



Rescue package could stabilize more than just banks

I think that it is time in this very ugly environment to not only touch upon the damage done to the tax-exempt asset class (Lehman Bros. Municipal Bond Index -4.69% for September) but virtually all fixed income securities in general.

One needs to look no further than the Treasury bond market for a symptom of the problem. In the Treasury market, the credit crisis manifests itself in wild fluctuations in price, and it shows itself in other asset classes as they simply get cheaper relative to Treasuries. While we are in the camp that thinks that the rescue package is not a panacea, it does provide the banking / financial system with a much needed opportunity to recapitalize itself.

Looking at Municipal bonds, the problems have been wide ranging and include everything from firms going out of business, less capital allocated to traders who are employed by the remaining firms, and an inability of leveraged investors to obtain the financing necessary to fund their positions. Let us be mindful that the way leveraged investors operate is by borrowing monies using short maturity debt and investing in longer-dated maturities (normally carrying higher yields). Unfortunately, as short term rates (financing costs) surpassed those of long-term rates (investment) the leveraged investors suffered losses and were forced to unwind their trading positions. This resulted in a forced liquidation of longer-maturity bonds. This liquidation could not have come at a worse time for the market, with fewer remaining firms operating with an even more scarce capital base.

We have commented in the past that all asset classes could experience some deterioration in credit quality. For example, at one time it cost a few basis points (hundredths of 1%) to insure against the risk of U.S. Treasury bonds defaulting. Currently, that cost has risen to 29 basis points. Obviously, if the risk has increased in Treasury's, other fixed income asset classes are finding ways to build in their own increased risks (i.e. wider yield differentials compared to Treasury bonds). With that said, we strongly believe that the majority of the recent back-up in yields in the tax-exempt market is due to the unavailability or high cost of funding. To quantify, we would argue that approximately 80 - 85% of the poor performance of municipals has been caused by a lack of liquidity / capital constraints with the balance attributable to credit deterioration or anticipation of credit downgrades.

To summarize our views, the imbalance of sellers versus buyers can correct itself for many reasons. The de-leveraging nears an end, financing costs retreat, or capital infusions occur either organically (i.e. raising capital) or through the proposed rescue package.

Sincerely,
Robert S. Waas
Managing Member

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