

### 2008 Year in Review

It was a long decade this year indeed! As 2008 draws to a close, it is our tradition to take a look in the rear-view mirror and compare our prognostications for economic activity, bond yields, and the tax-exempt market with actual results. More importantly however, we will examine the themes that we believe will be the most dominant in the upcoming twelve months.

With respect to the economic environment in 2008, unfortunately it unfolded as expected:

- We anticipated that this strain of “financial stress is highly contagious” and wouldn’t be “contained”.
- “Fed-up”: Felt that Fed actions would follow the crisis rather than be in front of it.
- The market’s psychology shifted from no risk is too great, to any risk is too large.
- Liquidity trap: Thought that financial institutions would be more concerned about preserving and replenishing capital than the potential return of lending it out.
- Contrary to conventional wisdom, we felt that the threat of rising inflation was not a lasting concern. In mid-2007 we began to express concerns about the coming deflation.
- While consensus estimates called for the U.S. economy to escape a recession, our base case scenario was for a severe and protracted recession.
- Against this backdrop discussed above, we believed that 10-year U.S. Treasury interest rates would move lower.

Notwithstanding the above, we at RSW are humbled by our inaccurate forecast for 10-year tax-exempt yields. We believed that high-quality 10-year municipal bond yields would move in the same direction of Treasury bond market yields. In other words, tax-free yields would decline, not rise.

Where did we go wrong? We didn’t see several key events that caused municipal bond yield movements to decouple from the Treasury market, and become more closely correlated with corporate bond yields. Namely:

- Many of the monoline financial guarantors were stripped of their “AAA” credit rating, causing yields to spike higher as credit risk was reassessed by market participants based on the underlying credit quality of the issuer.
- Forced selling by leveraged investors overwhelmed the “buying power” of investors. These entities borrowed money by issuing short-term auction rate securities and used the proceeds to finance longer-maturity bonds. When the interest rates on these auction rate securities soared, leveraged investors were forced to sell their longer-maturity holdings
- Issuance of fixed rate bonds surged as issuers “called” their auction rate bond holdings and issued fixed rate debt
- Liquidity in the tax-exempt marketplace receded as the balance sheets of the broker / dealer community shrank due to massive write-downs of capital. This dramatically impaired their ability to “inventory” tax-free bonds.

- Market liquidity was further drained as Bear Stearns, Lehman, and UBS left the institutional municipal bond business.
- The bid/ask spread (the difference between the value of a bond and what someone is willing to pay) gapped wider. On many occasions the bid-to-ask spread was at least four points (4%).

### What We Believe To Be In Store For 2009

Rates will remain near zero for as long as needed as the Fed throws everything but the kitchen sink (that's next) to stop the economy from seizing-up. As we have witnessed, de-leveraging is a dangerous and ominous opponent. The Fed is not trying to slay this rival but instead they are trying to engineer an orderly dismantling of leveraged positions. Some may wonder if the Fed's policies have had any effect on the economy or health of the financial system. Our response: Could you imagine where we would be if Bernanke wasn't a student of the Depression?

As the Federal Reserve and Treasury battle the destructive effects of deflation an inevitable development should occur. The market may begin to worry more about the inflationary implications of worldwide hyper-stimulative monetary policy whether actual inflation results or not. Therefore, at some point in the interest rate cycle (perhaps late next year) we expect Treasury yields to begin to build in this possibility. Although it may be counter intuitive, all asset classes outside of U.S. Treasuries should welcome this development.

If we think about the world before Goldman and Morgan Stanley became banks you would understand our rational. As credit begins to flow, concerns about defaults recede, and as comparisons to the Great Depression fall out of fashion, it will become a world of anything but Treasuries. In order to quantify our thinking let's reference the municipal bond market and the following dynamics. Should the financial and economic outlook improve, a renewed appetite for risk could send 10-year Treasury rates back toward a range of 3 ½% to 4%. Normally, you would look at that development with trepidation, but the same circumstances that create higher Treasury rates would presumably diminish the markets overblown fear about the creditworthiness of "AA and AAA"-rated municipal bonds. Before this credit crisis it was unheard of for 10-year high quality tax-free bonds to trade at 100% of Treasury bonds. If we were merely to return to that historically attractive pricing, while Treasury rates rose toward 4% "AA and AAA" rated tax-exempt yields could fall by 25 to 50 basis points (1/4 to ½ %). If this seems implausible, what were the odds that 10-year Treasury bonds would approach 2%.

### Municipal Bond Perspective

Investors and managers alike need to adjust to the new reality which could be with us for the next twelve months. Namely, a marketplace that is less liquid than we have been accustomed to. At the heart of the issue here is the lack of participation from Wall Street firms which have traditionally carried sizeable inventories of Municipal bonds. With their own balance sheets impaired and in need of liquidity, they have curtailed most of their "at-risk" operations. This has caused municipal bond prices to move in "accordion" like fashion as prices tend to sag when the level of new-issuance is high, and rise when the level of new issue supply contracts. Accordingly, we have had to adjust our management style as we can only seek to implement portfolio changes during those periods where there was a normalized bid-to-



ask spread. In other words, although we have pre-determined buy and sell disciplines, knowing when not to implement a transaction can be as important as knowing when to proceed.

Looking ahead, we believe that the budgets of state and local governments will remain strained through much of next year. With that said, we expect actual payment defaults in the higher tier investment grade bonds to be limited, though downgrades may be abundant. While it is true that the headlines about state budget deficits will be painful, and the political horse trading to close the gap excruciating, states (except Vermont) must balance their budgets annually. Investors should soon become attuned to the fact that a budgetary crisis is not synonymous with an inability to pay principal and interest. While we have previously commented that aspects of our management style will be augmented, it is important to understand that our "core" philosophy will not deviate. We will not be lured by excess yield, but instead be most concerned with the financial strength of the issuer.

Sincerely,

Robert S. Waas  
Managing Member

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