Fed Watch

The third quarter drew to a close with the Fed staring down the decision of whether to continue hiking short term interest rates at its September 20th FOMC meeting. Unlike the past 10 rate increases which lacked any suspense, this pronouncement was atypical. The untold pain and suffering caused by Hurricane Katrina, one of the Nation's worst natural disasters in its history, sparked heavy government opposition to further interest rate boosts. Against this backdrop of dissention, Chairman Greenspan continued to prove his political independence by remaining focused in his mission to deflate the housing bubble and combat inflation as the Fed once again raised the Fed Funds Target Rate for the 11th consecutive time by 25 basis points. Today, with oil refining capacity and natural gas production slashed as a result of Hurricanes Katrina and Rita, FOMC members are becoming more concerned that high energy prices will create more generalized inflation, especially given the recent rise in consumer and business inflation expectations. As a result, the Fed continues to increase the degree of its hawkish rhetoric, suggesting that further rate increases can be all but assured.

"Don't Fight The Fed."

Why are long-term interest rates so well behaved in spite of a series of Fed rate hikes? "Don't Fight the Fed". Over the last two decades this phrase has held a different meaning then it does today. Traditionally, a Federal Reserve that has embarked on a course of tight monetary policy has historically caused all interest rates along the yield curve to rise. This time is different, however. In fact, during the period of time covering the Chairman's robotic series of eleven 25 basis point rate hikes, the 10 Year Treasury yield has fallen roughly 50 basis points to stand at 4.33% on September 30, 2005. In sum, a Fed that has shown the resolve and determination to stop the rise of inflation and combat asset price appreciation continues to offer some clues as to why long term interest rates are so well behaved.

1970's style inflation?

Highly unlikely. It is our belief that current inflation concerns will prove to be only temporary as U.S. economic growth is poised to slow in the months ahead against a structural backdrop, that in fact, remains deflationary. When we are witnessing an era of exceptional corporate profitability, pristine balance sheets, corporate acquisitions, and a multitude of company stock repurchases, you would think that the stock market should be "irrationally exuberant". However, through September 2005, the S&P is up just 2.76%. Could it be that corporations are accumulating vast sums of cash because only limited opportunities exist for them to invest in their traditional business while achieving a desired return on investment? We hold the belief that this secular shift where corporations are hesitant to invest in their core business is deflationary, not inflationary.

How about a "Soft Landing"?

Sounds quite plausible, however, upon examining the Fed's track record of engineering a "soft landing", we remain skeptical. Historically, the Fed has caused the economic pendulum to swing too far in both directions. They then cease their campaign only after they have accumulated enough evidence proving that they have accomplished their primary mission. By that time, however, it is normally too late. With history on our side, we expect this series of Fed tightenings to be followed by a series of easings. At a Federal Reserve symposium in Jackson Hole Wyoming, Greenspan acknowledged that they are paying greater attention to asset inflation to determine interest rate policy. With respect to asset prices in general, Greenspan warned “that such an increase in the market value is too often viewed by market participants as structural and permanent.” In addition, he added that ”History has not dealt kindly with the aftermath of protracted periods of low risk premiums.” Combined with the Fed’s deafening speak that long term inflation expectations must be contained, this rhetoric points to the reasonable presumption that an overshoot in tightening monetary policy will result in below-trend economic growth.

The “Perfect Storm”

Many economic analysts are claiming that there won’t be any long term negative economic effects due to Katrina and Rita. Their concept that the rebuilding of the Southeast will lead to strong GDP growth holds some water, however, we believe it omits one important element. The health of the consumer is coming under serious pressure and should serve to mitigate the rebuilding dividend. Many forces seem to be ganging up on the consumer, causing a pinch in discretionary spending with the potential for a “perfect storm” scenario. Without providing specific details for each one we have listed those key issues below:

- Consumer is already leveraged.
- Zero % savings rate.
- Housing market is peaking. Affordability index is at a 10-year low.
- Natural Gas prices up over 100% from last year.
- Gas prices surging at the pump.
- Soaring home heating oil prices
- Consumers are now spending 6% of their income on energy compared with 4% a year ago.
- Relentless health care cost increases.
- Rising property taxes.
- Marginal equity returns.
- Relatively low bond yields.

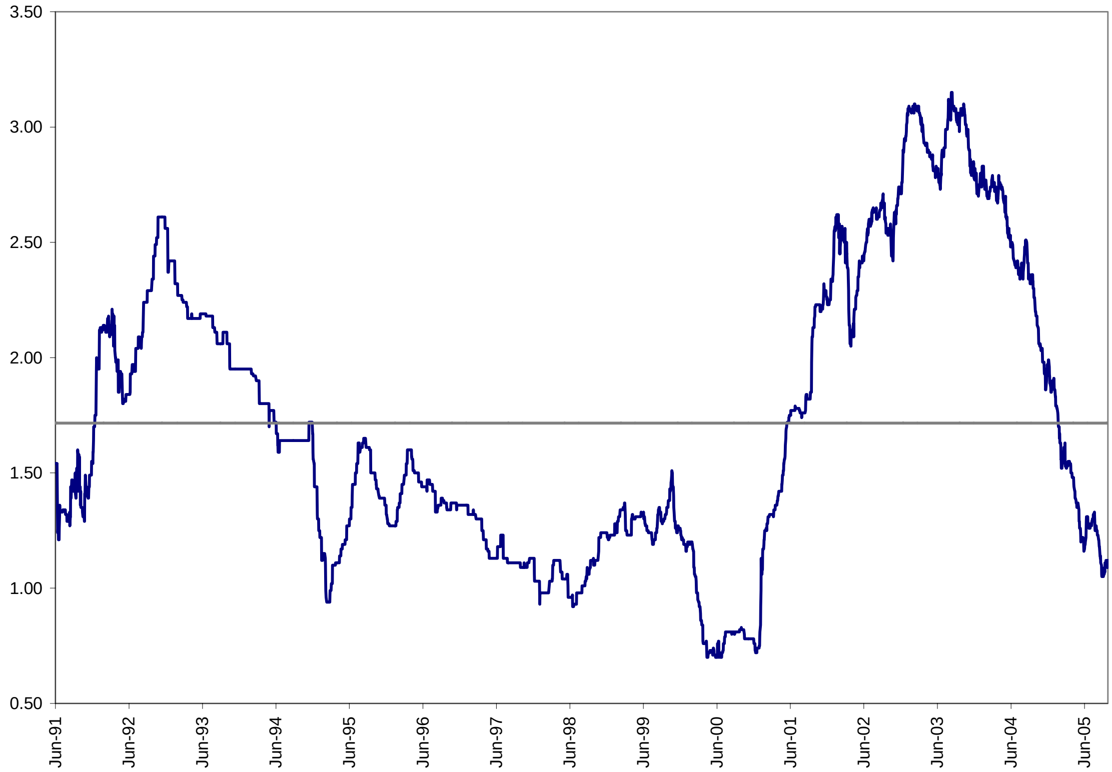
Municipal Bond Market Overview

Our benchmark, the Lehman Bros. Municipal Bond Index posted a loss of 13 basis points during the quarter. The relatively flat total rate of return masks the interest rate volatility during the period as 10 year municipal bond yields thrashed around in a 30 basis point range. The quarter began on a weak note as the tax-exempt market was under pressure during the month of July. Traditionally one of the highest total rates of return are scored in July on the back of light new-issuance and increased demand. This time was different however, as the municipal bond market suffered cumulative losses in July for only the second time since 1990. Price losses for maturities 15 years and longer were more than 1.5%. While July reinvestment ($41B) and the growth of municipal hedge fund inflows aided the distribution of new issues, the specific tax-exempt demand could not offset the overall pressure on interest rates that contributed to higher yields. Municipal Bond sales totaled nearly $35B, the largest issuance ever for July, driving the 12-month moving average to $384B, the highest total since March 2004.

Strategy

As far as yield curve exposure is concerned, we entered the third quarter with our traditional overweight in bonds that mature in approximately 15 years. During the period we sought to reduce our sizeable exposure to this maturity range as the yield curve continued to flatten and the risk to reward ratio of these securities weakened. We reinvested a portion of the proceeds in "AAA"-rated 10-year premium coupon callable bonds, which we believed to be undervalued on a relative basis. During the period, the yield relationship between 10 and 15 year bonds narrowed to just 27 basis points, only 7 basis points off of the tightest spread recorded since March 1990.

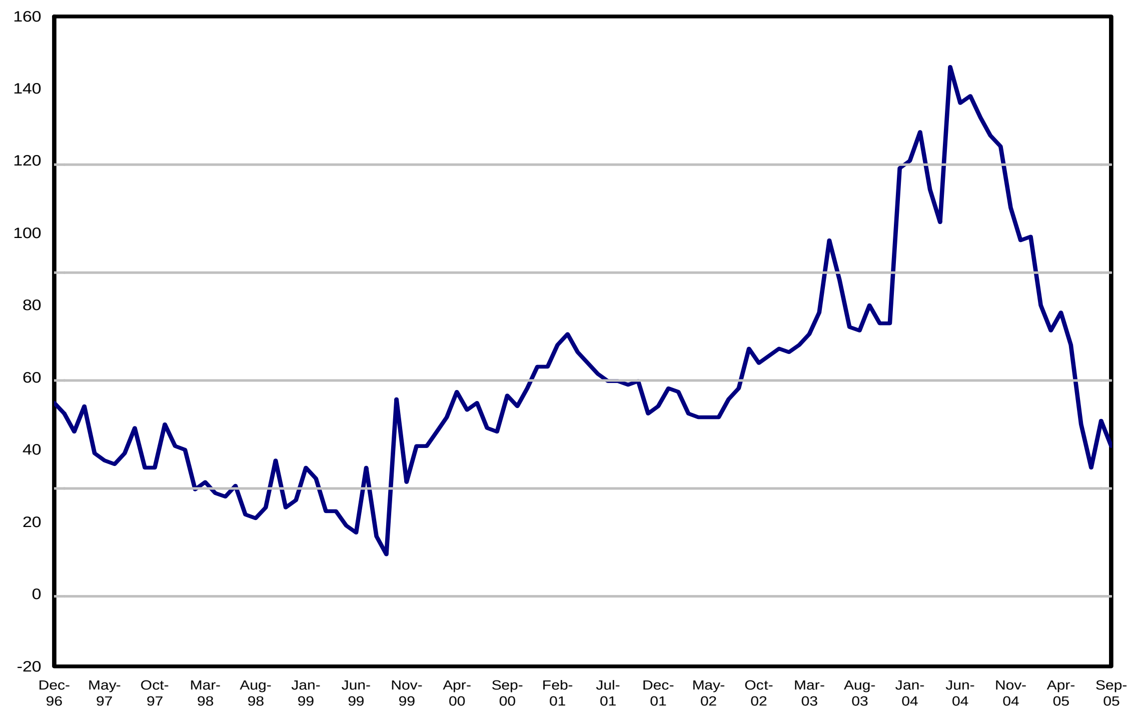
2 Year / 15 Year AAA Municipal Bond Spreads



Source: Bloomberg, RSW Investments

We continue to maintain our view that credit intensive securities are expensive versus "AAA"-rated bonds. Our portfolios are therefore concentrated in the highest credit quality sector as investors are only able to pick up minimal incremental yield by downgrading credit quality. Please see the chart below which serves to highlight this point, by comparing the historical option adjusted spread of "BBB"- rated bond to "AAA" -rated securities since 12/31/96.

Credit Spread Relationship: BBB vs. AAA-rated Munis



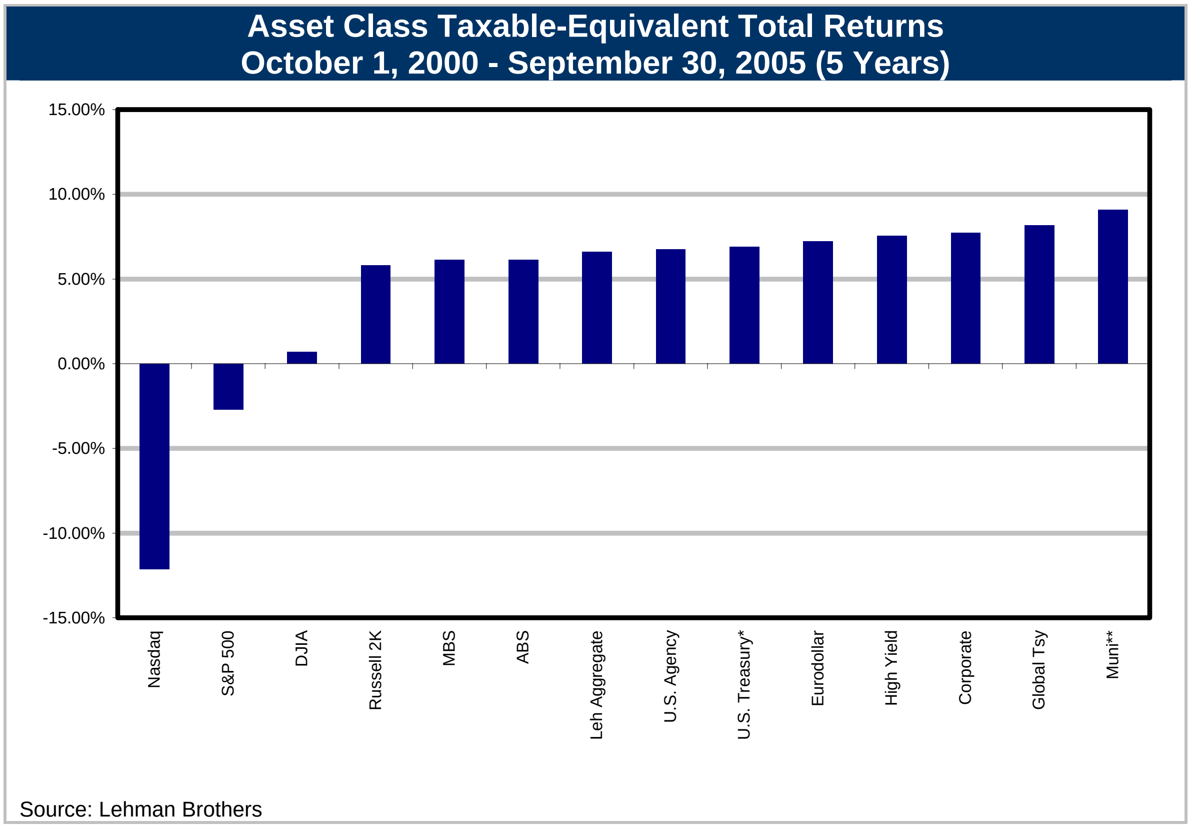
Source: Merrill Lynch

For the period, the RSW composite total rate of return fell short of the Lehman Bros. Municipal Bond Index by six basis points, a negative total rate of return of 19 basis points versus 13 for the benchmark. A significant contributor to the under-performance was the strength registered in long-term (22+ years) bonds. This segment scored a 19 basis point positive return, one of the best for the period. Given our mandate, we are by design, an intermediate duration manager and therefore have significantly reduced exposure to the longest maturity bonds.

	Q3 2005	6 Month	Q3 vs. Lehman	6 Mth vs. Lehman
RSW Intermediate Composite	-0.19%	2.72%	-	-
Lehman Municipal Bond Index	-0.13%	2.80%	-0.06%	-0.08%
Lehman Long Muni Bond Index (22 yrs +)	0.19%	4.25%	-0.38%	-1.53%

What is the impact of the hurricanes to the Municipal Bond Market?

We believe that any rhetoric surrounding the possibility that the yields in the tax-exempt market will rise due to Insurance companies liquidating their tax-exempt portfolios are overblown. While Property and Casualty companies have been sizeable investors in the Municipal Bond Market, they are likely to slow their purchases, rather than become mass liquidators of securities. The property damage that was caused by Hurricane Katrina was due to flooding, which limits the negative impact to the private insurers, who do not typically sell flood insurance. In addition, the claims that are paid by such an event are typically filed over a long period of time. In reality, the primary impact should be to the relative attractiveness of the Southeast states compared to other states. The massive issuance of debt which should materialize over the next six to nine months will cause the Southeast states to be trading at relatively attractive levels as the issuance will need to be priced “right” to clear the market.



* U.S. Treasury income returns are exempt form State income taxes and adjusted (3.25% in 2002 – 2003, 3.23% in 2001, and 3.18% prior) using a national state average (top bracket), net of Federal income tax.

** Based on an equally weighted national average Federal and State (top bracket) income tax rate (38.45% for 2003, 41.85% for 2002, 42.33% for 2001, and 42.78% prior – local taxes have not been considered in the analysis.

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