzed the returns of the Lehman Bros. Municipal Bond Index on a monthly basis over the last 10 years. Please see the chart below.



With the April tax date behind us, we anticipate that the market will be in a better technical position. We believe that the current back-up in rates will provide an opportunity for investors to lock-in higher yields as the 20+ downward trend in interest rates remains intact. Please see the chart below which displays the path of 10-year yields since 1986.


10-year U.S. Treasury Yield Channel 1986 - Present
Yield (%)
12.0
10.0
8.0
6.0
4.0
2.0
0.0
1986
1986
1987
1988
1988
1989
1989
1990
1990
1991
1992
1992
1993
1993
1994
1995
1995
1996
1996
1997
1998
1998
1999
1999
2000
2001
2001
2002
2002
2003
2004
2004
2005
2005
2006
2007