2007 Year in Review

As we close the books on 2007, it seems like the appropriate time to compare our forecasts with what actually happened. Perhaps more importantly, we will once again examine the themes that we believe will be the most dominant in the upcoming year.

In general, we feel as though the year unfolded as we outlined:

- There was no housing bottom in 2007; the bottom fell out.
- The residential real estate debacle did spill over to become a more general economic and financial problem.
- Slower economic activity and slower consumer spending did materialize during the year
- The Federal Reserve began to slash interest rates, not remain on hold as per the consensus view.
- Treasury note yields would work their way lower, rather than higher.
- The Fed's preferred inflation gauge: Core PCE Deflator (Personal Consumption Expenditure Core Price Index) moved back within the Fed's target range although we agree that the outsized headline inflation numbers warrant careful monitoring.
- While the recession we were looking for in 2007 has yet to unfold, growth has slowed markedly. Though it remains our preferred view for 2008, the jury has yet to decide whether the US economy will experience a recession that fits the "classic" description.

Looking Ahead to 2008

Many of the concepts and themes that we have been discussing in the past year should continue to be relevant over the next twelve months, and perhaps beyond.

Fed Up

Sharing our thoughts about Federal Reserve policy seems like a logical place to begin, but should financial market participants continue to hang on the Fed's every word? We think not! Time is an important commodity and can probably be put to better use than parsing statements made by the Federal Reserve Board Members. "Mainstream experts", on the other hand, believe that there is only one Captain who can maneuver the ship back into calmer waters. Investors and traders certainly seem to hold this view as prices jump when they detect a more "dovish" Fed policy. Even the mention of a "white feather" has sparked rallies since the Fed began to ease on September 18. This "irrational exuberance", however, seems misguided as the liquidity crisis and housing downturn continue unabated in spite of the reductions in short-term funding rates.

In fact, during this decade, interest rate policy decisions have seemingly become ineffective, or at least work with a longer lead time than they have historically. For example, during the two year period from December 2000 to 2002 the Federal Funds rate was slashed by 525 basis points, falling from 6.50% to 1.25%. These moves however, were not effective in preventing the tech bubble from bursting and the economic recession from resulting. Although the June 2004 to June 2006 period looked quite different, the results were eerily similar. Increasing rates from a half-century low of 1% to 5.25% proved an equally fruitless effort in removing the “froth” from the bubbling housing market before it burst.

All of this brings us back to what we said in our Q2 2007 Fixed Income Newsletter: “the Fed has either been incorrect or they have been consistently downplaying the looming crisis intentionally, perhaps to instill a sense of calm to the markets.” If we look at the health of the financial system and projected economic activity, we find that this particular type of financial stress is highly contagious and like none we have seen before. Therefore, we believe that the Federal Reserve could perhaps be administering inadequate amounts of antibiotics for this strain of flu. Interest rate cuts can have a profound impact on averting a classic recession but this environment is anything but text book. Therefore, we must keep an open mind to the possibility that the Fed may be left without any remedy for the challenges that lie ahead.

Compounding the problem are investors who appear more concerned about the return of their principal as opposed to the return on their principal. Likewise, financial institutions appear to be “shell shocked” and driven by the need to rebuild their capital base rather than the potential return by lending it out. Against this backdrop, we conclude that interest rate cuts by the Federal Reserve may not be potent enough to motivate creditors to lend, consumers to spend, and corporations to borrow.

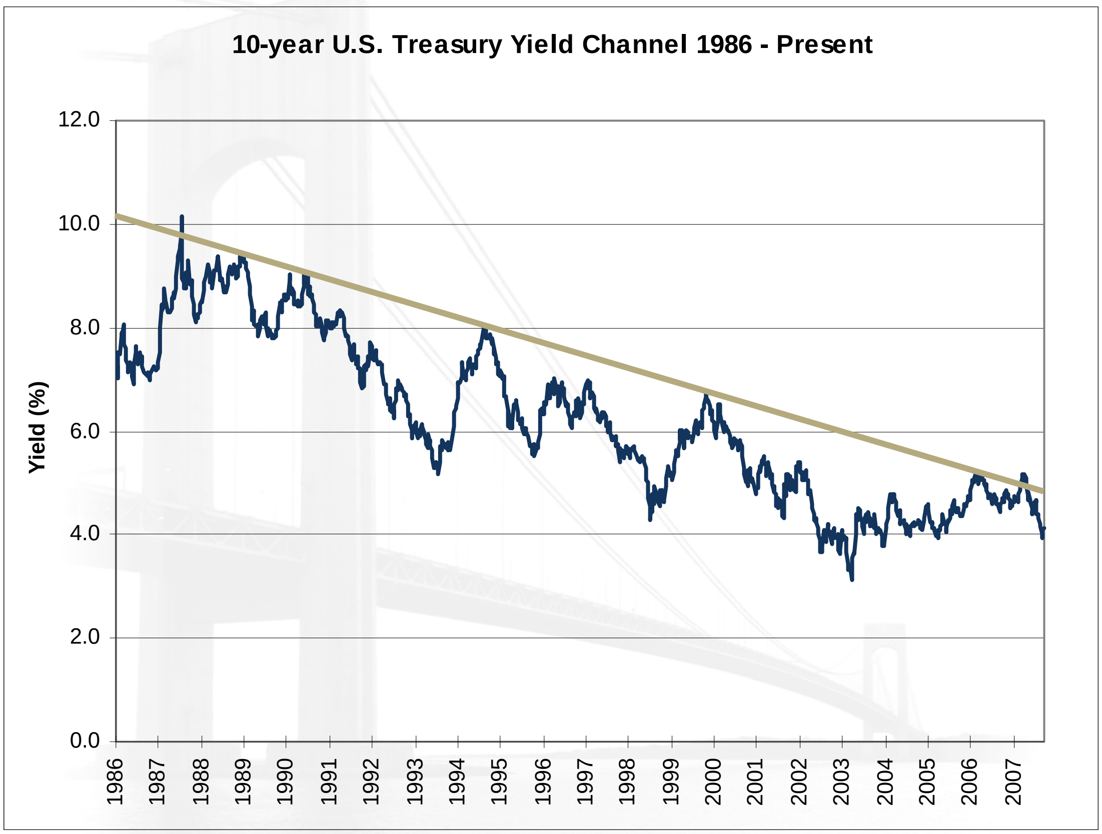
Is Time and Price the Only Cure?

The huge waves of liquidity that were formed to acquire assets are in the process of receding. The economic and financial environment over the last several months has been challenging, but may only serve to offer a taste of some events that could unfold in 2008. When a credit bubble of unprecedented proportions finally bursts, the impact should be far-reaching and could last for years, not months. This is not to say that we believe the “Western World” as we know it is ending; just that we could be in for a protracted and painful process of purging the excesses that have been generated over the last decade.

Recently market commentators and “experts” have stated, with respect to the liquidity crisis, that the worst may be behind us. Their opinions appear to have been strengthened as Citigroup recently announced their plans to bail out seven investment entities and carry $49 billion of securities on to their balance sheet. At RSW, we believe that these plans only serve to underscore the fundamental problem. The credit quality of the collateralized debt obligations (CDO’s) is continuing to erode and there doesn’t appear to be a functioning secondary market for holders to liquidate their positions. Furthermore, as banks and broker/dealers bring these securities on to their balance sheets, their forward earnings could be negatively impacted. Tying up capital with non-performing assets is a poor formula for financial institutions to enhance profitability. Therefore, these decisions appear to have been made out of necessity, not by choice.

As is the case with all markets, sometimes the only cure is time and price. Asset prices go from being “over-bought” to being “over-sold”. We are now in that part of the price discovery process where prices of securities, real estate, some commodities, etc. need to adjust downward to levels that will attract a new class of buyer or risk taker.

Interest Rates: Will the Bond Bulls Yield to the Bears?
Against the backdrop we talked about, we have concluded that interest rates for higher quality securities will continue to drift lower in 2008. Quite often however, the path that yields take during the year is anything but a straight line and thus we believe that the year ahead will be no different. With that said, should any cyclical increases in interest rates materialize during the year, they should be short-lived. Higher interest rates, if only for a brief period of time, should only serve to compound the problems of the already fragile U.S. financial system and economy. Said another way, we expect that Treasury market yields should continue their pattern of making lower highs and lower lows (see chart below).



Municipal Bond Perspective
As we near the end of 2007, we find that the tone of the municipal bond market is in a different place than it was a year ago. Aside from tracking the fluid environment described above, tax-exempt investors, issuers, and traders have been gripped by events surrounding the financial health of the municipal bond insurers, as well as the Supreme Court case of Davis v. the State of Kentucky.

With respect to the monoline financial guarantors we learned that they too have exposure to the credit market turmoil. Aside from insuring investment grade municipal bond obligations, financial guarantors have diversified their portfolio by putting their “AAA-rated stamp” on the higher quality tranches of collateralized debt obligations (CDO’s). As the losses mounted in this sector however, the business practices of the guarantors came under increased scrutiny as the amount of their exposure to collateralized debt obligations surfaced. This forced the yields of bonds carrying insurance higher, as the value of the insurance was heavily discounted.

Looking out into 2008 we expect the cloud to lift as the larger financial insurers take the necessary steps to "beef up" their balance sheets in order to entice the rating services to maintain their "AAA"-rated status. In fact, the uncertainty surrounding this issue is now beginning to break. As of this writing, MBIA, the world's largest bond insurer and AMBAC, the second biggest bond guarantor had the credit ratings affirmed as "AAA "by Moody's Investor Services. Financial Guaranty Insurance Corp (FGIC) on the other hand was placed on credit watch negative for possible downgrade.

Uncertain times can create opportunities
Should the financial guarantors be unable to fully recapitalize in the time frame outlined by the rating agencies, what does it mean? Does that imply deterioration in the credit worthiness of municipal obligations? Just because the value of the extra layer of protection is being questioned does not change several fundamental realities of the tax-exempt asset class.

As of this writing, 10-year tax-exempt bonds[1] are yielding 90.05% of Treasury securities versus the 3-year average of 84.31%. This means that an investor can earn an additional 25 basis points (0.25%). According to the rating agencies a municipal security carrying a "AA" rating is equivalent to a corporate with a "AAA" rating. Since 1970, instances of default in municipal securities have been rare. According to Moody's Investor Services, during the period 1970 – 2005 the cumulative default rate for all investment grade (a minimum Baa rating by Moody's) municipal obligations was 0.0651% or less than one-tenth of 1%.

Simply put: Long before there were financial guarantors, municipalities still issued bonds, investors clipped their coupons, and had their principal returned 99.935% of the time. This brings us back to one of the prime principals of investing: assessing risk to reward. Whether or not the insurers are downgraded to "AA'", the credit worthiness of the obligor has not changed. A "AA"–rated water and sewer bond will continue to be a "AA"-rated water and sewer bond because the municipality is independent of the bond insurer. To our way of thinking, the largest change that has occurred in the municipal industry over the past two decades is the growth of the municipal bond insurers. With their existence, the incremental yield that used to pass to the investor, instead flows to the guarantor as the issuer pays a premium. Said another way, the insurers are taking yield out of investors pockets and putting it into their own to insure against a default rate that can barely be seen with the naked eye.

The municipal bond market has also been grappling with the issue of whether or not it is unconstitutional for a state to tax the income earned on out of state municipal bonds. This case (Davis v. the State of Kentucky) is currently being heard in the Supreme Court. We have held the view that a coin flip is about the only way to handicap the outcome of such a prominent court case. However, the scale may be tipping in the favor of in-state bondholders. Comments from Chief Justice Roberts suggest that he would be in favor of the status quo and oppose any changes to the tax code. For example he stated: "This is an area where Congress can regulate if it wants to and it has never shown the slightest interest in interfering with state tax exemptions for their own bonds."

Like most “perfect storms” in the financial markets, risk is re-priced along with potential rewards which are ratcheted higher for those who can remain calm and apply a disciplined and methodical approach.

Robert S. Waas
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[1]Source Municipal Market Advisors (MMA) Consensus Yield Curve

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