2006: RSW Perspective and Municipal Bond Strategy

As we enter the New Year, a tug of war continues to rage over the timing of a perceived conclusion to the Fed's series of robotic short-term interest rate hikes.

The minutes from the November 1st FOMC Policy Meeting showed that some decision makers were concerned about a hard economic landing, stating that there were "risks of going too far with the tightening process". Said another way, some FOMC members and stock market investors are apprehensive that the Fed will overshoot on its rate-hiking campaign. With that said, the Federal Reserve raised the Fed Funds Target Rate for the 13th consecutive time to 4.25% on December 13th, 2005. However, there were noteworthy changes in the rhetoric that accompanied the rate increase. The Central Bank removed the phrase claiming that their interest rate policy was "accommodative". The Fed further qualified their "measured pace" language, a phrase that had been left in check for 18 consecutive months. Instead, the new Fed speak states that "the committee judges some further measured policy firming is likely to be needed to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance".

So when will the Fed Yield?

With history as our guide, one can only assume that the Fed will continue raising rates until a hard economic landing is apparent. As far as inflation is concerned, we continue to believe that the concern remains overblown, and that the Fed is fighting an enemy that has failed to show up on the battlefield. We still do not see the ingredients necessary for a sustainable uptrend in the core rate of inflation. To our way of thinking, there are more deflationary forces at work in this economy, than inflationary. How can this possibly be the case? To answer this question, let's first examine the health of Corporate America. Is Corporate America truly healthy, or are there forces at work that give it the illusion of prosperity?

Where there's smoke there's mirrors!!

Corporate executives are under increased pressure to improve their stock price and have been actively taking steps to drive share prices higher. To accomplish their goal, many decision makers have been targeting an increased level of cash on the balance sheet, using that cash to execute stock buyback programs. In fact, according to Thomson Financial, 2005 marked the largest year for corporate stock buybacks since the "frothy" days of the late 1990's. Rather than construct more industrial plants, spend cash on research and development, or make acquisitions, many are opting to simply buy back their own stock.

The net effect of this program has been a rise in stock prices driven more by liquidity than value. In fact, today's environment smells very similar to that of the 1980's: an era characterized by the need to generate hefty results today, at tomorrow's expense. Buybacks are happening in most industries, and not just among technology firms. The less equipment corporations purchase, the smaller the amount of depreciation expense and thus, the higher profits and earnings become. Many are not investing in the future of their companies, but rather, they are artificially inflating the value of their stock. If the United States continues to remain a net importer, consuming more than it produces, it appears likely that the U.S. will also continue to be an importer of deflation.

The health of the housing market is another topic that has been furiously debated, and with good reason. The U.S. economy is highly leveraged to the housing sector and there is now more than anecdotal evidence to support the view that housing is in the early stages of a downturn. For example, the most recent data showed that New Home Sales decreased by 11.3% in the month of November. Additionally, the National Association of Home Builders Index (a measure of Builder confidence) slid to 57 in December, its lowest level since April 2003. With new home sales and confidence on the decline, homeowner affordability remains at one of its lowest levels in 14 years.

Real estate and all of its related industries have taken on a significant role within the Nation's economy. In particular, employment growth has benefited substantially as a result of the recent housing surge. Residential investment as a share of Gross Domestic Product is at the highest level the country has seen in decades. From November 2001 to October 2005, housing and real estate have accounted for a monstrous 36 percent of private-sector payroll job growth. From the Clerks at Home Depot, the Architects and Carpenters, to the Investment Bankers who securitize mortgages into bonds, virtually all of the labor associated with housing is based in the United States.

If housing prices were to post just a flat year in 2006 or if residential investment were to fall even modestly, thousands of jobs would be in jeopardy. Stated another way, the housing sector could go from being one of the primary drivers of economic activity to a significant drag on employment growth. Combined with the forces mentioned below, this serves to detail the reason that we remain most concerned about the consumer's ability to maintain this level of spending. For the past several months we have been on our soapbox commenting on the financial health of the consumer, and we remain steadfast in our belief that there are unprecedented forces ganging up on individuals. A weaker housing market, skyrocketing health care and energy costs, higher taxes (property taxes and the dreaded "AMT"), a negative savings rate, and of course, the noticeably higher interest rate expense associated with Adjustable Rate Mortgages and Home Equity Loans, all amass a fury of head-winds that should serve to temper the consumer's appetite and ability to spend.

There are already signs that the consumer is beginning to retrench. This occurrence has been met with a significant level of early price discounting by Retailers, a tactic which has lured customers into malls to kick-off the holiday shopping season. Automobile manufacturers have also significantly reduced prices by offering "employee discounts" with the goal of purging their bloated inventory. Although the revenue side of the ledger for these merchants may look robust, few retailers are likely to be satisfied with their profit margins. As consumers realize that their real wages are growing by a paltry amount, that they cannot rely on extracting equity from their homes, and that competition from Asia may threaten their standard of living, the rational reaction will be to spend less. Let's also bear in mind that many countries have been producing flat out to feed the United States "consumption machine". Given the dependence of the world economy on U.S. consumer spending, we believe the Fed will interpret the economic data as a warning sign that deflation could set in and that a recession could follow, unless the economy is yet again "rescued" by monetary stimulus.

Of course, this portion of the report would not be complete without a comment on the possible implications of the culmination of the Greenspan era, as Bernake gets set to assume the Chairman's position. For brevity sake, we will sum up our thoughts as follows: "New boss, same as the old boss". Bernanke may be a bit more of an inflation hawk, but at the end of the day, their style and beliefs appear to be quite similar. With that said, this does not preclude the markets from testing Bernanke's metal when he officially takes the reins in February. This is not to be unexpected, as Greenspan himself was indeed tested at the onset of his own term back in 1987.

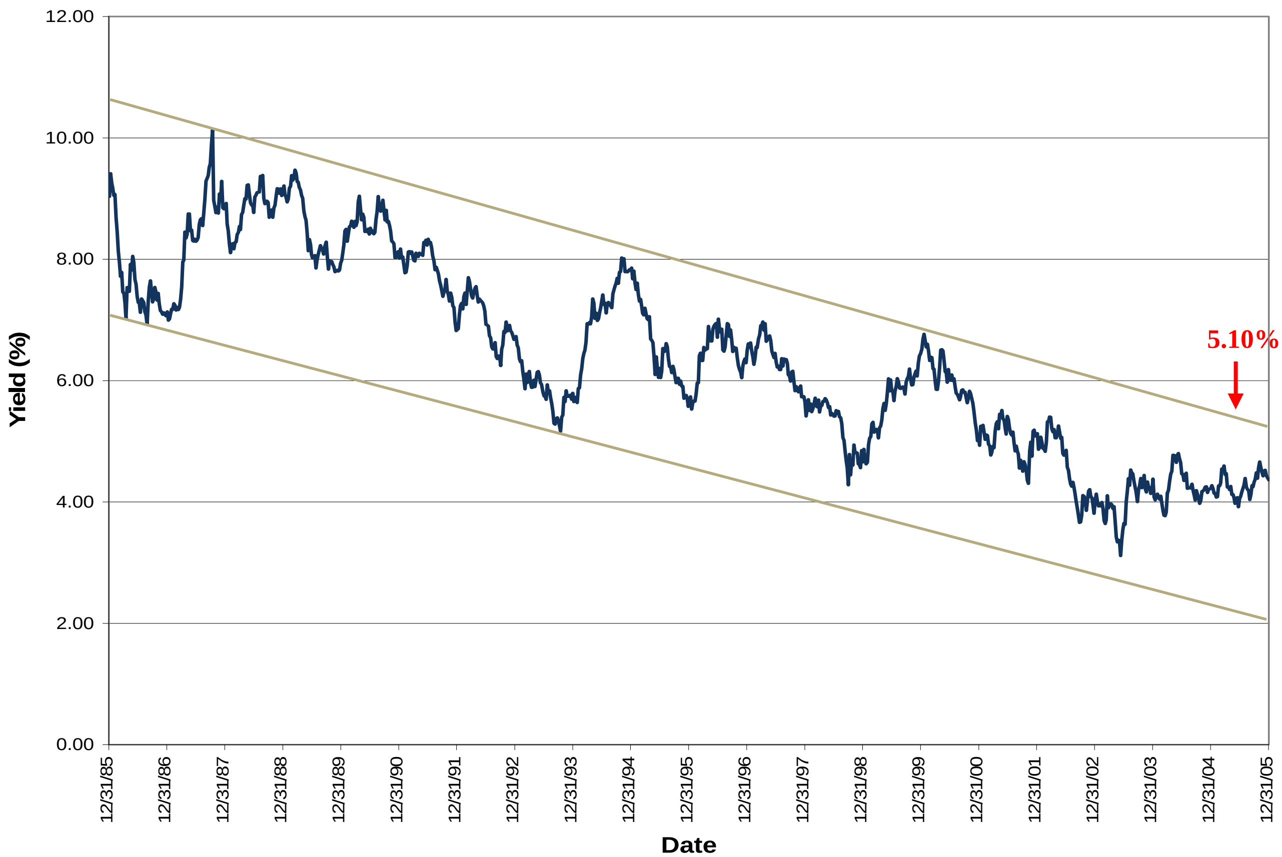
What are the implications for Fixed Income Investors?

First, starting with the yield side of the equation, you have probably already made the correct assumption that our base case is for lower short and long term interest rates. We believe that the last series of moves by the Fed will result in an "overshoot", whereby economic activity slows more rapidly then desired. This should designate the end of the Fed's tightening campaign and allow for longer-dated bonds to rally as investors declare a victory in the fight against long-term inflation and vigorous economic activity. Lastly, the second half of the year should mark the beginning of an easing process by the Federal Reserve as it becomes apparent that economic activity will slow markedly. As this unfolds, the bond market will anticipate a series of interest rate cuts by the Federal Reserve and spark a greater rally in shorter-dated bonds compared to longer-maturity securities.

It is our suspicion that many individuals and Portfolio Managers have allowed the average maturity of their portfolios to shorten. This is fairly typical and predictable as short-term rates are moving higher. With shorter maturities seemingly more attractive, the individual investor will gravitate toward these securities and miss the opportunity to lock-up the yields offered in longer maturity bonds. It is our belief that many of these investors will be disappointed as they fail to seize the opportunity to invest further out the yield curve. The forces that have held long term interest rates steady for the last year and a half should only be enhanced once the Fed declares victory on their perceived inflationary threat. This does not mean, however, that interest rates have to move in a straight line. There are often periods of significant volatility in the fixed income markets.

Please refer to chart 1 to gain a perspective on the path of 10-year Treasury Note yields for the past 20 years. As you will observe, the upper trend line (support) which defines the long-term yield range comes in at 5.10% for 2006. We strongly suspect that a spike to this level would cap any higher interest rate movements, should our preferred scenario take longer then expected to materialize. Of course, factors such as a US dollar collapse, stronger than expected inflation numbers, or other factors such as a "left field event" could also drive yields temporarily higher. If this were to occur, the spike to higher rates should only prove to be temporary (see strategies below). As we have witnessed on many occasions, there appears to be "self-breaking" mechanisms in place that prevents yields from rising outside of the indicated range. This economy is leveraged and very dependent on a low interest rate environment. Any interest rate shocks could cause a severe downturn in the overall economy and in particular, cause erosion in home prices, with similar price action in the equity markets.

10 Year Treasury Note Yield Channels: 12/31/85 – 12/27/05



Municipal Market Outlook and Strategy

Potential for Tax Reform: Here too we can be brief. At this point, the President does not have the political capital to successfully wage a tax-reform campaign. In fact, as the President outlined his agenda for 2006, conspicuously absent was the priority of tax reform. Just as an aside, one of the proposals that President Bush was examining dealt with eliminating the deductibility of state and local taxes. As you read the next excerpt, we believe it will become quite obvious why this piece of legislation would not have the support to be enacted.

State of the States:
There are several large issues looming which will take years to play out. State and Local Governments are facing the same issues that Corporate America is dealing with, namely unfunded pension obligations and rising health care costs. Government's like corporations have made promises on pension and health care that they ultimately will not be able to afford. With health care costs more expensive now than most forecasters predicted and people living longer, there are fewer workers funding more pension recipients. While these are not new developments, there are new accounting rules effective in 2007 that will force state and local governments to fess up to the size of their long-term obligations to pay for retiree's health care benefits. Until now health care benefits have been recorded on a pay-as-you go basis.

As this situation unfolds, there is the potential for debt obligations of State and Local Governments to be downgraded. However, the jury is still out on the path that will be taken to deal with these issues. Many governments will probably use a variety of tactics such as slashing benefits, raising taxes, initiating deep spending cuts, or floating bond issues to pay for the promised benefits. These are troubles that we have been monitoring for years and have responded to by concentrating on investing the majority of our assets in only the highest quality issues. Should credit quality spreads widen and we are more adequately compensated to invest in lower quality issues, we will seek to invest in essential service bonds. These are vital services which individuals deem to be necessary and are backed by the revenue stream of the entity.

For the year ahead, the technical position of the market should be in fairly decent shape. In 2006, estimates for new issue supply remain centered around a drop of 15% from the record levels exhibited by 2005. The reduced supply of new issuance coupled with lackluster equity and hedge fund returns, and 10-year yield that approaches 4%, should reinvigorate demand for tax-exempt assets. The Municipal market should also prove to be the "investment of choice" to relative value managers as the Municipal bond asset class remains relatively attractive when compared to taxable bonds.

Should the scenario outlined above take longer than we anticipate to materialize, please be mindful that our strategies for a rising interest rate environment seek to make the most of this difficult situation. We employ techniques which maintain a constant level of volatility, enhance tax-exempt cash flow, harvest capital losses, and strive to maximize the portfolio's capital appreciation for future declining interest rate environments.

For the reasons cited throughout the report, we believe that higher quality bonds will turn in a superior total rate of return in contrast to lower-rated securities. For example, as of November 30th the incremental yield that can be garnered by investing in "A"-rated bonds is only 22 basis points compared to "AAA"-rated bonds. We will only seek to shift a greater portion of our client's assets into "A"-rated securities when our clients are adequately compensated for the additional risk. Once it is apparent that the economy is slowing, and credit quality spreads widen, we may be afforded an opportunity to execute these transactions in the second half of 2006. It is most likely that this potential will be realized after the Federal Reserve concludes their monetary policy in the first half of the New Year.

Looking out over the next year, tax-exempt assets should continue to deliver higher after-tax total rates of return when compared to taxable investments. In particular, 10 to 15 year municipal bonds should be the best performers compared to the other maturity segments. Lastly, please see the chart below, showing 5 year historical total rates of return for various assets classes.

Asset Class Total Returns: 11/30/02 – 11/30/05